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Introduction

This report presents the findings of TA 3150-PRC “A Study on Ways to Support Poverty Reduction Projects” in the People’s Republic of China (PRC). It outlines strategies for supporting rural poverty projects generally (Chapter 2), and particular interventions in microfinance (Chapter 3), voluntary rural mobility (Chapter 4), agroindustry (Chapter 5) and rural infrastructure development (Chapter 6). The strategies focus on how to use OCR resources for poverty reduction projects and draw on detailed research into the historical approaches and experience in PRC and internationally. The findings of the research are presented in appendices to this main report. The appendices are summarised at the beginning of each relevant Chapter and a summary of coverage is presented at the end of this section. The remainder of this summary is concerned with the recommendations of the study. The reader should refer to the main text for details and the main text and related appendices for justification.

The Context

The 8/7 programme initiated by the PRC government in 1994 to lift the remaining 80 million poor out of poverty in 7 years draws to a close in 2000. With the likely positive achievement of the 8/7 objectives it is an appropriate time to consider the future of poverty reduction programmes in PRC based on the lessons learned domestically and internationally and the emerging challenges.

Despite the exemplary success of the poverty reduction efforts in PRC, research into and analysis of the existing programmes (subsidised loans, food for work, and budgetary grants for poor areas) has highlighted opportunities for improvement. Specifically these are as follows.

- The poor county system for allocating poverty reduction funding, although effective in the past, is now outmoded in its present form because many poor live outside poor counties. It is recommended that the system is modified to ensure that all counties have access to a share of the resource based on a combination of the number of poor and a "means test" that assesses counties ability to provide funds themselves.

- The poverty line in PRC is income based and set at about US $ 0.66 per capita per day compared with the internally recognised poverty line of US $ 1 per day. The newer conceptions of poverty are wider than income and it is recommended that consideration is given to integrating targets that relate to quality of life indicators in the future strategy for poverty reduction. Additionally, as the numbers of very poor reduce, it is recommended that consideration be given to introducing a second poverty line of at least US $ 1 per day. It is estimated that some 106 million rural people in PRC still live in "relative" poverty by this definition.
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- There are many targeting issues associated with the present PRC programmes. For example, the income poverty line does not take account of rural, urban and regional differences; county-based targeting bypasses many of the poor; emergent urban poverty is not addressed within the framework; biases within the subsidised loan programme have resulted in the non-poor capturing many of the benefits; food for work funds have crowded out other budgetary allocations reducing their additionality; and local government discretion in the use of budgetary grants has meant limited use for poverty reduction. These targeting issues can only be addressed by fundamental changes in the approach to poverty reduction using the types of interventions advocated in this report.

- Present programmes are sustainable only as long as there are budgetary subventions. The subsidised loan programme is not only unsustainable at an interest rate of 3.00 percent per year and recovery rates of about 60 percent, but also creates false expectations about the future price of money, may result in resource misallocation, crowds out commercial funds and domestic savings and discourages experiments with sustainable means because these are unable to compete with the interest rate. The subsidised loan programme needs to be phased out and replaced with sustainable microfinance operations.

- As local governments have been required to become increasingly self-reliant, many are focused on growth and revenue issues rather than poverty reduction, and poverty reduction funds have been diverted to address these pressing needs. It is recommended that the new methods of funding advocated in this report (such as parallel funding and challenge funding) are applied in order to address this issue.

4 The nature of the poverty problem is also changing. Many of the remaining 42 million “very poor” live in remote mountainous regions where the provision of infrastructure is uneconomic and delivery of social services difficult. There are more than 120 million rural unemployed, and productivity gains in agriculture are increasingly difficult to achieve. Reform of state owned enterprise is swelling the ranks of the unemployed with layoffs expected to reach 25 million by 2000. Urban poverty is rising as a result and is estimated to affect 12 million people at the end of 1999. Inequality between urban and rural incomes is rising. While the report concludes that the solution to poverty in remote mountainous regions is the expansion of the resettlement programmes of the government, there are also many other pressing priorities: to ensure that those near the poverty line do not slip back below it and to proactively address the emerging urban poverty problem: “poverty avoidance”. Supporting the “working” and “near” poor should also form an important part of future strategy.

The Role of LGOP

5 PRC is unique in its bureaucratic infrastructure for poverty reduction reaching from national to township level through LGOP and PADOs. As the problem of the very poor is progressively solved, this infrastructure could be very usefully refocused on consolidating the gains, improving impact by addressing the constraints of existing programmes, and perhaps most importantly bringing to bear the international
experience and lessons learned about effective poverty reduction in the design of its own programmes and those of the official development agencies that support it.

6 Examples of the key roles that LGOP could play in the future include: redefinition of poverty and the income poverty line to address the shortcomings in the present definition; development of indicators for the wider definition of poverty and development of poverty measurement techniques that help to capture the status of poverty in relation to the wider definition; piloting of new funding mechanisms and sources that can supplement budgetary resources and may in due course justify the more rapid reduction in relative poverty through the greater and more efficient application of such resources; pilot and in due course roll out more sustainable designs for poverty reduction, particularly in the areas of rural finance and microfinance; the development and replication of the means for better targeting and impact of poverty reduction funding involving policy measures, organisational systems and sectoral guidelines for better project design; foster better governance at the provincial and sub-provincial levels in the use and management of poverty reduction funds from both government and other sources; and a role in the overall management of any new funding mechanisms adopted nationally. LGOP is also well placed to take on the role of managing poverty reduction in urban areas and would be able to bring to bear its long experience. ADB can assist LGOP with further technical assistance and training to support these new directions.

7 These roles can be integrated with ODA country assistance strategies for poverty reduction on an agency by agency basis, helping programmes to be government rather than donor driven, while specific design lessons from international experience1 can be incorporated into the government’s own projects.

8 With the end of the 8/7 Programme, LGOP has been defining its priorities for a new Poverty Reduction Programme (2001-2020). This is due for approval in December 2000 and will be implemented under four successive five-year plans. While still to be confirmed, the indications are that that programme will involve: adopting of a new rural poverty line focussing on the poorest 10 percent of the population; focussing the poverty reduction work in 22 poverty blocks in remote mountainous areas; reforming the microfinance component of the poverty reduction policy to directly target poor families rather than township and village enterprise where poor people work; broadening the participation of the private sector and NGOs in the poverty reduction activities; mainstreaming poverty reduction efforts in the Western part of PRC by focusing investment in the west and intensifying East-West poverty reduction cooperation and improving geographical equity; special poverty alleviation programmes for ethnic minorities including voluntary resettlement of absolute poor away from mountainous and other areas with little development potential; addressing emerging urban poverty caused by enterprise restructuring, and increasing migration; and reforming the social protection system (particularly pension and health insurance as well as labour market policies) to be more inclusive and target better the rural and urban poor. These priorities represent significant new thinking in LGOP’s approach and offer many opportunities for ADB participation.

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1 See paras 23 - 30 of appendix A5 “International Poverty Reduction Approaches and Experience”
Opportunities for Bank Participation

9 ADB’s comparative advantages go beyond the provision of OCR funding. It can engage the government in policy dialogue to assist with the development of more effective poverty reduction programmes, it can supplement budgetary allocations, it can “crowd in” and “leverage in” domestic and foreign resources from government, other donors and the private sector, and it can provide technical assistance. ADB’s projects can also be used as the arena for testing policy and implementation mechanisms, support more difficult policy changes such as the abolition of subsidised lending, and provide sufficient funding for roll-out that is beyond the resources of most other donors.

10 It is recommended that at a macro-level ADB should engage the Government in dialogue on the lessons learned from the aid effectiveness research and how to apply these in PRC. The most important of these is that where there is good governance, particularly local governance, poverty reduction funding is most effective. A provincial level focus in implementation will help to achieve this. It is also recommended that ADB encourage the use of the design characteristics of successful poverty reduction projects and promotes these. ADB’s evolving relationship with LGOP provides the best possible platform to affect this.

11 Specifically, in summary, the principles are that: poverty is recognised as complex and associated with natural, physical, financial, human and social capital access and development, is individually variable and is affected by externalities; the goals need to address policy, economic growth, income redistribution, gender equality, livelihood quality, facilitating access and the environment; ODA, government and NGOs approaches are all legitimate ingredients provided they are client based; sustainability, capacity building, environment, gender and subsidy reduction are the main design concerns; individual projects build on people’s strengths, target households, communities, implementing agencies and wider policy; a multisectoral approach should be accommodated; design is participatory, iterative and flexible in implementation; the long term nature of capacity building and social capital development is recognised in design; project interventions are made at the local level and may be small or involve many small components; local and national governance issues should be addressed; partnerships of all types should be encouraged (particularly between the public and private sector and with NGOs where appropriate); project management should be within the implementing organisations and not discrete; and monitoring and evaluation should be linked to learning now, not later.

12 With regard to multisectoral approaches there is the opportunity for policy dialogue about the SIF and CDF approaches where the framework is designed to apply all of these principles and the opportunity is present for combining funding resources either through blending or by applying different resources to different components. These approaches allow more than just pro-poor growth to be addressed because they cover all sectors. ADB need not necessarily fund all sectors with OCR resources, but can participate in design and TA across all sectors and in the syndication of the funding, itself a critical task.

13 There are also specific sectoral opportunities for policy dialogue. These include:
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• in microfinance: creating a supportive regulatory and legal environment for microfinance institutions, developing and enforcing a system of performance standards, consideration of alternatives for implementation such as second tier banks, credit ratings, self-regulation, and the development of prudential supervision and monitoring; the liberalisation of interest rates which is essential for self-sustaining institutions to emerge; the development of urban microfinance schemes; the participation of NGOs and other non-bank, non-state institutions in microfinance; focusing on the working and near poor, including the urban poor; and the adoption of the well proven principles of sustainable microfinance into government’s own poverty alleviation loan programmes;

• in agroindustry and rural enterprise development: improvements to the enabling environment for SME development; initiatives to improve the management of SMEs (TVEs) in order to assist them to become more market oriented, including how best to increase the numbers of viable SMEs, create new jobs in SMEs, develop their management capacity, foster co-operation with larger enterprises, and increase technology uptake; and acceleration of the process of SOE reform and the reduction in SOE budgetary funding to free-up greater resources for poverty reduction;

• in rural infrastructure: improving the impact of workfare programmes for the poor, and particularly on concerns about wage rates, labour intensity, participation on programmes and the use of “labour tax”; increased community participation in rural infrastructure projects to increase ownership and sustainability; increased private sector participation and financing and the means to achieve this; developing and applying research findings on poverty impact measurement to the national strategy, bearing in mind that many governments have accepted either on the basis of project evaluation methodologies or the aid effectiveness research that rural infrastructure development (even in social sectors) can have high returns that justify OCR funding, measurement and analysis in the PRC context being a step towards evaluating this for PRC;

• in voluntary rural mobility: developing clear policies on land titling and transferability in settlement areas; developing clear cost recovery policies and openness with settlers about future expectations for this; and developing and implementing guidelines that allay the reservations of the international community about minority rights.

Opportunities for OCR Funding

14 In general, the use of OCR funds needs to be justified by the return on the investment. In PRC the present perception is that financial returns should be high, relatively short-term and that full cost recovery with interest including any premium to cover market and foreign exchange risks should be achievable. It is for these latter reasons that hitherto OCR resources in PRC have been concentrated on infrastructure investments, such as expressways, where the financial returns to the “project” are highly tangible and can be adjusted to respond to market changes (for example variable interest rates, fluctuating foreign exchange rates and inflation) so that there is a reasonable degree of certainty that the above criteria for OCR use can
be satisfied. This said, official development agencies, notably the World Bank and other governments believe that there are opportunities to use OCR funds directly and indirectly for poverty reduction.

15 This report distinguishes between “direct funding” where OCR funds are used to finance poverty reduction projects or components of such projects; “indirect funding” where OCR funds are used for projects that foster economic growth with the growth in turn impacting on employment, income and other quality of life impacts for the poor; and “parallel funding” where OCR funds are used for economic growth but with conditionality that crowds in or leverages in “direct funding” for poverty reduction projects.

16 The specific OCR funding opportunities recommended for ADB in this report have been reviewed by FCPMC which believes:

- direct funding of development of multisectoral interventions at the provincial level along the lines of the social investment funds (SIFs) and comprehensive development frameworks (CDFs) of the World Bank being used in other countries where there is an opportunity to blend OCR resources with soft resources from other donors, government and private sector funding, but at a level where provincial priorities and poverty characteristics can be taken into account is possible now;

- direct funding of poverty components of economic growth projects and projects targeted at the working and near poor, again using blended resources where appropriate and where as a matter of policy it is recommend that ADB fosters the crowding in of domestic resources to poverty projects as it has done for the Shanxi Roads Project, with the caveat that the additionality (and thus the origin) of crowded in local budgetary funds is clear is possible now;

- direct funding of microfinance organisations (MFOs), where donor participation can provide a fresh window to re-establish credit discipline and ensure better targeting of resources at the poor is possible now on a pilot basis. ADB can take a lead in piloting new initiatives on a sustainable scale, including funding across all productive sectors, urban and rural – for agricultural producers, SMEs and artisans, community infrastructure, and under some circumstances, migrant workers or voluntary resettlers;

- direct funding of microfinance at a national level through the establishment and participation in an apex microfinance fund (MFF) that in turn would establish and expand a mutually supportive membership of organisations, and provide wholesale finance and other support services to develop self-sustaining microfinance organisations is possible in the foreseeable future.

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2 In this report “parallel funding” means instances where ADB will provide OCR loans to, say, a provincial government to fund an investment that is already in the provincial government’s budget. The investment is not a poverty reduction investment but an economic growth one that will withstand OCR rates. The ADB funding substitutes for the domestic resources of the provincial government, and the government in turn invests all or an agreed part of the domestic funds freed-up in poverty reduction. ADB assists with aspects of the poverty reduction project through TA and training and monitors the agreed poverty reduction investment to ensure compliance with agreement.

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Executive Summary

Such an initiative would probably need to follow: pilot outlays in order to demonstrate the full potential of microfinance, and the creation of a suitable enabling environment for microfinance institutions;

- indirect funding through agreements with rich coastal provinces to finance economic infrastructure and other public goods linked to conditionality on the establishment or strengthening of “dragonhead” relationships with poorer inland provinces is possible now as a complementary mechanism to the existing “East-West Co-operation Programme”;

- indirect funding through commercial bank credit lines to the Agricultural Bank of China and other commercial banks, but with greater emphasis on funding “dragonhead” relationships at the enterprise level, the justification for this essentially private sector funding being that of assisting market entry through the provision of long term capital, is possible now;

- indirect funding through SME-type credit lines as a countermeasure to rising rural and urban unemployment and as a poverty avoidance strategy, again the private sector nature of the support being justified by the relatively underdeveloped nature of SMEs and the difficulties they face in accessing resources, is possible in the foreseeable future if there are intermediaries involved;

- indirect funding for the provision of credit guarantees for reforming and privatising state owned enterprises linked to the freeing-up of budgetary resources from SOEs and into poverty reduction may not be possible in the foreseeable future;

- parallel funding of public goods at the provincial level, linked to the use of matching funds at a provincial level for poverty reduction, but with proactive involvement of ADB in the poverty reduction components and a focus on multisectoral poverty reduction programmes rather than a poverty-related component of a larger project is possible later;

- parallel funding of public goods in the same way, but through a national level challenge funding mechanism that would foster competition for resources through good governance and would subsequently promote and roll out successful programmes and projects is possible later.

17 There are demonstrable examples of OCR funding for all of the direct and indirect mechanisms above, some in PRC and some in other countries. There are also significant potential roles for LGOP to take on in the management of new initiatives, particularly if national level microfinance or challenge funds were established.

Summary of Opportunity

18 There are opportunities for ADB to provide technical assistance and training in conjunction with all of these initiatives. The opportunities are summarised in the table below.
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<th>Agroindustry and Rural Development</th>
<th>Rural Infrastructure</th>
<th>Multisectoral</th>
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<td>Microfinance institution regulation</td>
<td>Rationale for voluntary rural mobility</td>
<td>Improving the enabling environment for SMEs</td>
<td>Private sector participation and regulatory reform</td>
<td>Application of SIF and CDF approaches</td>
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<td>Liberalisation of interest rates</td>
<td>Settler selection, land acquisition and tenure, and resource adequacy</td>
<td>Development of support services for SMEs</td>
<td>Community participation</td>
<td>Combining and blending funding resources</td>
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<td>Intermediaries for delivery</td>
<td>Transparency of conditions</td>
<td>SOE reform</td>
<td>Workfare programmes benefits for the poor</td>
<td>Increased civil society and NGO participation</td>
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<td>Focusing on the working and near poor</td>
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<td>Measuring poverty impact and programme effectiveness</td>
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<td>Learning from best practice</td>
<td>Best practice guidelines</td>
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<td>Settler microfinance</td>
<td>Producer microfinance</td>
<td>Community Microfinance</td>
<td>All types of microfinance</td>
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| Indirect Lending | | | | | |
|------------------| | | | | |
|                  | Components of Projects (including SIFs/CDFs)| | | | |
|                  | Dragon head Commercial bank lending to provinces and enterprises | | | | |
|                  | SME credit lines and microfinance | | | | |
|                  | Credit guarantees for reforming SOEs | | | | |

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Policy Dialogue Development

19 It will be useful to have an agenda, participation list, timetable and mechanism matrix for the policy dialogue that can also form part of the ADB’s Partnership Agreement on poverty with the PRC government. The following tables set out the proposed matrix. The timeline is based on FCPMC’s views of what is possible now.

**Poverty Policy**

<table>
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<td>Early to mid 2001</td>
<td>Series of ADB financed provincial level workshops; Continuous dialogue with LGOP</td>
</tr>
<tr>
<td></td>
<td>The poverty line</td>
<td>LGOP; SSB; Provincial governments; PRC researchers; Other donors</td>
<td>Early to mid 2001</td>
<td>Series of ADB financed provincial level workshops; Continuous dialogue with LGOP</td>
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<td></td>
<td>Phasing out of the subsidised loan programme</td>
<td>LGOP; PBC; ABC; PRC researchers; Other donors</td>
<td>Early to mid 2001</td>
<td>UNDP Microfinance Roundtable Meetings; Continuous direct dialogue with LGOP, ABC and PBC</td>
</tr>
<tr>
<td></td>
<td>Initiating SIF, CDF and parallel funding approaches</td>
<td>LGOP; Ministry of Finance; Selected Provincial governments; Line ministry representatives; Partner donors</td>
<td>Early to mid 2001</td>
<td>Series of ADB financed provincial level workshops; Continuous direct dialogue with LGOP and one or two selected pilot provinces</td>
</tr>
<tr>
<td></td>
<td>Initiating the Challenge and Replicator Fund mechanisms</td>
<td>LGOP; Ministry of Finance; Partner donors;</td>
<td>Mid to end 2002</td>
<td>Initial discussions on principles with a view to inclusion in the 2003 or 2004 programme</td>
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**Multisectoral Approaches**

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<tr>
<td>Multisectoral</td>
<td>Application of SIF and CDF approaches</td>
<td>LGOP; MoF; PBC; SSB; Provincial governments; PRC researchers; Other donors</td>
<td>Mid 2001</td>
<td>Series of ADB financed workshops and continuous dialogue with others</td>
</tr>
<tr>
<td>Approaches</td>
<td>Combing and blending funding resources</td>
<td>LGOP; MoF; PBC; SSB; Provincial governments; Other donors</td>
<td>Late 2001</td>
<td>Dialogue with LGOP and others on specific opportunities</td>
</tr>
<tr>
<td></td>
<td>Increased civil society and NGO participation</td>
<td>LGOP; MoF; PBC; ABC; PRC researchers; Other donors</td>
<td>Mid 2001</td>
<td>Series of ADB financed workshops and continuous dialogue with others</td>
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**Microfinance**

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<tr>
<td><strong>Microfinance</strong></td>
<td>Creation of the legal and regulatory framework</td>
<td>PBC; LGOP; PRC researchers; Partner donors</td>
<td>Early 2001 on-going to conclusion possibly over several years</td>
<td>Regular dialogue with PBC System Reformers; UNDP Microfinance Roundtable</td>
</tr>
<tr>
<td></td>
<td>Interest rate deregulation</td>
<td>PBC LGOP PRC researchers Partner donors</td>
<td>End 2000 on-going</td>
<td>Regular dialogue with PBC System Reformers; UNDP Microfinance Roundtable</td>
</tr>
<tr>
<td></td>
<td>Development of MFO and MFF concepts</td>
<td>PBC; ABC (Head Office and selected provincial branches; Selected RCCs; LGOP; Partner donors</td>
<td>Mid 2001 for MFOs and 2002 for MFF</td>
<td>Regular dialogue with ABC and RCCs UNDP Microfinance Roundtable</td>
</tr>
<tr>
<td></td>
<td>Adoption of microfinance best practice</td>
<td>PBC; ABC (Head Office and selected provincial branches; Selected RCCs; LGOP</td>
<td>Mid to end 2001</td>
<td>Regular dialogue with ABC and RCCs UNDP Microfinance Roundtable</td>
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### Voluntary Rural Mobility

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<tr>
<td><strong>Voluntary Rural Mobility</strong></td>
<td>The rationale</td>
<td>LGOP; Western China Human Resources Development Centre; Governments of Gansu, Guangdong, Guangxi, Hubei, Jilin, Ningxia, Shaanxi, Shanxi</td>
<td>End 2001</td>
<td>Regular dialogue with LGOP; Possible LGOP presentation in Manila to ADB staff</td>
</tr>
<tr>
<td></td>
<td>Land acquisition and tenure</td>
<td>LGOP; Western China Human Resources Development Centre; Governments of Gansu, Guangdong, Guangxi, Hubei, Jilin, Ningxia, Shaanxi, Shanxi</td>
<td>End 2001 on-going possibly over several years</td>
<td>Regular dialogue with LGOP</td>
</tr>
<tr>
<td></td>
<td>Household registration</td>
<td>LGOP Western China Human Resources Development Centre; Governments of Gansu, Guangdong, Guangxi, Hubei, Jilin, Ningxia, Shaanxi, Shanxi</td>
<td>End 2001 on-going possibly over several years</td>
<td>Regular dialogue with LGOP; Regular provincial visits</td>
</tr>
</tbody>
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### Section Overview

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<tbody>
<tr>
<td><strong>Adoption of best practice guidelines</strong></td>
<td>Adoption of practices guidelines</td>
<td>LGOP; Western China Human Resources Development Centre; Governments of Gansu, Guangdong, Guangxi, Hubei, Jilin, Ningxia, Shaanxi, Shanxi</td>
<td>Early 2001 on-going possibly over several years</td>
<td>Regular dialogue with LGOP; Regular provincial visits</td>
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### Agroindustry

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<tr>
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<th>Timeline</th>
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<tbody>
<tr>
<td><strong>Participation in east west cooperation</strong></td>
<td>Participation in east west cooperation</td>
<td>LGOP; Provincial governments</td>
<td>Late 2001</td>
<td>Roundtable discussions</td>
</tr>
<tr>
<td><strong>Improving the enabling environment for SMEs</strong></td>
<td>Improving the enabling environment for SMEs</td>
<td>LGOP; TVE Bureau; Ministry of Agriculture</td>
<td>Late 2001</td>
<td>Roundtable discussions</td>
</tr>
<tr>
<td><strong>Creation of SME support services</strong></td>
<td>Creation of SME support services</td>
<td>LGOP; Chinese Service Centre for Poverty Alleviation; TVE Bureau; Ministry of Agriculture; Selected provincial governments; ABC Head office and selected provincial branches</td>
<td>Late 2001</td>
<td>Roundtable discussions; Provincial tour</td>
</tr>
<tr>
<td><strong>Support for SOE reform</strong></td>
<td>Support for SOE reform</td>
<td>State Economic and Trade Commission (STEC)</td>
<td>2003</td>
<td>Direct dialogue to explore opportunity for ADB following experience current government pilot project</td>
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</table>

### Rural Infrastructure

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<th>Timeline</th>
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<tbody>
<tr>
<td><strong>Private sector participation and regulatory reform</strong></td>
<td>Private sector participation and regulatory reform</td>
<td>LGOP; SDPC</td>
<td>Mid 2001 to conclusion</td>
<td>Roundtable discussions</td>
</tr>
<tr>
<td><strong>Workfare programmes benefits for the poor</strong></td>
<td>Workfare programmes benefits for the poor</td>
<td>LGOP; SDPC</td>
<td>Mid 2001 to conclusion</td>
<td>Roundtable discussions</td>
</tr>
<tr>
<td><strong>Community participation in infrastructure projects</strong></td>
<td>Community participation in infrastructure projects</td>
<td>LGOP; SDPC</td>
<td>Mid 2001 to conclusion</td>
<td>Roundtable discussions</td>
</tr>
<tr>
<td><strong>Poverty impact measurements</strong></td>
<td>Poverty impact measurements</td>
<td>LGOP; SDPC; Selected provincial governments in central and western PRC</td>
<td>From end 2000 on production of first pilot project results through 2005 on subsequent findings</td>
<td>Roundtable discussions</td>
</tr>
</tbody>
</table>
Sector Recommendations

Microfinance

OCR Funding

20 It is proven internationally that OCR type funds blended with other resources can be utilised successfully for microfinance. It is recommended that OCR funding is applied in the following order of priority because of ease of implementation:

- pilot schemes for the rural enterprise, producer, community and settler microfinance as components in other projects testing the MFO modality; and
- wider implementation, initially in one or two provinces using a combination of the MFO and the MFF modalities.

21 Components of SIF, CDF, and parallel-funded type projects should follow as soon as these mechanisms are developed by the government and ADB using the same modalities.

TA Funding

22 TA funding contributions will be required from ADB for the design of any of the proposed interventions with OCR funds into components of projects (including SIFs and CDFs) and microfinance. The contributions would be applied under ADB's normal procedures for project preparation technical assistance (PPTA). Implementation will require advisory and operational technical assistance (AOTA) for development of the legislative and regulatory environment and capacity building for MFO establishment.

Voluntary Rural Mobility

OCR Funding

23 Certain types of infrastructure and microfinance provision can withstand OCR rates but special intervention is required because of scarcity of capital (particularly long-term capital). It is recommended (subject to satisfactory policy dialogue outcomes) that OCR funding is applied in the following order of priority because of ease of implementation:

- major infrastructure developments within resettlement projects including roads, irrigation and utilities where there are full cost recovery opportunities;
- microfinance for settlers, testing the Microfinance Organisation (MFO) modality (and later the Microfinance Fund modality).

TA Funding

24 TA funding contributions will be required from ADB for the design of any of the proposed interventions with OCR funds into components of projects (including SIFs and CDFs) and microfinance. The contributions would be applied under ADB’s normal procedures for project preparation technical assistance (PPTA).
Implementation will require advisory and operational technical assistance (AOTA) for the implementation of microfinance and possibly to assist settlement authorities with international best practice guideline implementation.

**Agroindustry and Rural Enterprise Development**

**OCR Funding**

25 Commercial enterprise can by definition withstand OCR rates but special intervention is required because of scarcity of capital (particularly long-term capital). It is recommended that OCR funding is applied in the following order of priority because of ease of implementation:

- credit line facilities for "dragonhead" industries with ABC as the partner of choice, effectively extending the existing relationship with ABC under conditions that relate more closely to poverty reduction;
- credit line facilities for SMEs with selected branches of ABC and RCCs as partners in co-operation with local government and the private sector for the development of SME support services;
- individual loans, equity participation and guarantee arrangements directly from ADB to private sector agroindustry in the context of other rural development or poverty reduction projects preferably through a facility designed for the purpose rather than on a case by case basis along the lines of the IFC Reach programme (to service sectoral and multisectoral projects of both ADB and other donors) and including the capacity to provide sufficient working capital to enterprise to fund outgrowers through credit in kind or microfinance;
- credit guarantees for reforming SOEs or their divested components.

26 Components of SIF, CDF, and parallel-funded type projects should follow as soon as these mechanisms are developed by the government and ADB using the same design criteria as credit lines. Microfinance interventions (other than working capital components of enterprise loans) should conform to the overall strategy for microfinance development.

**TA Funding**

27 TA funding contributions will be required from ADB for the design of any of the proposed interventions with OCR funds into components of projects (including SIFs and CDFs), credit lines, guarantee funds and microfinance. The contributions would be applied under ADB's normal procedures for project preparation technical assistance (PPTA). Implementation will require advisory and operational technical assistance (AOTA) for different aspects of capacity building in lenders and borrowers.
Rural Infrastructure

OCR Funding

28 Accepting that certain types of infrastructure and microfinance provision can withstand OCR rates and that special intervention is required because of scarcity of capital (particularly long-term capital) it is recommended OCR funding is applied in the following order of priority because of ease of implementation:

- major infrastructure developments as components of projects that include small-scale rural infrastructure (irrigation and utilities where there are full cost recovery opportunities);
- microfinance for small-scale community infrastructure as components in projects, testing the Microfinance Organisation (MFO) modality (and later the Microfinance Fund modality).

TA Funding

29 TA funding contributions will be required from ADB for the design of any of the proposed interventions with OCR funds into components of projects (including SIFs and CDFs) and microfinance. The contributions would be applied under ADB’s normal procedures for project preparation technical assistance (PPTA). Implementation will require advisory and operational technical assistance (AOTA) for the implementation of microfinance and possibly to assist local authorities with aspects of participatory methods, project appraisal, improving cost recovery and the measurement of infrastructure impact on poverty.

Improving ADB’s Marketability

30 Based on the above analysis there are considerable opportunities for ADB to participate in poverty reduction in PRC. However, there are several actions that ADB can and should take to improve its marketability given the already strong presence of the World Bank in this market place. Specifically, it is recommended that:

- ADB review the possibility of raising resources domestically in PRC, which would render it the advantage of being able to offer long-term resources without foreign exchange risk and make it most competitive with alternative sources of domestic finance where loan term remains an issue.
- ADB review its policy to consider the possibility of giving more flexible repayment terms for poverty projects, for instance low start repayments where the benefits of investments (particularly in social sectors) may be in the long-term;
• ADB reviews the possibilities for new products for fixed spread lending and hedging with a view to putting in place such products⁵;

• ADB considers establishing strategic alliances with other ODAs (particularly those with soft funding available) during the formulation of its poverty reduction strategy agreements with governments on a country by country basis, including PRC⁴;

• ADB revisits its poverty strategy to ensure that mechanisms such as parallel funding are articulated and form an integral part of the strategy, and that the strategy explicitly recognises that ADB’s operations may be equally effective if directed at the working and near poor rather than the absolute poor in the instances where there is good governance;

• ADB reviews its modus operandi for poverty projects and gives consideration to the establishment of a multisectoral task force or improved means to carry out multisectoral projects that will allow it to be effective in SIF and CDF type interventions.

Next Steps

31 It would be advantageous for ADB to package these features together for a special poverty reduction initiative in PRC (and possibly other major borrowers with reservations about OCR lending such as India) ahead of the wider institutional reform that would be necessary to operationalise such changes throughout ADB. The relevant Programmes Department and the Poverty Unit could jointly spearhead such an initiative.

32 It is clear from the foregoing analysis in this Chapter and the more detailed findings on the four sectors chosen that are summarised in the following four Chapters and supported with the academic and case study evidence from PRC and around the world in the supporting appendices, that OCR interest rates can be disabused as a constraint on borrowing ADB funds for poverty reduction projects. While there are limits on the use of those funds, and FCPMC has reached clear conclusions about what is possible now and what is possible later, there is an immediate and wide range of opportunity. Although there are many areas of policy dialogue to be covered, policy change is not a prerequisite for all interventions, and policy change on a pilot basis would be acceptable for all.

³ While it is recognised that variable rates generally create uncertainty for borrowers, ADB itself needs to charge in relation to its costs of borrowing. This is transparent under the single currency LIBOR based system. Although there is volatility in LIBOR and in the foreign exchange rate this is easier to hedge under the single currency LIBOR system that it is under ADB’s pooling system where it is difficult for borrowers to measure the foreign exchange impact. Governments also are generally in the LIBOR market for other borrowings, and should be better equipped to manage the risk here than with the pool based system. Where they are not, ADB can consider providing technical assistance to enhance this capacity.

⁴ There are significant advantages for other smaller donors in teaming up with ADB because they have the opportunity to see their lesser resources go further and greater prospects for roll-out and sustainability of their projects. The most important factor in co-financing is that the partners work together on the project from the outset through conception and design so a shared vision of the project is built. IFAD is probably the most experienced co-financing organisation because it does not implement it own projects. ADB could apply the IFAD methodology to the partnerships.
A sensible approach is to pilot a variety of the recommendations as a lead in to selecting and expanding ADB-financed poverty reduction programmes in PRC in the future. For example, such a “Poverty Reduction Pilot Project” could:

- initiate a SIF/CDF type programme in one province or autonomous region,
- support a series of MFOs in a second,
- undertake some direct lending to “dragonhead” enterprises, and
- provide a further agroindustrial credit line to ABC.

Where appropriate these can focus on the 22 poverty blocks that LGOP envisages will be at the centre of their new Poverty Reduction Programme.

Initiatives on funding poverty components of other projects would continue independently. Provincial level piloting has been a common means of introducing new approaches in PRC in the past and such a project would provide a good foundation for roll out of successful components in the future and this is the recommended approach for operationalisation of the components of the strategy that are possible now.

The ADB Poverty Partnership Agreement with PRC which is due to be completed by the end of March 2001 should take account of these priorities together with others emerging from its on-going poverty analysis process which includes this and other TAs, preparation of a comprehensive poverty profile, and consultations with NGOs and others.

Research Paper Appendices Coverage

International Poverty Reduction Approaches and Experience (A5)

In its introductory section this paper reviews the evolving conception of poverty over three decades, the current goals in poverty reduction and the outlook for their achievement. It goes on to review the evolution of donor approaches to poverty reduction and summarises the trends and important aspects of current thinking about the successful design of poverty reduction interventions and the potential lessons for the PRC. In the subsequent section on a case study basis it examines the approaches of various governments in Asia and Latin America to poverty reduction and highlights aspects of other government’s programmes that may be of interest to PRC policy makers. The evolution of NGO and private sector approaches is then considered with emphasis on the complimentary of their approaches with those of government and donors and a focus on partnership. Selected examples of aid effectiveness research are reviewed leading to generalised conclusions about success factors in poverty reduction based on academic and official development agency research. A final section summarises the lessons from an international perspective to serve as principles for consideration in future poverty reduction programme design in PRC.

PRC Poverty Reduction Approaches and Experience (A6)
In its introductory section this paper outlines the characteristics of the three distinct phases in approaches to poverty reduction in PRC from its establishment in 1949, and summarises social and economic development indicators from 1978, the beginning of reforms. It then considers in detail the definition of poverty in PRC using the poor county methodology and reviews the issues associated with this approach. It reviews the definition of individual poverty and the various official poverty lines and the issues with these. This is followed by an examination of the trends in rural and urban poverty, and the distribution of various dimensions of poverty including geographic location, gender, minority nationality and quality of life measures. The government role in supporting poverty reduction is then reviewed followed by illustrations of NGO and private sector interventions. A detailed review and assessment of the PRC poverty reduction strategy from 1986 examines the three components of the strategy: the subsidised loan programme, the food for work programme and the development funds (fazhan zilin) programme identifying the issues with each of the programmes and assessing their effectiveness in poverty reduction. More recent innovations are outlined, and conclusions about the future of government-supported programmes and the priorities for poverty reduction in PRC are presented.

International Rural and Microfinance Approaches and Experience (A7)

This paper defines poverty and poverty reduction and provides a rationale for the objectives of efficiency and sustainability in poverty reduction programmes. Definitions of microfinance are then discussed and the conceptual link between microfinance and microenterprises is established. The main features of microfinance programmes and aspects of programme outreach are reviewed. A brief history of microfinance is provided, including a review of informal finance and directed poverty lending. An overview of economic conditions in Latin America and Asia is provided and then a review of international experience in microfinance focusing on these two regions is undertaken by type of microfinance organisation. The types examined include government owned banks, specialised microfinance banks, commercial banks, non-governmental organisations (NGOs), non-banking financial intermediaries, credit unions and co-operatives, village banks and stand-alone government and donor microfinance programmes. Case studies are provided to illustrate points of best practice for microfinance that will effectively reduce poverty and lessons are drawn for consideration in the PRC context.

PRC Rural and Microfinance Approaches and Experience (A8)

The introductory section of this paper provides an overview of the rural financial system in PRC covering the formal and informal sectors including the microfinance sector. It then reviews the evolution and current situation of each of the major rural financial institutions in the formal sector: the Agricultural Bank of China (ABC), the Agricultural Development Bank of China (ADBC), Rural Credit Co-operative (RCCs); and the informal sector including Rural Credit Foundations (RCFs), various kind of ‘Hui’s (Rotational Savings and Credit Associations or ROSCAs), farmers’ mutual lending and the different microfinance schemes sponsored by NGOs, government, the formal financial sector and donors. The paper considers the historical context of each type of organisation, its outreach and client base, and interest rate and financial management issues as a basis for examining the effectiveness and demonstrating the issues facing the rural financial sector and
policy makers in the context of poverty reduction. It then analyses the policy needs and the alternative strategies for the development of sustainable microfinance.

**International Voluntary Rural Mobility Approaches and Experience (A9)**

41 This paper discusses motivations and objectives of international resettlement programmes, noting that the purposes of the programmes have lasting impacts on the outcome of the programmes. It then examines the organisational characteristics of resettlement, followed by an assessment of the effectiveness of these programmes and factors determining their performance. Since resettlements are a costly investment, all governments have sought to contain costs and recoup at least part of the costs, it then examines cost reduction and cost recovery practices. In conclusion, it considers some of the guidelines that should be followed in voluntary resettlement programmes as useful lessons for the PRC policy makers.

**Voluntary Rural Mobility Approaches and Experience in PRC (A10)**

42 The paper identifies the types of resettlement in PRC that have taken place and provides the historical background to voluntary rural resettlement. It reviews the necessity for resettlement of the poorest from remote mountainous areas and compares this with other alternatives for poverty reduction. It concludes that resettlement is the preferred though last resort option in many remaining areas of PRC. It identifies land availability for resettlement and the barriers to its spontaneous occurrence and concluded that government involvement is necessary for resettlement to take place. It describes the institutional structure for managing voluntary resettlement and the settlement process. It summarises the economic, poverty reduction, cultural and ecological effects from the limited available evidence and shows that this can be positive. It reviews the sources of funds for resettlement, their uses and notes that cost recovery is not yet prevalent in voluntary resettlement schemes. It concludes by identifying problem areas to be addressed through improvements in voluntary resettlement policies and guidelines.

**International Agroindustry and Rural Enterprise Development Approaches and Experience (A11)**

43 This paper sets out the key issues related to agroindustrial and rural enterprise development in the context of their relationship with poverty reduction. It draws the distinction between enterprise viability that is a prerequisite for poverty reduction and poverty reduction potential that is not a prerequisite for enterprise viability. It discusses the general conditions for viability with special reference to those conditions that most affect agroindustry in poor and often remote areas such as the areas with remaining pockets of poverty in the PRC. It discusses the key considerations in procurement, processing, marketing and environment that are of concern to any enterprise in attaining viability. The paper goes on to review the international experience on linkages between poor farmers and agroindustry. It considers enterprise driven linkages that are essential vertical linkages between the producer and the marketplace organised by the processing enterprise (such as "dragonhead" enterprises in PRC) and farmer driven linkages that are essentially horizontal linkages between farmers (such as co-operatives and co-operative type organisations). The analysis is then broadened to consider the role of rural enterprise generally and the predominance of SMEs in this sector. This compares to the predominance of TVEs and emergent private sector businesses in the rural
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industrialisation process in PRC. It considers the generic constraints that are faced by SMEs in developing and transitional economies and the initiatives that can assist their development: creating efficient and unbiased financial markets, a good business operating environment, appropriate education training and capacity building facilities and access to information; and identifies the lessons learned internationally about successfully fostering SME development (of which agroindustry is a special case). It concludes with a summary of the effectiveness of agroindustry in poverty reduction and the lessons PRC policy makers can usefully consider the lessons from international experience.

PRC Agroindustry and Rural Enterprise Development Approaches and Experience (A12)

The introductory section of this paper reviews the historical context and recent trends in employment by type of enterprise in PRC and the key issues in assessing the potential for impact of agroindustry and rural enterprise development on poverty reduction. It draws a distinction between viable enterprise that is a prerequisite for successful poverty reduction impact, and effective poverty reduction linkages to poor farmers that are not a prerequisite for viable enterprise. The issues of viable enterprise and effective poverty reduction are then addressed in turn. The paper first considers the trends in rural enterprise development in terms of the declining state-owned enterprise (SOE) sector and the emergence of township and village enterprises and the private sector as alternative employment opportunities. It analyses the reasons for the success of TVEs, their rapid expansion in numbers, their more recent decline and their future competitive position in relation to the private sector. It considers the role of agroindustry in the overall rural economy; regional differences in agroindustrial employment, output and growth; and issues of corporate governance in SOEs and TVEs that are germane to enterprise viability. Specific consideration is then given to “dragonhead” agroindustry, the different models, the risk factors, the observations drawn from the fieldwork case studies, and the advantages of the “dragonhead” approach over other approaches. It assesses the effectiveness of agroindustry in poverty reduction and arrives at conclusions about the future potential, policy needs and the means of improving enterprise viability and the criteria for effective poverty reduction linkages.

International Rural Infrastructure Approaches and Experience (A13)

This paper reviews international approaches to rural infrastructure development and the impact of different rural infrastructure types on poverty. In its introductory section it considers the impacts in terms of their broad effects on quality of life (QOL). It then reviews the emerging trends in rural infrastructure development covering the increasing role of the private sector, institutional reform, the development of smaller projects and the need for participation. Subsequent sections consider the issues associated with poverty reduction for electricity, roads, irrigation, water supply and telecommunications and discuss a range of policy issues. Lessons that are of value in the PRC context are derived.

PRC Rural Infrastructure Development Approaches and Experience (A14)

This paper reviews PRC experience with rural infrastructure development as it relates to poverty reduction. Infrastructure includes economic and social infrastructure. This report focuses on economic infrastructure. The paper defines
rural infrastructure and describes the development of infrastructure in PRC for the irrigation, rural hydropower, water supply, and road sectors. It identifies the economic and social impacts of rural infrastructure on poverty. It gives an overview of the situation with the development of infrastructure in poor regions of PRC and reviews the main government policies and their effectiveness. It describes the way in which infrastructure projects are managed in design, construction and operation and reviews funding sources and cost recovery. It provides a special review of the food for work (FFW) programme. It assesses the effectiveness of poverty reduction and infrastructure as a component and identifies future development opportunities for improving effectiveness.
Currency Equivalents as of 30 September 2000

Currency : Yuan
US$1.00 = 8.2786 Yuan
Yuan 1.00 = US$0.1208

Abbreviations and Acronyms

ABA   Alexandra Business Association (of Egypt)
ABC   Agricultural Bank of China
ACDI  Agricultural Co-operative Development International
ACWF  All China Women’s Federation
ADB   Asian Development Bank
ADBC  Agricultural Development Bank of China
ADEMI Association for the Development of Enterprises
ADF   Albanian Development Fund
ADP   Annual Development Programme (of Bangladesh)
AfDB  African Development Bank
AHRS  The Ad Hoc Research Scheme (India)
AKRSP Aga Khan Rural Support Programme
ALM   Asset and Liability Management
AOTA  Advisory and Operational Technical Assistance
ARF   The Agricultural Research Fund (Kenya)
ATTF/ASARECA Agricultural Technology Transfer Fund of the Association for Strengthening Agricultural Research in East and Central Africa
AusAID Australian Assistance for International Development
BAAC  Bank for Agriculture and Agricultural Cooperatives (Thailand)
BDC   Business Development Centre
Biotechnology Biotechnology Consultants Limited
BKD   Badan Kredit Desas (Indonesia)
BRAC  Bangladesh Rural Advancement Committee
BRI   Bank Rakyat Indonesia
CASS  Chinese Academy of Social Sciences
CATF  Competitive Agricultural Technology Fund
CCA   Canadian Co-operative Association
CCF   China Children’s Fund
CDC   Commonwealth Development Corporation
CDF   Comprehensive Development Framework
CGAP  Consultative Group to Assist the Poorest
CGI   Credit Guarantee Institution
CICETE China International Centre for Economic and Technical Exchanges
CIDA  Canadian International Development Assistance
CMAC  Cajas Municipales de Ahorro y Crédito (of Peru)
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<th>Acronym</th>
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<tr>
<td>COPAC</td>
<td>Committee for the Promotion and Advancement of Co-operatives</td>
</tr>
<tr>
<td>CPEC</td>
<td>Caisses Populaires D'Epargne et de Crédit (of Niger)</td>
</tr>
<tr>
<td>CUDECOOP</td>
<td>Confederación Uruguaya de Entidades Cooperativas</td>
</tr>
<tr>
<td>CULT</td>
<td>Credit Union League of Thailand</td>
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<tr>
<td>DAC</td>
<td>Development Assistance Committee (of OECD)</td>
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<td>DID</td>
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This report has been prepared by Biotechnology Consultants Limited under the Asian Development Bank-financed TA No 3150-PRC. The views expressed herein are those of the Consultants and are not necessarily those of the Asian Development Bank or the Government of the People’s Republic of China.
1

Introduction

Project Description

Project Sector Goals, Immediate Objectives and Outputs

1 The sectoral goals of the technical assistance (TA) are to reduce poverty in the People's Republic of China (PRC) by implementing sustainable poverty reduction activities and narrowing regional disparities, and to disseminate knowledge gained to poverty experts throughout PRC

2 The more specific immediate objective of the TA is to assess the possibility of using Asian Development Bank (ADB) Ordinary Capital Resources (OCR) loans for poverty reduction activities, and in the process to generate outputs in five key areas, specifically:

- proposals for a microfinance system for the rural poor (including women and ethnic minorities);
- a checklist of key social factors to be addressed if state-sponsored voluntary mobility is to be successful (described as a "voluntary rural mobility framework" in the project framework prepared by ADB);
- funding guidelines for the use of OCR funds for agroindustries and other enterprise-driven private sector activities;
- guidelines for rural infrastructure provision in poor areas to maximise the effectiveness in poverty reduction and an evaluated pilot project that tests the guidelines; and
- a poverty typology and a fund management system for poverty loans.

3 These outputs have been synthesised into recommendations for the priorities for poverty reduction in PRC; the types of project best suited to OCR funding; and recommendations for institutional and management arrangements. This report documents the findings and serves as the basis for further processing of OCR lending for poverty reduction by ADB if it is decided to proceed.

Terms of Reference

4 The work was carried out according to detailed terms of reference (TOR) agreed between ADB and Foreign Capital Project Management Centre (FCPMC) of the State Council Leading Group Office of Poverty Alleviation and Development (LGOP).

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See appendix A1 for the Project Framework.
They provided for the engagement of five groups of international and domestic specialists in the areas of:

- rural poverty policy,
- rural finance and microfinance,
- voluntary rural mobility,
- agroindustrial and rural enterprise, and
- rural infrastructure development.

Each of these subteams has been deployed to address the relevant main output of the TA stated in paragraph 2.

The Executing Agency and Consultant Team

The TA has been executed by FCPMC of LGOP. The table below shows by subgroup the consultant team members for the study and the FCPMC counterpart staff who are working with them.

<table>
<thead>
<tr>
<th>Subteam</th>
<th>Name</th>
<th>Organisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall Management</td>
<td>Dr Feng Qiang (FCPMC Team Leader)</td>
<td>FCPMC</td>
</tr>
<tr>
<td></td>
<td>Mr Wang Xingui (Chief Co-ordinator)</td>
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<tr>
<td></td>
<td>Jon Wynne-Williams (Consultant Team Leader)</td>
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<td>Fred Bennett (Deputy Consultant Team Leader)</td>
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<tr>
<td></td>
<td>Mr Xu Hua (Co-ordinator)</td>
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<td>Ms Bethan Hughes (Project Assistant)</td>
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<td>Poverty Policy</td>
<td>Mr Jon Wynne-Williams (Subteam Leader)</td>
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<td>Dr Wu Guobao</td>
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<td>Ms Hong Shen</td>
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<td>Mr Zhang Liang</td>
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<td>Rural Finance and Microfinance</td>
<td>Mr Fred Bennett (Subteam Leader)</td>
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<td>Mr Liu Jianjin</td>
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<td></td>
<td>Ms Sun Ruomei</td>
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<td>Mr Cao Jianbin</td>
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<td>Voluntary Rural Mobility</td>
<td>Dr Justin Lin (Subteam Leader)</td>
<td>HIID</td>
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<td>Mr Lu Mai</td>
<td>HIID/SRC</td>
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<td>Mr Bai Nangsheng</td>
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<td></td>
<td>Ms He Xiaojun</td>
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See appendix A2 for the detailed TOR.
Contract Phases

8 A contract for the consulting services for the TA was signed on 29 June 1999 between ADB and Biotechnology Consultants Limited (Biotechnology) in association with the Harvard Institute for International Development (HIID).

9 The TA has been carried out in four phases:

- a period of desk research for documentation of the approaches to and experience with poverty reduction internationally and in PRC including inception (30 June to 23 July 1999);
- a period of fieldwork to obtain first hand information in PRC, consult with beneficiaries, prepare case studies, deliver five consultative workshops, and prepare a draft strategy as basis for further consultation (26 July to 15 October 1999);
- a further period of fieldwork, drawing on the draft strategy involving wider consultation on its proposals and leading to the production of the draft final and final report and dissemination of the findings (18 October 1999 to 15 October 2000); and
- a subsequent period for the start-up of the pilot rural infrastructure project and training of FCPMC staff and other poverty officials in PRC and overseas.

Structure of the Report

Main Report

10 The main report contains the following sections:

- 2 Strategies for Supporting Rural Poverty Projects
  
  that summarises the overall trends in poverty reduction internationally and in PRC, presents the proposals prepared under the TA that use this information as a basis for building on proven successes, and makes recommendations for their operationalisation.

  Four chapters that consider the subsectors in more detail including the policy dialogue agenda, OCR lending and non-lending opportunities for ABD, the applicable international models, and implementation mechanisms follow this:

- 3 Rural and Microfinance Development
- 4 Voluntary Rural Mobility Development
- 5 Agroindustry and Rural Enterprise Development, and
- 6 Rural Infrastructure Development

Appendices

11 Appendices are provided to which the reader is referred for detailed argument and case study material support Chapters 2 through 6 of the Main Report. Each
Chapter is supported by two appendices: one that considers international approaches and experience and one that considers PRC approaches and experience. The international coverage draws conclusion about useful lessons for PRC from other countries, while the PRC papers draw conclusions about lessons that can be learned domestically for more effective poverty reduction in future. These ideas are married in the overall strategies presented in the main report. Each of the main Chapters begins with a summary of the findings of the relevant appendices. Supporting information on commercial funded microfinance projects and recent OCR funded poverty reduction projects is also provided as are details of the training programme and pilot project developed under the TA.

12 The appendices are:

- A1 Project Framework
- A2 Terms of Reference
- A3 Commercially Funded Microfinance
- A4 Examples of OCR Funding
- A5 International Poverty Reduction Approaches and Experience
- A6 PRC Poverty Reduction Approaches and Experience
- A7 International Rural and Microfinance Approaches and Experience
- A8 PRC Rural and Microfinance Approaches and Experience
- A9 International Voluntary Rural Mobility Approaches and Experience
- A10 PRC Voluntary Rural Mobility Approaches and Experience
- A11 International Agroindustry and Rural Enterprise Approaches and Experience
- A12 PRC Agroindustry and Rural Enterprise Approaches and Experience
- A13 International Rural Infrastructure Approaches and Experience
- A14 PRC Rural Infrastructure Approaches and Experience
- A15 Training Programme
- A16 Pilot Infrastructure Project
Strategies for Supporting Rural Poverty Projects

Introduction

International Experience

13 From the mid 1990’s the complexity of poverty has been restated, and poverty programmes and projects have begun to move away from the exclusive use of income (US$ 1 per day) and poverty lines for poverty definition. The poverty reduction goals for official development assistance (ODA) have been expanded to include social and environmental measures as well as those of economic well-being. However, the outlook, even for income poverty reduction is mixed, with World Bank estimates showing a real possibility that more than 1.5 billion people worldwide will be living below the US$ 1 per day poverty line by the end of 2000.

14 Multilateral and bilateral ODAs are united in their overall goal to reduce and eventually eradicate poverty. There is great consistency of focus and recognition that past approaches, particularly to structural adjustment, have not always benefited the poor. The changing conception of poverty and its adoption as an overarching goal have led to many new ideas about the design of poverty reduction projects and how to learn from them to make projects more effective in the future. A summary of the findings indicates that:

- poverty must be recognised as complex and associated with natural, physical, financial, human and social capital access and development, is individually variable and is affected by externalities;
- the goals need to address policy, economic growth, income redistribution, gender equality, livelihood quality, facilitating access and the environment;
- ODA, government and non-government organisation (NGO) approaches are all legitimate ingredients provided they are client based;
- sustainability, capacity building, environment, gender and subsidy reduction must all be main design concerns;
- individual projects should build on people’s strengths, target households, communities, implementing agencies and wider policy;
- a multisectoral approach should be accommodated;
- design should be participatory, iterative and flexible in implementation;

1 The reader is referred to appendix A5, “International Poverty Reduction Approaches and Experience” for the detailed arguments that justify the findings and a wide range of supporting illustrative case study experience.
• the long term nature of capacity building and social capital development should be recognised in design;

• successful project interventions are made at the local level and may be small or involve many small components;

• local and national governance issues should be addressed;

• partnerships of all types should be encouraged (particularly between the public and private sector and with NGOs where appropriate);

• project management should be within the implementing organisations and not discrete; and

• monitoring and evaluation should be linked to learning now, not later.

This provides a lengthy agenda of new thinking for the PRC government to consider as few of these principles are reflected in its existing programmes.

The past three decades have also seen changes in the approaches to poverty reduction by governments. In the countries where governments are heavily dependent on aid, the approaches have mirrored those of the donors because donor dependence results in the domination of donor ideas in project design. In the countries where governments have had their own programmes, the approaches of government have also mirrored the approaches of donors where aid finance is involved, but have lagged behind the most current thinking in their own programmes which have tended to be adaptations of earlier donor approaches.

In the run-up to the completion of the 8/7 programme\(^2\), there are many models that the PRC government may wish to consider for future approaches. Some examples are: the Thailand social investment fund (SIF) approach; the development of autonomous microfinance agencies or funds such as in Albania; the food for education programme in Bangladesh; the holistic comprehensive development framework (CDF) approach being pioneered in Bolivia, Dominican Republic and Vietnam; the design characteristics of India’s workfare programmes that try to underwrite participation of the poor and use NGOs for service delivery; Pakistan’s approach to poverty alleviation funding in its efforts to improve governance, and Vietnam’s attempts to restructure state-owned enterprises and free up budgetary resources.

NGO’s relative freedom and the small-scale nature of operations have facilitated many new approaches. However, scaling up has been difficult for reasons of inadequate funding and lack of the wider programme management skills needed for rollout. NGO’s development of microfinance and participatory development methods have contributed important lessons to the new thinking and their approaches are worthy of consideration for inclusion in future government strategies in PRC. The private sector can also have a role in poverty reduction. Partnerships like “dragonheads” have been pioneered in PRC, but there are also many examples of other roles for private sector participation in poverty project implementation and for

\(^2\) The 8/7 Programme for poverty reduction was launched by the PRC government in 1994 to lift the remaining 80 million absolute poor out of poverty in 7 years (by the end of 2000).
the provision of complementary funding. Lessons about private sector participation, particularly from the World Bank’s evolving CDF projects will be of particular interest to PRC.

19 Conclusions from a review of aid effectiveness research are as follows. Economic growth is essential for social development and particularly to ensure the provision of basic social services, but one does not follow automatically from the other and: strong and sustained political commitment to distribution of income factors; investment in human resources; and encouragement of labour intensive growth are also required if there is to be an impact on poverty. Promoting productive employment through education and training, particularly for those in informal sectors, needs to focus on raising worker efficiency and should be regularly revised to take account of labour markets and national development needs, with particular attention being given to the non-farm sector in rural areas. Provision of basic social services (primary education, primary health care, nutrition, family planning, clean water and sanitation) are effective in reducing poverty because they give people the skills and improved health they need to work effectively, but programmes must be targeted to ensure benefits reach the poor and self-help should be fostered. Greater assurance of finance for basic social services is needed from government, from mobilisation of community resources in kind, through debt relief or debt swaps, additional aid and borrowing, and the use of tax and cost recovery mechanisms. The complexity of poverty needs to be recognised and interventions need to take account of local circumstances, including the possibility that some groups and institutions can stand to gain from the poverty of others and how this should be addressed. Building partnerships with the poor and encouraging self-reliance are not short-term activities and participation and empowerment of the poor and building on existing strengths are important entry points for sustainability. Design must include institutional analysis for all partners including NGOs and other civil society organisations.

20 Few of these principles are embodied in PRC’s current government poverty reduction programmes, but they are all reflected in the Poverty Reduction Strategies of ADB and other ODA. With the conclusion of the 8/7 programme, there is a window of opportunity to use this accumulated international experience in the design of PRC’s future poverty reduction programmes. ADB and others can play a major role in policy dialogue, funding and technical assistance and training in the context of their own projects and those of the government.

PRC Experience

Trends

21 Prior to 1978 the main thrust of poverty reduction in PRC was in improving farmer’s access to all types of assets. Improvements in this phase were gained at the expense of economic efficiency because of centralised control. In 1978 the household responsibility system was introduced, providing farmers with greater control over assets and greater incentives for production. Agricultural terms of trade were also improved during the 1978 to 1984 period. As a result of these measures the number of rural poor fell from 250 million in 1978 to 128 million in 1984 (15.1

3 The reader is referred to appendix A6, “PRC Poverty Reduction Approaches and Experience” for the detailed arguments that justify the findings.
percent of the population). Subsequently, between 1984 and 1989, with government policies focused on more market oriented economic growth, income inequality increased, the rate of poverty reduction slowed, and the government introduced targeted poverty reduction programmes. Between 1989 and 1994, relaxation of controls on labour migration, promotion of rural industrialisation and adjustments in the definition of poor areas led to a reacceleration of poverty reduction. In 1994 the government introduced the 8/7 programme to lift the remaining 80 million rural poor out of poverty in 7 years. The number of rural poor had declined to 34 million at the end of 1999.

22 Over the two decades to 1998, PRC had average gross national product (GNP) growth of 9.2 percent per year. Gross Domestic Product (GDP) per capita increased from about 400 yuan to about 1,880 yuan over the same period. By 1997 the employment participation rate for the economically active population had reached about 84 percent. Participation in the agricultural sector was about 50 percent of total employment. Between 1978 and 1998 real incomes in rural and urban areas increased 356 percent and 230 percent respectively and the incidence of absolute poverty declined by 85 percent in rural areas.

23 PRC uses average per capita income at the county level to target the allocation of funding from central government poverty reduction programmes. However, there are different standards for different areas, some of them politically motivated. The averaging mechanism means that the poor in non-poor counties do not benefit. This issue has yet to be thoroughly researched, but the available research estimates that on average only 70 percent of the poor population lives in poor counties. In some areas as many as 50 percent of the poor live in non-poor counties that do not benefit from central government funding for poverty reduction.

24 The average per capita income definitions used for determining poor counties are not the same as the national poverty line. This is set at about USD 0.66 equivalent per day based on the price of a food bundle and is universal for PRC. Critics of the poverty line highlight in particular the facts that: it does not distinguish between regional differences in the cost of living, the bundle does not include many items of actual consumption, and the standard is low by international comparison. Based on the World Bank’s more commonly recognised US 1 per day poverty line the poor population of PRC in 1999 was 106 million.

25 Overall rural poverty fell from 250 million people in 1978 to 34 million in 1999 according to the official poverty line. There is some evidence that the regional distribution of rural poverty is changing. Between 1992 and 1997 the total number of poor in PRC reduced by 38.5 percent. In eastern PRC the reduction was 57.2 percent while in the central and western regions the reductions were 32.4 and 33.7 percent respectively. These changes in absolute numbers resulted in the proportion of poor in the western region falling by about 7 percent, but rising by 3 percent and 4 percent respectively in the central and eastern regions.

26 Urban poverty is more difficult to assess. The available research suggests that urban poverty fell from about 20 percent of the population in 1980 to about 6 percent in 1994. Recently, provincial governments have set up urban “minimum survival lines” similar to poverty lines, but these do not have a common base so comparison and aggregation are not possible. It is expected that the incidence of
urban poverty will increase with continued lay off of workers from state owned enterprises (SOEs). The present indication is that urban unemployment will rise by 4 to 5 million per year and that the total unemployed urban population in 2000 will be about 25 million. The number of urban poor is estimated at about 12 million. There is also some evidence of increasing urban income disparity.

27 There is limited evidence of any gender disparity in poverty. There is no evidence of nutritional disparity, but there is disparity in terms of leisure time and education where women come off worse than men. This is most noticeable in the adult illiteracy rate that in 1995 was 9.58 percent for men and 23.24 percent for women. A high proportion of PRC's remaining poor are minorities, living in remote mountainous areas.

**Government's Approach**

28 Poverty reduction activities in PRC are supported by government and by NGOs. In 1986 the government established a leading group to manage poverty reduction programmes. This is now LGOP. It is responsible for formulating national policies and plans concerning poverty reduction, co-ordinating poverty reduction activities between government departments, and raising and distributing resources for poverty reduction programmes. Under the Leading Group an executive agency, the national Poor Area Development Office (PADO), is responsible for operations. This structure of leading groups and PADOs is replicated at the provincial and county level. Some 47 government departments also participate in poverty reduction programmes.

29 Prior to 1986, the government's main approach was to provide relief goods and grants to poor areas. After 1986, the policy of trickle down development was adopted with the underlying assumption that economic growth and industrialisation would automatically benefit the poor. Means used by policy makers to reduce poverty have basically been the same since 1986. The main means have been provision of subsidised loans, operation of public works programmes (food for work or FFW), and budgetary grants to poor counties. Table 1 shows the recent fund allocations.
Table 2.1  Funding Amounts for Three Main Poverty Programmes, 1986-1998 (million Yuan)

<table>
<thead>
<tr>
<th>Year</th>
<th>Subsidised Loans</th>
<th>Food-for-Work</th>
<th>Budgetary Grants</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>2,300</td>
<td>900</td>
<td>1,000</td>
<td>4,200</td>
</tr>
<tr>
<td>1987</td>
<td>2,300</td>
<td>900</td>
<td>1,000</td>
<td>4,200</td>
</tr>
<tr>
<td>1988</td>
<td>2,900</td>
<td>100</td>
<td>1,000</td>
<td>4,000</td>
</tr>
<tr>
<td>1989</td>
<td>3,000</td>
<td>600</td>
<td>1,000</td>
<td>4,600</td>
</tr>
<tr>
<td>1990</td>
<td>3,500</td>
<td>1,800</td>
<td>1,000</td>
<td>6,300</td>
</tr>
<tr>
<td>1991</td>
<td>4,100</td>
<td>1,600</td>
<td>1,100</td>
<td>6,800</td>
</tr>
<tr>
<td>1992</td>
<td>4,500</td>
<td>4,000</td>
<td>1,200</td>
<td>9,700</td>
</tr>
<tr>
<td>1993</td>
<td>4,500</td>
<td>3,000</td>
<td>1,300</td>
<td>9,800</td>
</tr>
<tr>
<td>1994</td>
<td>5,500</td>
<td>4,000</td>
<td>1,300</td>
<td>10,800</td>
</tr>
<tr>
<td>1995</td>
<td>8,500</td>
<td>4,000</td>
<td>2,800</td>
<td>15,300</td>
</tr>
<tr>
<td>1996</td>
<td>10,000</td>
<td>5,000</td>
<td>3,300</td>
<td>18,300</td>
</tr>
<tr>
<td>Total</td>
<td>57,600</td>
<td>29,900</td>
<td>18,000</td>
<td>105,500</td>
</tr>
</tbody>
</table>

30 Other means have included programmes to introduce new technologies to poor areas, requirements of government agencies and SOEs to enter into contracts to assist communities in poor regions, and encouragement of government departments and enterprises in eastern PRC to develop economic linkages with inland less developed areas. Between 1986 and 1989 regional targeting for fund allocation dominated. Between 1990 and 1995 regional targeting was combined with group targeting. Since 1996 village and household targeting has dominated.

31 Regarding the three funding programmes, there are institutional weaknesses. Local governments, empowered to allocate poverty reduction resources, have been faced with multiple objectives of poverty reduction, economic growth and budgetary solvency. This has resulted in fund diversion, and trickle down has not functioned as well as hoped.

32 Review of the subsidised loan programme shows that conflicting interests have arisen between the Agricultural Bank of China (ABC) that is mandated to carry out the lending and has a disposition not to lend to the poor, and PADOs that are mandated to identify poor borrowers for ABC to lend to. The programme has a poor record of repayment, the reported rate being about 62 percent in 1997, and poor credit discipline. In addition to the subsidy costs, non-repayment costs the government about 4 billion yuan per year. The programme is unsustainable other than through continued government subvention.

33 The food for work programme has been relatively efficient because it has bypassed county financial bureaux and disbursed funds directly to implementing agencies. Fund diversion is rare. However, FFW may have crowded out funds from local government budgets that would otherwise have been spent on poverty reduction, and there are issues in many locations about whether or not labour has been paid for the work carried out. Although poor communities have benefited from infrastructure development, the provision of wage labour in its construction is an important part of the rationale for food for work programmes. Nevertheless, the programme has remarkable achievements. Between 1984 and 1998, the FFW programme constructed 300,000 km of roads, provided safe water supply for 63
million people and 54 million livestock, and developed 3.7 million hectares of farmland, 4.9 million hectares of irrigation, 3.1 million hectares of forest and 1.6 million hectares of pasture land as well as playing an important part in improving electricity supply and communications.

34 The budgetary funds programme comprises various development funds for poor areas provided by central government. Their use is not transparent because of the classified nature of budget data in PRC. At worst development funds are pure budget subsidy and may have no significant additionally in poverty reduction.

35 More recently there have been experiments with new approaches to poverty reduction. The World Bank's poverty reduction projects have packaged different income generating, economic and social infrastructure and financial services elements together in poor areas in a more comprehensive approach to poverty reduction and many pilot microfinance projects have been started.

36 It is concluded that while the poverty reduction programmes to date have been effective, the emerging challenges of: concentration of the remaining absolute poor in remote rural areas; increasing income inequality; and rising urban poverty will not be so effectively met through polices that rely on trickle-down and economic growth. There are opportunities to improve targeting, sustainability and governance. These include redefinition of poverty through improvements to the poor county system; redefinition of the poverty line or introduction of a relative poverty lines to provide a basis for future targeting; phasing out of the subsidised loan programme in favour of more sustainable mechanisms in rural and microfinance; and bringing to bear international experience. LGOP would have a major role in the implementation of these changes.

Other Initiatives

37 One example of other poverty reduction initiatives is the four pilot Funds for Poor Co-operatives (FPCs) have been established by LGOP and the Chinese Academy of Social Science (CASS) since 1994. The funds are used for microfinance. Pilot microfinance offices have been established under provincial PADOs who supervise pilot schemes in Yixian County, Hebei; Danfeng County, Shaanxi; Yucheng County and Nanzhao County, Henan. Central government poverty reduction funds are used in this pilot programme.

38 Other examples include the operations of the All China Women's Federation (ACWF), Project Hope and Project Happiness. ACFWs activities include training poor women in agricultural technologies, promoting mutual assistance between women's groups, organising income generating activities and helping drop out girl's return to school. Project Hope was first sponsored by the Youth and Juvenile Development Foundation (YJDF) in 1989 and focuses on getting drop outs back to school and improving educational infrastructure. Project Happiness is operated by the China Family Planning Association, China Population Welfare Foundation and China Population Daily. Started in 1995, it raises funds to assist poor mothers with health care and literacy development.

39 The private sector has also been a force in poverty reduction in PRC. Brilliant Cause is the most noticeable example in which private entrepreneurs invest in poor
areas to combine employment creation with market development and profitability for the sponsors. In 1998, it had about 2,670 entrepreneur participants and total investment to date of about 7.5 billion yuan in almost 3,600 projects.

The Future of PRC’s Poverty Reduction Programmes

The Emerging Challenges

While the PRC poverty reduction programme has been extraordinarily successful, the emerging challenges are difficult because they cannot easily be solved only through investment or through economic growth, the engines of success so far. Specifically:

- For the remaining 34 million absolute poor, half are said to lack access to productive land, 25 percent have land but lack water, and 25 percent live in remote mountainous regions.

- Low levels of economic and social infrastructure and human resource development inhibit effective poverty reduction in remote mountainous areas, often occupied by minority nationalities. Only three-quarters of children in the central provinces and one-third in the western provinces receive the mandated nine years basic education.

- Many of the poor are still barely above the poverty line, and remain vulnerable to economic or environmental shocks such as declining agricultural prices, outmigration of able-bodied labour and flooding.

- There are more than 120 million rural unemployed, growth in productivity is increasingly difficult to achieve, and falling product prices have resulted in depressed annual growth of about 1 percent. In mountainous areas development is hampered by low levels of farmer education, and the need for significant investment in erosion control.

- There is increasing inequality between rich and poor, with urban incomes more than twice those of rural households on aggregate and significant regional differences reflecting the relatively rapid growth of coastal province economies.

- Reform of state-owned enterprises is swelling the ranks of the unemployed. Under a reform programme started in 1996, lay-offs from SOEs had reached about 18 million by the end of 1998 and are expected to continue to grow at 4 to 5 million per year to the end of 2000.

- Urban poverty is rising as a consequence of SOE lay-offs, the dismantling of the traditional benefits such as housing and social welfare and from the in-migration of rural people.

These factors, together with the opportunities to improve targeting, sustainability and governance need to be addressed in future poverty reduction. From the analysis of the existing programme, the key issues to be addressed in the future are:
• the definition of poverty and the poverty line;
• improvements in targeting poverty reduction efforts;
• improvements in the sustainability of poverty reduction programmes;
• improvements in governance in terms of both effectiveness and efficiency; and
• bringing to bear relevant international experience in poverty reduction so that PRC programmes can benefit from aid effectiveness and other international research.

42 The latter shows that there are many lessons that could be applied to the existing PRC government programmes and many considerations for the future design of government and ODA projects.

Improvements in Targeting, Sustainability and Governance

Targeting

43 The targeting of PRC’s poverty reduction efforts has been periodically reviewed. The targeting of villages and households rather than regions since 1996 has partly addressed criticisms of the Government’s programme, but there continue to be targeting problems. These, for example, result from:

• the use of a universal poverty line which inhibits good targeting because it does not take account of rural, urban and regional differences in consumption and expenditure patterns, prices and terms of trade;
• regional targeting based on poverty counties and to some extent politically influenced has by-passed many of the poor in non-poverty counties while benefiting the non-poor in poverty counties;
• the rising incidence of urban poverty has not been addressed with the same comprehensive approach as rural poverty, though urban unemployment is expected to increase;
• inherent biases in the subsidised loan programme that accounts for 55 percent of total poverty reduction funding, that mean that lending to the poor has not been the top priority, including attitudinal biases on the part of ABC officials in favour of lending to the non-poor and a disposition on the part of local government to invest subsidised loan funds in economic growth projects in times of fiscal stress;

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4 See paras 95 - 113 of appendix A5 “International Poverty Reduction Approaches and Experience”
5 See paras 77 - 79, 93 - 95, 103 - 107 and 113 - 115 of appendix A6, “PRC Poverty Reduction Approaches and Experience”
6 See Table 2.1
Strategies for Supporting Rural Poverty Projects

- the use of FFW funds as a substitute for ordinary budgetary commitments for infrastructure development, reducing the additionality of FFW funding in poverty reduction; and

- the absence of effective targeting of development funds provided to local governments as budgetary support because local government has discretion in their use.

44 These targeting problems stem from income and area based approaches to poverty reduction and the absence of incentives for good targeting in the systems of governance used to administer the poverty reduction programme.

45 Changing the definition of poverty and the poverty line are both potentially good ways to improve targeting because the poor population (including the urban poor) will be more clearly identified and the poverty line more sensitive to regional and urban/rural differences.

46 It is difficult to improve targeting in the subsidised loan programme because of its inherent biases to lend to enterprises rather than individuals and the pressures on ABC staff that encourage them to lend to the non-poor. The subsidised loan programme is in fact counter-productive in addressing poverty reduction and needs to be phased out in favour of more market oriented banking services and microfinance mechanisms⁷.

47 Improving the additionality of the food for work programme and the development funds programmes is problematic without transparency in local government spending. Eventually the programme could become part of county level CDFs, but transparency in budgeting and audit of local government expenditure are prerequisites for improving targeting.

**Poverty Definition**

48 The poor county system, while perhaps an effective tool in the past, is now demonstrated to be in need of revision ⁸. This is not because of flaws in the idea of regional targeting itself, but because of issues concerning how it has been implemented in PRC⁹.

49 It is suggested that a sound approach would begin with the identification of the actual location of the poor that would provide the justification for the allocation of resources on a nation-wide basis. The allocation of resources at the county level could be maintained, but every county would qualify for a share of the resource. The resource could be allocated on a per capita basis though this would not necessarily be the most efficient use of central government funding because some counties even though they may have a large poor population may also have a large rich population and a strong revenue base.

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7 See Chapter 3 for details.
8 See paras 17 – 27 of appendix A6 “PRC Poverty Reduction Approaches and Experience”.
9 See para 43 and the more detailed analysis in See paras 77 - 79, 93 - 95, 103 - 107 and113 - 115 of appendix A6, “PRC Poverty Reduction Approaches and Experience”
Therefore, it may be more appropriate to introduce some kind of "means testing" system for counties that would provide support for poverty reduction on a sliding scale related to overall county revenues. It is possible that a minimum level of per capita public expenditure in poor areas (focused on economic and social infrastructure) could be agreed at the county level, and that in addition to entitlements on the "means tested" basis additional funding could be made available for counties that exceeded the targets on a pro rata basis. Significant research effort is needed to develop these ideas and should be initiated with a proper analysis of the distribution of the poor and the existing composition of local government spending.

In due course this approach could be refined further. At the county level targets for different poverty and quality of life indicators could be set (for example literacy, child mortality, life expectancy etc) within the context of mini county level poverty reduction plans (similar to the CDFs being developed at a national level with the World Bank in some countries\(^\text{10}\)). Funding could then be allocated in relation to achieving these development targets.

**The Poverty Line**

The definition of the poverty line that underlies the 8-7 programme in PRC is income based, the income level being defined in relation to a bundle of food and non-food expenditure, the food bundle in turn being defined in relation to calorific intake. This has resulted in a narrow “income” definition of poverty that does not take account of poverty’s wider characteristics. Adoption of a wider definition of poverty based on the objectives set out in “Shaping the 21\textsuperscript{st} Century” published by the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD) covering in addition to income: education, gender equality, infant and maternal mortality, health care, and environmental sustainability and regeneration should be considered for future efforts\(^\text{11}\).

PRC's universal income poverty line of about USD 0.66 per day is below the international standard of USD 1 per day and has been set in relation to available government resources. This has reflected the Government’s focus on the very poor and the scarce resources available for poverty reduction. Recognition of relative income poverty and a commensurate shift in the strategy to an aggregate of at least the internationally recognised standard of USD 1 per capita per day is a logical next step. It is estimated by the United Nations Development Programme (UNDP) that in 1999, some 106 million people fell below this poverty line in PRC so the task of reducing relative poverty remains substantial.

However, the line needs to be reset taking account of rural, urban and regional differences in consumption and expenditure patterns, prices, and terms of trade; and the resulting lines used as the basis for identifying the poor population within counties, in turn giving rise to county allocations of central government poverty reduction funding. Provincial governments providing funding to counties would use the same method. While it is recognised that it will be politically difficult for the government following the success of the 8/7 programme to redefine absolute poverty

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\(^{10}\) See paras 119 - 129 in this Chapter and paras 50 - 57 in appendix A5 for details of the CDF approach.

\(^{11}\) See paras 4 - 5 of appendix A5, "International Poverty Reduction Approaches and Experience"
and in doing so again increase the number of absolute poor, the introduction of higher poverty lines is necessary if future targeting is to be effective. Some countries have two poverty lines: an absolute poverty line and a relative poverty line. Others address specific segments of the population such as the poorest ten percent. There is much merit in this latter approach because it creates a long-term agenda independent of income levels and can be used to tackle the needs of the poor as well as the absolute poor and LGOP are likely to take this approach in future.

55 In due course, with the resultant increase in the numbers defined as poor, this will require further consideration of the allocation of poverty reduction funding. In approaching this issue, it will be useful to consider if new ideas and funding mechanisms will allow more ambitious poverty reduction targets to be set than would be the case if reliance were only on budgetary funding: both in terms of the speed of their achievement and the national minimum level of poverty targeted. In parallel, means that address the targeting, sustainability and governance issues of existing programmes will need to be considered.

**Sustainability**

56 There are various aspects of PRC’s current poverty reduction programme that are only sustainable through continued subvention from the budget, that is they are not self-sustaining. Most notably, the subsidised loan programme suffers from a lack of self-sustainability both in terms of:

- the interest rate charged, which at 3.00 percent is far below a realistic level for covering the cost of funds, operating costs, provisions for loan losses and a margin to maintain the real value of the capital against inflation; and

- poor credit repayment discipline that exacerbates the above problem to the extent that even if a normal commercial rate was used in the existing programme, the high level of default would continue to cause unsustainability.

57 The subsidised credit programme and development funding also work against sustainability because they:

- create false expectations with the poor about the future price of money and build-up resistance to paying market rates;

- can result in the misallocation of resources in the extreme resulting in investment in enterprise that is non-viable without subsidy support;

- “crowd out” donor capital from poverty reduction credit and investment because it cannot compete on interest rate;

- prevent the use of domestic savings because the lending rate is below reasonable deposit and borrowing rates; and

- discourage experiments that are based on sustainable principles.

58 All components of the Government’s poverty reduction programme remain a drain on treasury resources even though they may contain components that are potentially self-sustaining at commercial rates such as some types of infrastructure
and rural enterprise funding. However, sustainability of certain elements of the programme could be substantially improved. The phasing out of the subsidised loan programme and the introduction of market based banking services for the poor is the first step and will have the greatest impact in terms of freeing up central poverty reduction funding for the development of other non-recoverable investments such as in education and health.

**Governance**

59 Good governance is central to poverty reduction. PRC has established a national network of PADOs and the commitment to poverty reduction is strong. PRC is unique in this level of commitment. However, as local governments have been required to become financially self-reliant, many are focused on growth and revenue issues rather than poverty reduction. This has led in many areas to the poor being denied access to centrally allocated poverty funds that have been diverted to other purposes.\(^\text{12}\)

60 In terms of effectiveness, there are opportunities to improve impact on poverty through the adoption of policies that result in greater self-sustainability and the testing and rollout of sectoral project design guidelines that draw on recent PRC and international experience. In terms of efficiency, there are opportunities to improve targeting, reduce leakage, and leverage and crowd in resources for selected investments.\(^\text{13}\)

**Bringing to Bear International Experience**

61 It is important to develop widespread ownership of new ideas being introduced in PRC for poverty reduction, both on a project basis and in the government's own programmes. International agencies supporting the PRC poverty reduction effort would like to see the ownership of new paradigms evident not only at national level but at provincial and local government levels so that they have confidence in the governance of projects at the implementing agency level.

62 To do this, central government through LGOP will need to develop an education and awareness programme at the provincial and county levels, eventually on a national scale. The first steps will involve developing this awareness and applying the international lessons learned in selected project initiatives and in the pilot testing of new approaches such as CDFs, SIFs, challenge funding and parallel financing. Subsequently, case study material from these initiatives can support promotion of successful ideas nation-wide. This process will take several years, partly in order to learn from the successful interventions using new methodologies and partly because the new methodologies themselves will take time to be understood at local government level because they are less prescriptive and formulaic than the present approaches.

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\(^\text{12}\) See paras 77 - 117 of appendix A6, “PRC Poverty Reduction Approaches and Experience”

\(^\text{13}\) These are more particularly described in Chapters 3 to 6 of this report covering microfinance, voluntary rural mobility, agroindustry and rural infrastructure.
Lessons Learned - Microfinance

63 Regarding the different types of microfinance institution that have proven successful there are specific lessons that are useful for PRC policy makers in determining the future of microfinance in PRC.

64 Success of an agricultural development bank in providing microfinance depends on a list of strong preconditions, including: a dynamic agricultural sector; at least moderate macroeconomic equilibrium and a sound fiscal system committed to reform; an existing or developing legislative, regulatory and supervisory framework, including access to the courts to enforce contracts; and an autonomous and healthy institution demonstrating a good quality loan portfolio with low arrears, independent programme design and implementation by competent staff and management and an information system capable of providing quality information on the loan portfolio.

65 While the first two requirements generally can be met in the PRC context, the government owned agricultural development bank, Agricultural Bank of China (ABC) may not be an ideal candidate for the role of microfinance provider. This is because of its poor quality portfolio, staff and management who have little expertise in lending to very small borrowers and an information system that is not capable of providing the kind of detailed information required for management of a large portfolio of small loans. In particular, ABC’s lack of autonomy with respect to its existing poverty reduction lending programme is of concern. The corporate culture of ABC is inappropriate for microfinance operations: branches in rural areas prefer to make larger loans backed by collateral that are repayable in one lump sum at maturity, rather than microfinance loans that are small, have no collateral and are paid in frequent instalments 14.

66 In PRC, there are no existing specialist microfinance banks. The lessons from international experience on the difficulties of programme expansion and of making the transition from non-bank to bank, and in particular the time and expense required to make such a transformation, should be noted. In the PRC context, the paucity of large rural financial institutions with a firm commitment to microfinance coupled with extensive experience in microfinance operations makes selection of a candidate for such a transformation difficult.

67 In the commercial banking sector the useful lessons from those who have pioneered it are: starting and sustaining a microfinance programme requires committed and visionary leadership: commitment is most likely to be found in small banks or in specialised units of larger banks; profit must be the principal motivation, not social image enhancement; there must be a strategic fit between the commercial bank and the new market (perhaps caused by commercial pressure in its traditional markets); successful microfinance operations require a different set of operating procedures, extensive investments in appropriate information technology, training, staff incentives, a wide network of bank branch offices and a schedule of hours of operation that are convenient for microfinance clients; careful consideration must be given as to how to structure and organise a microfinance programme within a commercial bank (for example, as a fully integrated product, a division or a

14 Author’s field notes, interview with President and Vice-President of ABC Ankang County Branch, Shaanxi Province, 29 July 1999.
subsidiary); and managers need to focus on operational efficiency and delinquency control, not solely on profits, because profits can mask problems in a non-competitive environment\textsuperscript{15}.

68 The model of the commercial bank that establishes a new microfinance subsidiary is of interest in the PRC context because of the lack of a good fit between microfinance operations and the existing corporate culture of PRC commercial banks, plus the lack of existing microfinance institutions large enough to be capable of moving into this role.

69 The feasibility of using NGOs as a major component of broad-based provision of microfinance services on even a regional basis in PRC is problematic, because of the quasi-legal status of existing microfinance project in the country and because of the small relative size of all existing pilot microfinance projects. However, because NGOs make up the bulk of microfinance providers internationally, and they collectively have vast experience with microfinance, their experiences particularly in the areas of operations and credit methodology particularly must be taken into account when designing any microfinance programme.

70 Recognition that microfinance organisations have special organisational and operational characteristics that flow from the unique nature of their loan portfolios is important in the PRC context, as elsewhere. It is necessary that microfinance institutions be classified as a unique kind of financial institution, so that they can be made subject to appropriate laws, regulations and supervisory requirements that may be substantially different from those that apply to other financial institutions.

71 Two lessons from international experience are important to take into the PRC context. The first is that self-help groups, independently established, can be operated in a financially prudent, self-sustaining manner without the imposition of regulation from outside. The members of the credit union manage their own affairs to their own benefit. Secondly, it is important to note that such institutions serve a valid financial intermediary role in rural areas. Although credit unions may not specifically target the poor, they can serve low-income clients successfully with a broad range of financial services. This helps to stimulate economic well being and the accumulation of physical, social and human capital in rural areas. The model development of People’s Credit Funds in Vietnam over the past six years is illustrative of a successful partnership between the State Bank of Vietnam and the Central Credit Fund and donors including ADB and can be considered for the development of RCCs.

72 The village bank model is of interest in the PRC context because it offers a way to link a larger organisation, such as a commercial bank, with a specialised microfinance institution based at the local level, controlled and operated by its members. The question of charging interest rates sufficient to ensure self-sustainability are cast in a new light when the interest accrues to the poor themselves. The supervising financial institution serves as the conduit for funds, so the poverty reduction benefits are not limited due to lack of local resources. Other

benefits include low administrative and transaction costs and sustainability, while prudent financial operation is maintained by the supervising financial institution.

**Lessons Learned – Voluntary Rural Mobility**

73 Many international lending agencies have formalised and adopted guidelines or policies for involuntary settlement projects, first initiated by the World Bank in 1980, followed by Inter-American Development Bank (1990), Development Assistance Committee of the Organisation for Economic Co-operation and Development (OECD) (1991), Asian Development Bank (1995) and other international agencies. Involuntary settlement occurs when a project involves “acquisition or redirection of use of lands that are owned or utilised by individuals and communities.” Examples of such projects include the construction of dams, irrigation canals, highways, railroads, airports, etc. The reason that greater attention has been given to involuntary settlement is obvious: the settlement has adverse impact on the welfare of displaced people.

74 Because of the adverse impact on the displaced people, the guidelines or policies mostly deal with the compensation or remedial issues. For example, ADB involuntary settlement policy stipulates that the following basic principles should be observed for any project involving involuntary relocation of people:

- Involuntary resettlement should be avoided where feasible.
- Resettlement should be confined to where population displacement is unavoidable.
- Ensure that displaced people receive assistance, preferably under the project, so that they would be at least as well off as they would have been in the absence of the project.

75 The latter two guidelines also apply to voluntary resettlement. ADB guidelines also stipulate some specific actions that should be undertaken to smooth the settlement. These guidelines are applicable to voluntary settlement, too. These include:

- “The affected people should be fully informed and closely consulted on resettlement and compensation options. Because adversely affected people are particularly vulnerable, resettlement and compensation decisions should be preceded by a social preparation phase to build up the capacity of the vulnerable people to deal with the issue.”
- “Appropriate patterns of social organisation should be promoted, and existing social and cultural institutions of settlers and their hosts should be supported and used to the greatest extent possible. Settlers should be integrated economically and socially into host communities so that adverse impacts on host communities are minimised. One of the effective ways of achieving this integration may be by extending development benefits to host communities.”

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17 ADB, 1995, ibid
“The full costs of resettlement and compensation, including the costs of social preparation and livelihood programmes as well as the incremental benefits over the “without project” situation, should be included in the presentation of Project costs and benefits.”

“To better assure timely availability of required resources and to ensure compliance with .... resettlement procedures during implementation, eligible costs of resettlement and compensation may be considered for inclusion in Bank loans financing for the project, if requested.”

In addition to the ADB Guidelines on involuntary settlement, the international experiences of voluntary settlement reviewed in the report indicate that the following principles are also important for the success of a voluntary settlement project:

- Settlers should be fully informed of the resource potentials and risks of the settlement area.
- Settler selection process should be free of political favouritism.
- The host population should be adequately compensated for the loss to new settlers.
- Spontaneous settlement and private sector involvement in project implementation should be encouraged.

Lessons Learned – Agroindustry and Rural Enterprise

In the context of PRC’s rural industrialisation and the experience with TVE development (both successful and otherwise), international approaches and experience can offer some useful guidelines for making agroindustry and rural enterprise more effective for poverty reduction. The specific guidelines can be summarised as follows.

- Enterprise viability is the primary consideration. This is enterprise and location specific and generalisations should not be made other than that relevant procurement, processing, marketing and environmental aspects need to be examined in each case.
- Enterprise should be encouraged to locate in poor areas or to obtain raw materials from poor areas only if the criteria of viability can be satisfied. This should not be brought about by direct subsidy to enterprise operations, but government can assist though infrastructure provision and by sponsoring market or product development research for specific uses of raw materials from poor areas, particularly if these are unique to those areas due to agroclimatic or other factors.
- Enterprises should be free to choose the type of linkage that they form with poor farmers based on their own judgement of the risks and rewards of different types of linkage. Government should not attempt to force enterprises

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18 See appendix A12, “PRC Agroindustry and Rural Enterprise Development”
to joint venture with farmers because it restricts enterprise autonomy, but can actively encourage the development of farmers organisations that are able to negotiate effectively with enterprise and/or joint venture with it.

- SME non-farm rural employment creation, although it does not directly benefit poor farmers, has been the engine of economic growth in many economies including PRC, and has created work for migrant labour from poor areas. The constraints to SME development generally are shared by agroindustries and other rural enterprises, and so synergies can be exploited in developing support services by targeting these at SMEs generally rather than agroindustrial SMEs specifically.

- By definition, “viable enterprise” can withstand commercial funding and it is inappropriate to develop enterprise that cannot. As a consequence the use of OCR or other commercial resources for funding agroindustry is not a contention. However, where there is financial market failure donors and governments can address this through the creation of specific financial facilities (loans, equity and guarantees) that assist SMEs or more specifically private agroindustry. There is often a particular need for long-term capital because of the lead-time to full production for agricultural SMEs. The provision of long-term capital should not be subsidised for this reason, rather the terms and conditions of the financing should relate to realistic schedules for the enterprise to repay.

- Support services of various kinds (for example market research and technology development, business development, and information services) have all proven useful in assisting development of rural enterprise including agroindustry. The research generally shows that self-sustaining market oriented services that compete for resources and customers can be more effective than government operated services. Government can sponsor the start-up of such services as a means of overcoming specific market failure and can assure their direction towards SMEs or agroindustry or poverty reduction though the eligibility criteria that are used to allocate resources.

Lessons Learned – Rural Infrastructure

78 Rural infrastructure continues to be viewed by policy makers and scholars as a crucial element of growth and development in impoverished rural areas. At the same time, however, there is awareness that many of the expected benefits of costly infrastructure investments made over the years have not been realised. The preceding review of experiences with rural infrastructure highlights some lessons for practitioners to consider when designing new programs and policies for infrastructure.

79 The first lesson is that institutions matter. The context in which specific programs are carried out has important implications for their success or failure. Particularly important here are governance issues. For example, clearly defined property rights are often an important requirement for well-functioning systems where collective action is an issue such as in irrigation. The continuous management and oversight of projects also requires good governance, not only in terms of financial responsibility and a lack of corruption but also technical competence.
The long-term viability of projects crucially depends on prior planning for their operations and maintenance. One of the key lessons the literature points to is that many projects fail not because of their initial design but rather their lack of sustainability over the long run. In part, this is related to the lack of consideration given to long-term financing for maintenance and repairs, a problem particularly associated with collective goods such as roads and irrigation systems where it is hard to charge individuals for use. While giving more local control over fee collections and maintenance may help with compliance and financing, this may not be the solution for very impoverished communities that do not have the financial resources to invest in infrastructure upkeep.

Many of the potential problems associated with infrastructure projects such as upkeep, willingness to continue to use and pay for services, appropriateness for the community, etc. can be made easier by promoting participation by beneficiaries and stakeholders. Not only is such participation linked to more suitable designs of projects but also is associated with better cost-recovery and sustainability. With respect to cost recovery and willingness to pay, there is often far greater willingness to pay on the part of rural peasants than often assumed. However, this also depends on the quality of services and the expected benefits. For this reason, dialogue with beneficiaries is important so that they know what to expect realistically from services. Some projects, for example, solar home systems have foundered when the unrealistic hopes of consumers were frustrated and they did not continue to use the systems. Another consideration is the definition of stakeholders. While the experience with local management boards such as for roads or water systems has often been positive, identifying a broad set of those affected by policies may be useful for avoiding problems of competing claims and satisfying many interest groups. Social capital, or the bonds of trust in a community and experience with acting in concert, is also linked to better outcomes of infrastructure systems. Where such ties do not exist, project designs that includes ways of building up community or user linkages and participation are important for policy makers to consider.

At the same time, participation is not a cure-all. One of the downside risks is that local élites or other vocal groups will capture projects and their benefits. Because political action and “voice” are often exercised by those who are politically well connected or have the skills and habit of engaging in such behaviour (usually the better educated), decentralisation and devolution of power to local levels may shut out the dispossessed. In this case, impoverished rural groups may not be the beneficiaries of infrastructure investments.

Soft infrastructure, particularly access to credit and agricultural extension services, appears to enhance the effectiveness of investments in hard infrastructure. Because peasants often are unable to afford the initial costs of infrastructure or the equipment it requires (such as connection fees, machines or appliances), credit can be an important tool for bringing new clients online. Also, where rural infrastructure can help increase productivity or access to markets, peasants may need training in areas like use of new seeds and the application of fertiliser or may require marketing advice. Developing these kinds of services or figuring out how to link existing ones with infrastructure projects needs to be considered when designing projects.

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Finally, but not least, policy makers should increase their focus on the social impacts of infrastructure. While the evidence shows that timesavings, education, improved health, environmental improvement, skill development, capacity building, increased information and gender factors are all impacted on by infrastructure the research in this area remains weak. Greater investment in monitoring and evaluation of social impact is desirable because it will demonstrate scientifically a greater aggregate impact for infrastructure development than the simple economic impact. This in turn will influence decision-making more in favour of the disadvantaged and contribute to the justification for investment using commercially priced funds.

Lessons from the Study Tour

As hoped, the study tour led to several useful ideas for further consideration by LGOP in future planning of poverty reduction in PRC. Specifically, the study tour participants conclusions were as follows.

- In PRC there has long been an income index to define poverty. This index is suitable for the phase that solves the needs of food and clothing, but the value is limited. PRC could learn the “Basic Needs” strategy from Philippines. It is suggested that PRC should consider establishing broader, more comprehensive and composite poverty reduction targets and relevant indices when working out the 21st Century Poverty Reduction Plan consistent with PRCs own societal goals and compatible with international standards.

- Greater attention could be given to publicisation of LGOP activities. Pamphlets, a yearbook and a PRC Poverty Reduction website are ideas to consider. LGOP could issue regular information on poverty status, poverty reduction projects (internationally and domestically sponsored) and could use the information base to help secure new investment in poverty reduction.

- It is suggested that LGOP should orientate the use of poverty reduction funds’ increasingly to market principles. Interest rates should be liberalised and microfinance organisations should be free to lend at higher interest rates than for commercial credit in recognition of the higher costs. For the infrastructure projects where the beneficiaries are clearly identified (for example: in irrigation and electricity projects) recovery mechanisms for principal and interest should be considered.

- LGOP should formulate a general poverty reduction programme in accordance with the State Developing Plan that in turn would be implemented though different project initiatives. In specific projects, developed over time, greater civil society, NGO, private sector and beneficiaries’ participation in project design, implementation and supervision should be developed.

- The present PRC poverty reduction programme is worked out by county. This often reflects the country cadres’ wishes rather than being based on an analysis of the actual needs of the poor. New working methods should be introduced to consult with beneficiaries and assist them to analyse their status and needs to achieve better results through self-education and capacity building.
Government should ensure the agriculture departments have enough funds and energy to provide proper agricultural extension services including farmer training, on-farm advisory services and continuous capacity building for extension agents.

Urban poverty issues cannot be ignored. World Bank, ADB and some international institutes would like to develop the collaboration in urban poverty field, but there is no relevant department in PRC. It suggested that urban poverty reduction is incorporated into State Poverty Reduction Plan, managed by LGOP.

It was observed that ADB was most interested in collaborating with PRC on poverty reduction, particularly at the provincial level. It is necessary to continue to deepen the understanding in LGOP of ADB procedures and policies in order to take advantages of this intention. There are many options for use of OCR funds, particularly in combination with softer resources.

The Role of the Leading Group Office for Poverty Alleviation and Development

Examples of the key roles that LGOP could play in the future include:

- redefinition of poverty and the income poverty line to address the shortcomings in the present definition;
- development of indicators for the wider definition of poverty and development of poverty measurement techniques that help to capture the status of poverty in relation to the wider definition;
- piloting of new funding mechanisms and sources that can supplement budgetary resources and may in due course justify the more rapid reduction in relative poverty through the greater and more efficient application of such resources;
- pilot and in due course roll out more sustainable designs for poverty reduction, particularly in the areas of rural finance and microfinance;
- the development and replication of the means for better targeting and impact of poverty reduction funding involving policy measures, organisational systems and sectoral guidelines for better project design;
- foster better governance at the provincial and sub-provincial levels in the use and management of poverty reduction funds from both government and other sources; and
- a role in the overall management of any new funding mechanisms adopted nationally.

These roles can be integrated with ODA country assistance strategies for poverty reduction on an agency by agency basis, helping programmes to be
government rather than donor driven, while specific design lessons from international experience\textsuperscript{20} can be incorporated into the government’s own projects.

88 With the end of the 8/7 Programme, LGOP has been defining its priorities for a new Poverty Reduction Programme (2001-2020). This is due for approval in December 2000 and will be implemented under four successive five-year plans. While still to be confirmed the indications are that that programme will involve:

- adopting of a new rural poverty line focussing on the poorest 10 percent of the population;
- focussing the poverty reduction work in 22 poverty blocks\textsuperscript{21};
- reforming the microfinance component of the poverty reduction policy to directly target poor families rather than township and village enterprise where poor people work;
- broadening the participation of the private sector and NGOs in the poverty reduction activities;
- mainstreaming poverty reduction efforts in the Western part of PRC by focusing investment in western PRC and intensifying East-West poverty reduction cooperation and improving geographical equity\textsuperscript{22};
- special poverty alleviation programs for ethnic minorities including voluntary resettlement of core poor in mountainous and other areas with little development potential;
- addressing emerging urban poverty caused by enterprise restructuring, and increasing migration; and
- reform the social protection system (particularly pension and health insurance as well as labour market policies) to be more inclusive and target better the rural and urban poor.

89 These priorities represent significant new thinking in LGOP’s approach and offer many opportunities for ADB participation.

**Opportunities for Bank Participation**

90 The present PRC approaches to poverty reduction through the subsidised lending programme, the food for work programme and the development funds

\textsuperscript{20} See paras 23 - 30 of appendix A5 “International Poverty Reduction Approaches and Experience”

\textsuperscript{21} These 22 development blocks (sometimes crossing provincial boarders) comprise various counties in geographically remote areas such as the Yimeng Mountains, the Jinggangshan Mountains, the Dabieshan Mountains and the southwest Fujian Mountains.

\textsuperscript{22} Under this program, richer provinces, cities, ministries and companies in coastal PRC form partnerships with poorer provinces in the west. For example, partnerships exist between Beijing and Inner Mongolia, Tianjin and Gansu, Shanghai and Yunnan, Guangdong and Guangxi, Jiangsu and Shaanxi, Zhejiang and Sichuan, Shandong and Xinjing, Liaoning and Qinghai, Fujian and Ningxia, and Ningbo and Guizhou. Between 1996 and 1999 these 13 eastern provinces and large cities funded 1.64 billion and RMB 20.6 billion have been invested in 4,146 commercial projects.
programme cannot currently be supported by ODA funding because of issues concerning transparency, targeting, sustainability and the price of ORC funds.

91 ADB’s present approaches to poverty reduction through indirect mechanisms (such as the credit lines to ABC and trickle down from large infrastructure projects) and direct mechanisms (such as the introduction of poverty components into economic growth projects exemplified in the Shanxi Roads Project) have some merit within the present country programme and have an impact on poverty.

92 However, there are limits to the impact that can be had through these mechanisms and the proportion of funding impacting on poverty is small in comparison to the overall lending to PRC. New approaches, based on ADB’s comparative advantages and the willingness of the PRC government to borrow at ORC rates for certain types of project need to be considered.

93 Although it can be argued that methodological changes and the consideration of wider benefits (including quality of life benefits) can justify the use of OCR funds for poverty reduction, the initial indication is that these arguments may not be sufficiently persuasive for the PRC government to agree to large scale borrowing for poverty reduction, even though many other governments have found ways to utilise them23 24.

Comparative Advantages of ADB

94 The overall comparative advantages of ADB go beyond the provision of OCR funding. In summary, they are:

- it can engage the PRC Government in policy dialogue to facilitate changes that adopt, as proven, such new ideas and approaches;
- it can provide funding, additional to budgetary allocations, to facilitate the development of new ideas and approaches on a pilot basis and over the long term for the development of public goods, albeit at OCR rates;
- ADB funding, when used strategically, can be used to crowd in domestic resources to poverty projects;
- ADB funding, when used strategically, can be used to leverage in the resources of other external partners, public, private and civil society; and
- it can provide technical assistance funding on a grant basis to assist in design and implementation, bringing to bear its vast experience and the experience of the consultants it engages.

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23 See appendices A3 and A4, paras 31-80 of appendix A5 and paras 107 – 109 below for examples.
24 It should be noted that in PRC the World Bank and other donors have hitherto used soft funds for poverty reduction, and while lessons can be learned from the methodologies (these are embodied in the overall approach to poverty reduction advocated in this report), new mechanisms need to be found if OCR resources are to be used by ADB (and the equivalent IBRD resources are to be used by the World Bank).
95 ADB also has advantages relative to the government and bilaterals and some multilateral agencies. Specifically:

- provided there is government consent, ADB projects can be used as an arena for testing policy and implementation mechanisms without the need for these to become policy at the outset;

- ADB projects can be used to introduce policy changes that might otherwise be difficult for the government (for example non-subsidised lending);

- ADB’s resources and experience are far greater than that of any of the bilaterals, and can be used to develop larger scale projects or roll-out the successful models developed by others;

- bilateral assistance is mainly technical assistance and ADB’s greater range of services (policy dialogue, funding and technical assistance) mean it can be more effective in carrying forward new ideas at both the policy and project level25;

- ADB has advantages over some multilaterals, such as UNDP that is mainly a technical assistance organisation sponsoring small-scale projects without funding on a scale needed for roll-out.

Policy Dialogue

General Principles

96 ADB can engage the PRC government in policy dialogue on the lessons from aid effectiveness research and how to apply these in the PRC context. The most important of these is that poverty reduction funding is of greatest value where there is good governance and in particular where local governance is committed to effective targeting, maximising coverage and minimising leakage26.

97 Traditionally, good governance has been fostered at a national or sectoral level through seeking agreed policy reforms, often directly linked to funding through tranching. While there are many successes, it is good governance at the local level – provincial, county and township – that will have the greatest effect on the success of poverty projects.

98 The overall approach should as far as possible utilise the characteristics of successful poverty reduction projects27. ADB can play a significant role in bringing to bear the concepts, approaches, design and feedback lessons that lead to the principles, in its own projects and in the Government’s poverty reduction programmes. Its evolving relationship with LGOP provides the best possible platform to affect this.

25 It should be noted that bilaterals to some extent overcome this by setting up rountables and working groups that involve many donors and thus capture policy maker’s attention, such as the CIDA Microfinance Rountable.

26 See para 98 of appendix A5 “International Poverty Reduction Approaches and Experience”

27 See para 14
99 At a national or provincial level it can promote the use of these approaches, including the development of overall strategies such as SIFs or CDFs. With regard to multisectoral approaches there is the opportunity for policy dialogue about the SIF and CDF approaches where the framework is designed to apply all of these principles and the opportunity is present for combining funding resources either through blending or by applying different resources to different components. These approaches allow more than just pro-poor growth to be addressed because they cover all sectors. ADB need not necessarily fund all sectors with OCR resources, but can participate in design and TA across all sectors and in the syndication of the funding, itself a critical task.

100 Within specific subsectors, particularly where ADB is involved in financing, policy dialogue can also help to improve poverty reduction. Some specific examples are set out below.

- In microfinance, the focus of policy dialogue should be on:
  - creation of a policy, legal, regulatory and supervisory framework for microfinance. This is likely to be possible only on an incremental basis, given the current government position that such an environment is not required. The initial focus of policy dialogue in this area should be the legal status of the pilot microfinance projects already existing in PRC, coupled with the necessary regulation and supervision regime under which such microfinance programmes should be covered.
  - interest rate deregulation for microfinance programmes and re-focusing microfinance on providing financial services to the working and near poor rather than using microfinance as a method for disbursing funds for poverty reduction. A shift from a poverty reduction approach to a financial systems approach, at least for those areas that do not have a high population of absolute poor, will bring benefits in terms of improved market functioning, increased financial intermediation, improved efficiency in the use of financial resources including the mobilisation of domestic resources, and reduction of the drain on government funds. It will free up resources for application to absolute poor populations, which can be approached on a welfare basis if appropriate.
  - the participation of NGOs and other non-bank financial institutions (NBFIs) in microfinance. This can be addressed through the linking of NGO microfinance programmes with large financial institutions, while at the same time maintaining a link with the donor through its provision of technical assistance and/or funding.
  - the development of urban microfinance schemes to address the emerging urban poverty problem;

See paras 111 - 129 for details.
• adoption of microfinance international best practice in the government’s own poverty reduction programme 29.

• For voluntary rural mobility the dialogue should centre on:

  • the rationale for government assisted voluntary rural mobility in PRC and the uniqueness of the circumstances that result in this being the government’s logically chosen last resort option for many of PRC’s remaining absolute poor;

  • settler selection characteristics and the need to cater for those left behind as well as those who migrate;

  • easing the acquisition of land for settlement and ensuring the tenure of settlers on a permanent and hereditary basis and using land title as collateral for loans;

  • ensuring that there is adequate physical and financial capital for settlers and that obligations for repayment of any loan capital in cash or kind are clearly understood by settlers in advance;

  • ensuring that settlers can become registered households so that they can gain equal access to social services, particularly education for their children, and

  • the introduction of best practice guidelines 30.

• in agroindustry and rural enterprise development, the policy dialogue can address the systemic structural issues inhibiting economic growth and employment creation including:

  • improvements to the enabling environment for SME development;

  • initiatives to improve the management of SMEs (TVEs) in order to assist them to become more market oriented, including how best to increase the numbers of viable SMEs, create new jobs in SMEs, develop their management capacity, foster co-operation with larger enterprises, and increase technology uptake;

  • acceleration of the process of SOE reform and the reduction in SOE budgetary funding to free-up greater resources for poverty reduction 31.

• in rural infrastructure, the dialogue could centre on:

  • increased private sector participation and financing and the associated institutional and regulatory reform measures that can help to achieve this;

29 See Chapter 3 for a detailed explanation of the agenda.
30 See Chapter 4 for a detailed explanation of the agenda.
31 See Chapter 5 for a detailed explanation of the agenda.
• increased community participation in rural infrastructure projects to increase ownership and sustainability;

• improving the impact of workfare programmes for the poor, and particularly on concerns about wage rates, labour intensity, participation on programmes and the use of “labour tax”;

• developing and applying research findings on poverty impact measurement to the national strategy, bearing in mind that many governments have accepted either on the basis of project evaluation methodologies or the aid effectiveness research that rural infrastructure development (even in social sectors) can have high returns that justify OCR funding, measurement and analysis in the PRC context being a step towards this conclusion for PRC 32.

Funding

OCR Funds at the Policy Level

101 OCR funds have been used at the policy level for three main types of intervention:

• structural adjustment where national level funding is linked to economic liberalisation, often with detrimental affects on poverty because of its failure to compensate for worsening terms of trade for the poor and its impact on social sector spending through increased debt service;

• programme lending where general budgetary support ostensibly “buys” policy reform on a sectoral basis;

• sector specific policy reforms support that combine project funding of various types with specific conditionalities (for example apex credit lines linked to financial sector deepening and capacity building).

102 Generally, these types of intervention have indirect impacts on poverty, both positive and negative 33.

OCR Funds at the Policy and Project Level

103 There have also been hybrid policy/project interventions such as SIFs and the recently piloted CFD approach where existing government programmes are supported initially and “transformed” during the project life to be focused on successful poverty reduction measures 34.

32 See Chapter 6 for a detailed explanation of the agenda.
33 See para 17 and following box of appendix A5 “International Poverty Reduction Approaches and Experience”.
34 See paras 88 - 106.
OCR Funds at the Project Level

OCR funds can be used in three ways to support poverty reduction projects: directly, indirectly, and in parallel. In this context,

- “directly” means that OCR borrowings are used to fund poverty reduction projects or poverty reduction components of projects;
- “indirectly” means OCR borrowings are used to fund projects that foster economic growth, with the growth in turn having income, employment and quality of life impacts on the poor, along with others who also benefit from growth (“trickle down”);
- “in parallel” means that OCR borrowings are used “indirectly” for poverty reduction by funding projects that foster economic growth but with conditionality that crowds in or leverages in “direct” funding for poverty reduction projects.

The concept of “parallel” financing developed here combines the benefits of both “direct” and “indirect” funding giving greater impact on poverty and allows ADB to bring to bear all aspects of its comparative advantage in a single and very versatile approach. It is distinct from approaches yet tried, but applies all of the lessons of aid effectiveness and addresses the priorities of both the PRC Government and ADB.

Hitherto, the “direct” approach has been preferred by many advocates of ADB’s increased emphasis on poverty reduction. The advantages of the direct approach are:

- the impact on poverty, if measured, is transparent;
- good targeting can address issues of access, equity and income distribution;
- there are finite benefits in terms of natural resources, access for the poor to financial and physical assets, and (for certain types of projects) clearly developed social and human capital;
- fund diversion can be minimised.

The principal constraints (in the PRC context) are that:

- the foreign exchange risk premium may be passed down on a “guestimate” basis to those who are least able to manage it (the poor), and effectively remains unavoidable and unmanaged;
- the use of funding at market rates is difficult to “sell” because of perceptions about the need for subsidies, principally through the interest rate;
- poverty components of otherwise economic growth projects are “captive” to the wider project (for example feeder roads to a highway), there are difficulties in addressing poverty holistically and targeting is difficult;
the poverty components of individual projects have to be individually negotiated in a time consuming process in which ADB and the government respectively try to maximise and minimise the size of the components; and

where blended funds are used (for example where ADB may work with another ODA agency such as the International Fund for Agricultural Development (IFAD) to merge OCR funds with lower cost funds), project designs are often weakened to accommodate all agendas.

108 Nevertheless, there are specific opportunities for direct funding for ADB’s OCR resources as demonstrated by the use of OCR funds in other countries and in PRC.

109 “Indirect” funding has the advantages that:

• the goods and services (for example financial services) funded are able to transparently afford market rates of interest with the decision making being primarily based on financial rate of return criteria with economic analysis normally demonstrating additional benefits;

• there are finite benefits in terms of natural resources, access for the poor to financial and physical assets, and (for certain types of projects) clearly developed social and human capital; and

• the end user prices of the public (and private) goods financed can generally be adjusted to take account of foreign exchange risk and inflation.

110 The main constraints are that:

• the impact on poverty is not transparent and is more difficult to measure;

• issues of access, equity and income distribution are difficult to address because the linkage with poverty reduction is weak; and

• the focus of such projects is generally area based, and it is difficult to address the greater complexity of poverty at the individual or household level.

111 There are specific opportunities for both direct and indirect ADB support for poverty reduction projects, particularly in conjunction with measures that address the constraints.

Opportunities for Direct Funding Use of OCR

112 In general, the use of OCR funds needs to be justified by the return on the investment. In PRC the present perception is that financial returns should be high, relatively short-term and that full cost recovery with interest including any premium to cover market and foreign exchange risks should be achievable. It is for these latter reasons that hitherto OCR resources in PRC have been concentrated on infrastructure investments, such as expressways, where the financial returns to the “project” are highly tangible and can be adjusted to respond to market changes (for example variable interest rates, fluctuating foreign exchange rates and inflation) so
that there is a reasonable degree of certainty that the above criteria for OCR use can be satisfied. This said, official development agencies, notably the World Bank and other governments believe that there are opportunities to use OCR funds directly for poverty reduction.

### Multisector Opportunities Combining Policy and Project Support

#### Social Investment Funds (SIFs) 35

113 SIFs are multisectoral projects, generally using a mixture of OCR and softer funds and TA grants to support on-going and evolving government poverty reduction initiatives. They are complex projects, often working with many implementing agencies to take forward growth, equity and social development objectives at the same time. SIF programmes finance projects in social and economic infrastructure, productive activities, technical assistance and training, and environmental improvement. Most SIF agencies are located outside the government bureaucratic system and enjoy considerable financial and functional autonomy. Typically, agencies are exempt from civil service and procurement/disbursement regulations, maintain protected budgets, and have direct access to external donors and international financial institutions. With respect to the latter, external funding can constitute up to 90 percent of the agency’s budget.

114 SIF agencies do not execute projects. After determining eligibility requirements, operational procedures and the sub-project type menu, the role of the SIF agency is limited to appraising proposals, monitoring the project cycle and ensuring that projects are properly executed. Projects are proposed, designed and implemented by private or public agencies such as local governments, NGOs or community groups.

115 In an effort to ensure that projects are demand driven, many SIF agencies make funds conditional on community participation. Moreover, all SIF agencies require some measure of co-financing from the municipality, NGO, community group or direct beneficiary to cover project costs. Evidence suggests that co-financing and citizen participation increase project ownership and ultimately, the likelihood of project sustainability 36. Void of many bureaucratic delays and largely financed by external donors, SIFs are an attractive means for meeting the needs of the poor without sparking political debates over the reallocation of already strained budgets.

116 One common underlying theme is to use OCR type resources for the productive sector components and softer funds for other components. SIFs have been in operation since the mid 1980s, and by the end of the 1990s had become a cornerstone of World Bank operations with 51 subprojects being approved with a value of over US$ 1.3 billion. The use of OCR resources for SIFs is widespread: in addition to Brazil, Chile and Peru in Latin America an Asian example of how this approach is being applied is the SIF Project in Thailand 37.

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36 See paras 108-109 of appendix A5 “International Poverty Reduction Approaches and Experience”

37 See paras 35-36 of appendix A5 “International Poverty Reduction Approaches and Experience”
The Appropriateness of SIFs for PRC

117 The SIF approach provides a flexible methodology that can be adapted to most economic circumstances, including those of transition in PRC. Despite PRC’s success in poverty reduction, the historical paradigms of subsidised loans, food for work and non-transparent budgetary subvention have been effective more because of PRC’s overall economic growth than because of their efficiency at targeting poverty. To tackle the remaining absolute poverty and address the new challenges, PRC needs new methodologies. These need to take account of:

- the continuing desire to use soft funds where possible and a recognition that hard funds used appropriately can complement soft funding and accelerate poverty reduction;
- the need to test different approaches and a recognition that a much broader spectrum of strategies than the three used historically is possible and desirable during the initial phase strategic revision;
- the need to increase participation in project planning and implementation and recognition that greater stakeholder commitment will lead to greater sustainability.

118 SIFs have these characteristics. The Thai SIF\(^{38}\) (which is the only extant model in Asia) provides an illustration of what could be implemented in PRC covering as it does support for employment creation and skill training programmes, development of basic social services, development of small-scale rural infrastructure and the financing of community projects. In the PRC context the components of SIFs would be the OCR project interventions identified in Chapters 3 to 6 of this report plus other soft funded interventions as required.

Management Structure and Funds Flow for SIFs

119 There are significant similarities between typical SIF agencies and LGOP, although the latter is not free of government bureaucracy, but not between SIF operations and the current programmes operated by LGOP. There is certainly potential for piloting a SIF type approach with LGOP, using FCPMC as the SIF Agency, preferably at a provincial level where many of the difficulties of obtaining national consensus would be reduced. Blended funding from a strategic partner for ADB would assist in giving the necessary broad sectoral coverage.

120 Figure 2.1 illustrates how this idea would work in practice. In summary, donors and the government will pool funds into a SIF fund managed by a SIF agency, in this case FCPMC. FCPMC would be responsible for appraising proposals, monitoring the project cycle and ensuring projects are properly implemented. FCPMC would also be responsible for ensuring that cofinancing was available from SIF projects from governments, NGOs or communities. Funds would flow from FCPMC to the organisations designated to implement SIF components on loan terms and conditions similar to those on which it obtains funds plus a margin to cover SIF agency operating costs for FCPMC.

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\(^{38}\) See paras 35 and 36 of appendix A5 “International Poverty Reduction Approaches and Experience”
Comprehensive Development Frameworks (CDFs)  

Another multisector opportunity is the CDF approach of the World Bank. CDF takes a holistic approach to poverty reduction. It aims to improve policymaking through greater recognition of the interdependence of the social, structural, human, governance, environmental, economic, and financial development. The CDF principles that are a means to greater effectiveness in reducing poverty are:

- ownership by the country, with the country, not assistance agencies, determines the goals and the phasing, timing, and sequencing of the country’s development programmes;
- partnership with government, civil society, assistance agencies, and the private sector in defining development needs and implementing programmes;
- a long-term vision of needs and solutions, built on national consultations, which can engender sustained national support; and
- structural and social concerns treated equally and contemporaneously with macroeconomic and financial concerns.

CDFs are currently being implemented in thirteen economies in the form of pilots: Bolivia, Côte d’Ivoire, Dominican Republic, Ethiopia, Eritrea, Ghana, Jordan, Kyrgyz Republic, Morocco, Romania, Uganda, Vietnam, and West Bank and Gaza. Their diversity emphasises that the CDF approach is relevant to all countries and that there are no set criteria other than that government and partners embrace the concept. Jordan, Kyrgyz Republic, Morocco, Romania and Uganda do not have access to IDA (soft) funds for implementation.

In Asia, the Vietnam Government is working with donors and private businesses and NGOs to implement key principles of the CDF. Vietnam is well suited
to CDF partnerships because it has a growing portfolio of small and uncoordinated donor-financed programmes and the government, while retaining ownership of the development agenda, has also expressed interest in embarking upon a more systematic dialogue with the donor community.

124 The experimental implementation of the CDF approach has begun in health and transport and agriculture in Vietnam. In the health sector, donors, NGOs, and government are working together to study constraints, agree a common strategy, and move toward allocating tasks more coherently. Supporting the government’s new rural thrust, donor-government groups will design strategies to address the needs of the poorest 1,700 communes and implement a 5 million hectare afforestation programme. The CDF Consultative Group will be extended to non-government stakeholders and joint working groups will deal with the environment and governance and the issues of analysing and sharing information over public expenditure, budget data, and donor programmes.

**The Appropriateness of CDFs for PRC**

125 The CDF approach also provides a flexible methodology that can be adapted to most economic circumstances, including those of transition in PRC. CDF is not a blueprint, but a compass that reflects the growing convergence of views on an approach to development. Using the CDF approach can have all the advantages of SIFs\(^43\) and will allow:

- PRC to drive the development agenda while building stronger partnerships to support its efforts in reducing poverty;

- development of a convergence to a consensus about approaches that will enhance coherence, facilitate better understanding among partners and enable more effective support for poverty reduction;

126 This model is appropriate for consideration in PRC, both at national and provincial level, and can draw on the growing Vietnamese experience which will be most relevant because of the similarities between the structure and governance entities in the two economies as well as the increasing body of documented experience from other countries participating in CDF pilots.\(^44\)

127 There are significant similarities between typical SIF agencies and LGOP, although the latter is not free of government bureaucracy, but not between SIF operations and the current programmes operated by LGOP. There is certainly potential for piloting a SIF type approach with LGOP, using FCPMC as the SIF Agency, preferably at a provincial level where many of the difficulties of obtaining national consensus would be reduced. Blended funding from a strategic partner for ADB would assist in giving the necessary broad sectoral coverage.

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\(^43\) See para 120.

\(^44\) This is thoroughly documented and regularly updated on the World Bank web site at www.worldbank.org
Management Structure and Funds Flow for CDFs

128 Figure 2.2 illustrates how this idea would work in practice. In summary, the government, donors, the private sector and NGOs will form a CDF Consultative Group to work on the overall development agenda and poverty reduction targets, with Working Groups also formed to deal with specific project formulation or policy intervention. LGOP is a logical choice for the CDF co-ordination agency that would organise the consultation process and monitor and report on progress and outcomes of CDF components. CDF components would be implemented by donors or government or the private sector of NGOs in the normal way following the usual management and funds flow procedures of each participant. In addition to SIFs, there are examples of different possible components of a PRC CDF in Chapters 3 to 6.
The Benefits and Risks

129 The benefits of SIF and CDF type projects is that they are flexible in implementation and contain a high degree of "plan as you go"; they can address policy concerns; they support and enhance government programmes rather than set-up donor-driven projects; they provide a framework for a wide range of public-private sector partnership to function; and they recognise that blended funding is sometimes required for soft sectors and provides a vehicle for funding partnerships.

130 One main risk is sometimes perceived as being that such programmes do not make a coherent whole, however nor do most projects. One of the underlying intentions of this approach is to make progress on many fronts with many agencies and partners in pursuit of the reduction of different aspects of poverty. Provided that there are targets for each component (and these can be income, or literacy, or child mortality, or any appropriate indicator of poverty) the progress is measurable and the funding is available to make the measurement, the risk in this regard is no different from the normal project risk that targets will not be achieved. Risks associated with the non-achievement of targets within components are the normal risks of implementation delay, cost over-run, lower than expected uptake of technology or services, and so on.

131 Although it is now recognised that “plan as you go” methodologies are more effective than “blueprint” ones, donor agencies have often been uncomfortable with this. However, SIFs and CDFs support particular components of public spending and the poverty reduction impact is transparent. The World Bank has recognised that the “plan as you go” approach has many advantages and donors can in some ways perceive it as being similar to a credit line where subprojects are financed in response to demand, but are also subject to scrutiny.
Sector Specific Opportunities

Direct Lending for Components of Projects

132 There are many examples of OCR funding being used for poverty reduction components of projects. In fact, given the poverty reduction objectives of all ODA, this is an increasingly given fact for all countries that borrow OCR. It will, presumably, apply to PRC for World Bank borrowings from 2000 when IDA resources are no longer available. In some countries hard and soft funds have been blended by the World Bank and supplemented by government resources. Such countries include India, Indonesia, Kyrgyz Republic, Moldova, Nigeria, Pakistan, PRC, the Caucasian countries and some Caribbean islands. Blending offers the opportunity to use OCR resources for productive components: agricultural production, agroindustries and rural enterprise, SME development and infrastructure that can generate cost recovery, while using softer funds from other sources for social sector components. Effective strategic partnership with other donors is again an important consideration.

133 A few recent examples of 1999 loan approvals include:

- in Argentina where US$ 40 million of IBRD resources will help to provide 70,000 low income rural households with electrical power using renewable electrical technologies, without subsidy and with private sector management;
- in Bulgaria where US$ 5 million of IBRD resources will finance 100 microprojects for the poor on a pilot basis;
- in Egypt where US$ 120 million of IBRD resources will reduce crop losses for 700,000 rural smallholders through improved operational and maintenance efficiency of irrigation works;
- in Guatemala where US$ 30 million of IBRD resources will benefit about 500,000 indigenous poor through strengthening community organisations and municipal government and funding of community based social and economic infrastructure and cultural heritage projects.
- in India in the Shivalik areas where blended resources of US$ 85 million from IBRD and US$ 50 million from IDA will benefit more than 1 million people, mostly women through improving management of land and water resources and arresting environmental decline;
- in Malaysia where US$ 244 million will support the development of school and hostel construction and a pilot school-to-work programme for 45,000 children from disadvantaged social backgrounds.

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45 Refer to Chapters 3 to 6 for further details and management mechanisms.
46 See appendix A4 for examples.
47 See paras 4-5 and 13-22 of appendix A5 “International Poverty Reduction Approaches and Experience”
• in PRC where $90 million of IBRD resources are blended with US$ 30 million of IDA resources to directly benefit 250,000 poor families in the Anning Valley through productivity and technology gains;

• in the Philippines where US$ 150 million of IBRD resources will 700 subprojects through credit institutions and microfinance service providers;

134 There will be opportunities of this type on many future ADB projects in PRC, but it must be recognised that the use of OCR resources in this context is concentrated on the "working" and the "near" poor rather than the absolute poor. However, if this crowds or leverages in other financing that addresses absolute poverty, then the approach can be well justified.

The Special Case of Microfinance

135 Microfinance is a special case because it is both sectoral and cross-sectoral. There are numerous examples of self-sustaining microfinance schemes that operate along prudent banking lines and fund themselves with resources at OCR rates 48. Microfinance offers a means for PRC to develop sustainable financial services for the poor and to conserve and redirect the very substantial resources lost each year through poor credit discipline and loan recovery under the subsidised loan scheme 49 as well as to mobilise greater domestic savings. The design principles of sustainable and financially viable microfinance schemes are well understood. Donor sponsorship of microfinance initiatives could provide a fresh window to re-establish credit discipline while ensuring better targeting of credit resources for the poor.

136 OCR funds for microfinance can be used to fund components of programmes (using SIF or CDF type approaches) or projects. In the first instance, it may be appropriate to pilot schemes within other projects. This will allow international best practice to be tested in PRC and appropriate design modifications to be made. In the first instance also, on a project-by-project basis it may be necessary to use blended funds because financial viability is only achieved with lending volume, and this needs to be prudently built-up over time. Microfinance would need to be delivered through Microfinance Organisations (MFOs) that would be extensions of the outreach of ABC and RCCs 50.

137 On a sectoral basis, microfinance can be used to fund producers for agroindustry and can be linked to agroindustrial and rural enterprise development initiatives. There are examples of its use for the development of community infrastructure and small-scale productive infrastructure or the equipment needed to obtain economic benefits from it (for example water pumps or electrically driven tools). A special case would be the provision of microfinance for migrants in voluntary resettlement schemes or migrant workers, perhaps combined with starter grants in the way the India’s artisanal development programmes work 51. MFOs

48 See appendix A3 for details of some examples.
49 Recovery rates on about US$ 1.2 billion per year are on average less than 60 percent. The interest rate on the funds disbursed is 3.00 percent results in a complete lack of sustainability.
50 See Chapter 3 for a summary and appendix A8 for a fuller explanation of the pros and cons of ABC and RCCs as participants in a microfinance delivery system.
51 See paras 58-66 of appendix A5. “International Poverty Reduction Approaches and Experience”
could also provide social insurance loans to help overcome vulnerability to relapse into poverty for those affected by natural disaster or ill-health provided recovery is possible and to assist in the development of urban enterprise.

138 At a different level, the government of PRC and ADB may wish to consider the establishment of a “Microfinance Fund” (MFF). The fund could provide a vehicle for substantial OCR lending without the need for a project-by-project approach. Such a fund might follow naturally from some pilot experiments, and could be used to roll-out not only ADB sponsored pilot schemes, but successful NGO and government schemes where there are insufficient resources to replicate otherwise successful projects.

139 A fund such as MFF would be an independent, fully financially self-sustaining organisation. It would act as a clearinghouse for start-up funding for MFOs, provide funds for on-lending and technical assistance services for MFOs and their sponsor's organisations.

140 MFF could attract donor loan funds and onlend to its members. Onlending would be at a market interest rate sufficient to ensure the full financial self-sufficiency of the in the medium term (within three years of commencement of operations). Loans would be short to medium term, generally coincident with the terms of the micro-lending programme undertaken by the member organisation. Loans would be to the member organisation, not to its clients.

141 In advocating this type of approach it is important to bear in mind that while the 8/7 programme in PRC is focused on the very poor and many of the more intractable problems of remote geographic location and social and economic exclusion, there are still some 106 million poor with income of less than US$ 1 per day and many other poor. In these segments are the working and near poor who have the potential to take control of assets and earn their way out of poverty.

Crowding in Domestic Finance for Poverty Reduction

142 On a sector by sector basis there are potentially good opportunities to crowd in domestic finance for poverty reduction. Analysis of PRC’s poverty reduction programmes shows that the competing demands on local government at all levels to raise revenue, stimulate economic growth and reduce poverty often result in poverty funds being diverted to other uses or in their having little additionality in terms of poverty reduction funding.

143 An example of such a project in the infrastructure sector is the ADB’s Shanxi Road Project. This project that began as an expressway project has expanded to include the upgrading of provincial and country roads. ADB is making a US$ 250 million loan from its OCR resources, primarily for 176 kms of expressway. During project design it was found that the provincial budget allocations for expressways had been increasing rapidly between 1996 and 1998 and that the budgetary support to countries for road development had been decreasing equally rapidly. To reverse this trend the final project includes a further 101 kms of provincial and country roads to the expressway interchanges and 317 kms of country roads to link the transport system to poor townships. Although very little OCR funding will be used for the provincial and country roads (about 2 percent), the provision of budgetary funds by
the province for their development is a good example of crowding in of domestic finance to increase the impact of OCR funding on poverty. The more integrated road network will extend the benefits of better communications to the poor resident in the area. Similar developments are expected with other transport infrastructure that impacts on poverty areas. These include, for example, the Guangxi Highway Development Project which is developing a road between Nanning and Youyiguan in support of poverty reduction and minority development in these areas and the Hefei Xi'an Railway Project that will reduce poverty in the transport corridor.52.

144 For most infrastructure projects (roads, railways, ports, irrigation, telecommunications and electrification) in PRC funded by ADB there will this type of opportunity to crowd in finance to benefit poor areas or poor sections of society in this way, and it would be a useful policy adjunct to actively seek out this type of component on each occasion. The main constraint, and it must be addressed, is the origin of the additional local funds. If, for example, the additional road funding comes from the provincial health or education budgets rather than a reduction in the expressway funding budget, then the net effect on poverty of this approach is in doubt. This approach also suffers from the other constraints of direct lending for poverty components, does not influence policy or governance, and does not address the wider issues and causes of poverty thus to some extent impoverishing its impact. In the Shanxi case, an expansion of the provincial funding commitment to other types of rural infrastructure and even other sectors would have brought greater impact.

**Benefits and Risks**

145 The main benefit of direct lending for components of projects and microfinance are that the poverty linkage is transparent and can be measured. Direct lending has the advantage that in each project or component the poverty reduction objective can be clearly stated (in terms of income or a quality of life factor) and progress towards targets can be measured. There is also a high degree of accountability with direct lending because loan covenants can be used to require particular actions of the borrower and compliance can be checked. Conventional monitoring and evaluation mechanisms are also established features of direct lending and there is relatively little reluctance on the part of donors to spend TA resources on measurement.

146 Because of fungibility, there will always be an issue of whether or not the investment is actually additional to the investments the government and/or the private sector would have made in any case. The normal risks associated with the

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The goal of this Project is to promote economic growth in poor interior provinces to raise living standards and reduce poverty. This will be achieved by providing railway infrastructure that facilitates economic transportation of goods and people, and improve access of the poor to employment opportunities and income generation activities. The project scope comprises (i) construction of a 954 km single-track, standard-gauge railway between Hefei and Xi'an, including subgrades, bridges, and tunnels; (ii) laying of railway track; (iii) construction of 52 new railway stations; (iv) electrification of the 407 km Xi'an to Nanyang section; (v) provision of modern technology and equipment for signaling, telecommunications, yard operation, and mechanized maintenance of track; (vi) training of staff; (vii) environmental protection and mitigation of adverse environmental effects; (viii) land acquisition and resettlement of affected persons; (ix) consulting services for design, construction supervision, environmental monitoring, and monitoring of resettlement; and (x) institutional strengthening of marketing and business development capabilities.
non-achievement of targets within components such as implementation delay, cost over-run, lower than expected uptake of technology or services, and so on apply to all direct lending projects.

147 The major risks of taking an approach to poverty reduction that rely on components of projects are that the impact of the component will be less than the impact of a “bundle” of interventions for poverty reduction (as there are in SIFs and CDFs) because of the interactions between interventions. For example, if a road project such as the ADB Shanxi Road Project is only associated with the development of other rural roads as opposed to a bundle of rural infrastructure and services which could have greater overall poverty impact. Further, it is more difficult to influence policy through individual components of projects, again potentially weakening poverty reduction impact.

Opportunities for Indirect Funding Use of OCR 53

Credit Lines and Guarantees

148 The primary opportunities for indirect funding using OCR lie in the agroindustrial and rural enterprise sectors. Such funding would rely on “trickle down” mechanisms, and although many aspects of “trickle down” are discredited, the thesis that economic growth needs to underlie poverty reduction stands and the issues are more about access and equity than about the merits of indirect funding. There are several good options. ADB could:

- enter into an agreement in a rich coastal province to fund economic growth projects, with in turn the rich province agreeing to strengthen its “dragonhead” relationship with a poor province or autonomous region though increased assistance of various types: for example through inward investment and increased opportunities for migrant workers (in some instances this would be a special case of the parallel funding concept developed below)54;

- continue to provide commercial bank credit through ABC and other commercial banks for financing agroindustry and rural enterprise in poor areas. ADB’s Second Agricultural Bank of China Project, for example, has the objectives of: providing financial support for the continued growth of rural non-state enterprises located in poor areas with the potential to generate foreign exchange earnings and high direct and indirect employment opportunities55. Revisiting the design to focus on “dragonhead” enterprises that have had demonstrable success in poor areas would be a useful starting point for any successor project. Although commercial credit lines finance the private sector, there is justification for ADB involvement where there is market...

53 Refer to Chapter 5 for more detailed discussion and management mechanisms.
54 Inward investment in western regions of PRC by rich coastal provinces is becoming more common. In 2000, for example, Shanghai Municipal Committee made development plans with leaders in Henan, Shaanxi, Ningxia, Inner Mongolia, Xinjiang, Gansu and Qinghai for more than 500 cooperation projects valued at about 3.6 billion US dollars for infrastructure, ecological protection, resource exploration, tourism, science and education.
55 Asian Development Bank, 1994, “RRP of the president to the Board of Directors on a Proposed Loan and Technical Assistance Grant to the People’s Republic of China for the Second Agricultural Bank of China Project”, ADB, Manila
failure and the availability of long-term foreign exchange resources is valuable under these circumstances;

- consider the provision of broad based SME credit lines that funded non agriculture-related businesses in both urban and rural areas as a countermeasure to the increasing unemployment from rationalising SOEs and the rising urban poverty problem;

- consider the provision of a credit guarantee fund for reforming SOEs committed to privatisation that could offer high returns, be OCR funded and linked to the freeing up of SOE budgetary or loan resources for poverty reduction.

Sector Development Programme Loans

149 Programme lending is essentially budgetary support provided on a tranched basis in response to policy reform implementation. It is possible that OCR funding could be used to support poverty reduction indirectly in this way, if the policy reforms implemented were demonstrated to have an impact on poverty. To the extent that any of the policy reforms advocated in the dialogue for the four sectors considered in this report then that sector loan will have an impact on poverty reduction. In another sense, because money is fungible, programme lending may crowd-in funding to social or productive sector public spending that has poverty impact. However, the poverty linkage with programme lending is difficult to make transparent.

Recycling

150 On a project by project basis there will opportunities for recycling funds into poverty reduction. In both credit line projects and normal project lending to line agencies, funds may be recycled three or four times during the 25 year loan period. On a case by case basis it may be possible to persuade line agencies or provincial governments to recycle a certain proportion of the funds into poverty reduction. However, the same caveats apply as in the Shanxi Roads Project and the funding must be demonstrated to have additionality in poverty reduction terms, that is it must not simply “crowd out” domestic finance that would otherwise have been used for poverty reduction purposes. A case by case analysis is needed because it may in fact be more sensible to recycle funds into parallel or challenge funding mechanisms where the linkages become more transparent rather than recycle them directly into local government poverty reduction budgets.

Benefits and Risks

151 The main advantage of indirect funding in the context of PRC is that there is less resistance to the use of OCR resources. In the case of agroindustry and SME credit lines the approach is beneficial because it funds viable (and thus self-sustaining) enterprise. Ensuring poverty reduction benefits is less easy, but selection of good criteria for enterprises to be funded can significantly increase the chances of successful impact.

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56 See para 98 for the agenda
57 See Chapter 5 for details.
152 It is difficult to focus the programme lending approach on poverty reduction other than through the general level of public spending in particular sectors, and single or multi sector SIFs and CDFs would be more effective because while they also provide budgetary support, they support specific poverty reduction activities not the general level of public spending.

**Parallel Funding**

153 Parallel funding aims to capitalise on the advantages of both direct and indirect approaches and accepts the disadvantages in the context of poverty reduction because of the recognition that economic growth remains essential to create the overall environment from which the poor, given access, can benefit.

154 There are three main types of funding that are worthy of consideration. All have the same characteristics. They all recognise that there are budgetary constraints on poverty funding and use OCR resources to supplement these resources in an indirect way. The funding is used for public goods (or private goods where there is market failure that justifies one time intervention to correct the failure) that can absorb OCR costs and respond to pricing risks. It replaces existing budgetary commitments, with the existing commitments being freed-up to invest in directly funded poverty reduction. This approach merits serious consideration because of the findings of recent World Bank aid effectiveness research that show that for every US$ 1 of aid there is only 11 cents of additional funding for poverty because aid crowds out government funding. Mechanisms that crowd in government funding, even if it is funding that has “leaked” from poverty reduction budgets have potentially high rewards. In the case of PRC where targeting and leakage problems are severe within the existing programmes, parallel funding offers an alternative and potentially more transparent means to assure the delivery of poverty reduction funds.

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58 See para 98 of appendix A5 “International Poverty Reduction Approaches and Experience”
155 The three types are:

- “substitution”, where OCR funds directly replace existing commitments to public goods and the resultant savings are applied to direct poverty reduction efforts;
- “subsidy swaps”, where OCR funds are used for public goods with the conditionality that subsidies are progressively removed and the resultant savings are applied directly to poverty reduction; and
- “debt swaps”, where debt reduction or amnesty frees up government debt service obligations for poverty reduction.

156 In the case of PRC, “substitution” has the greatest potential applicability. “Subsidy swaps” have potential, if for example the government is prepared to phase out subsidies under the Subsidised Credit Programme\(^59\). “Debt swaps” are not applicable.

157 The diagram below shows how ADB can use its comparative advantages in a parallel funding structure.

\[\text{Policy Dialogue} \quad \text{Crowding and Leveraging in Government and Other Financial Resources} \quad \text{Experience and Technical Capability} \quad \text{OCR Resources} \quad \text{Experience and Technical Capability} \]

\[\text{Poverty Reduction Funds} \quad \text{Poverty Reduction Linkage} \quad \text{“Substitution” funding} \]

\[\text{Direct Poverty Reduction Projects} \quad \text{Economic Growth Projects with Poverty Reduction Impact} \]

**Benefits and Risks**

158 The benefit of the parallel funding approach is that it immediately disabuses any argument about the use of OCR resources for poverty reduction. By funding economic growth interventions that can withstand OCR rates, other fiscal resources (subsidised or not) can be channelled to poverty reduction according to the government’s preferences.

159 Parallel funding provides the opportunity to crowd-in funding on a project, or regional, or sectoral or multisectoral basis. The main risk is that the poverty reduction linkage is not effective. The World Bank argues that where there is good governance, targeting is not necessary and assisting the government generally though budgetary support or funding economic growth will result in increased allocations of poverty reduction funding. This is not the case in PRC, where although there many aspects of good governance in place, the present poverty reduction...
programme has significant targeting and sustainability problems. Accordingly both the linkage and the poverty reduction initiatives need to be carefully monitored.

160 The risk have to be addressed through:

- policy dialogue that ensures that the international lessons and international best practice are brought to bear in the locally funded poverty interventions and that the relevant design criteria are used;

- the production of explicit and verifiable evidence from central government, local government, line ministries or other executing and implementing agencies (depending on the type of project) of previous levels of public spending and funding sources over a two to three year period, and the production of future projections of public expenditure and funding sources over a further three to five year period (without the parallel funding resource) and firm commitments to these levels of expenditure;

- the subsequent incorporation of a parallel funding component into the budget to replace elements that will withstand OCR funding, with specific matching increases in expenditure on specified and fully designed and appraised poverty reduction interventions;

- the involvement of ADB through non-lending services (TA and training in particular) in the design and implementation of the poverty reduction interventions including their monitoring and evaluation; and

- the use of conditionality in the parallel loan agreement that ensures it becomes repayable on demand in the event the agreed poverty reduction interventions are not made at the agreed level.

161 These considerations apply generally to crowding-in initiatives, and should be applied in the context of funds crowded-in to components of projects (such as the Shanxi Roads Project) as well as with parallel funding.

**Technical Assistance**

162 ADB can use its technical assistance capability for poverty reduction in several ways in PRC, to support:

- the policy dialogue, through research of issues in dialogue areas and provision of access to international best practice experience using both consultancy and training approaches; and

- its lending, through project design, implementation and evaluation.

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60 See Chapters 3 through 6 and related appendices for the various guidelines advocated.
Some examples, based on the above analysis of opportunity\textsuperscript{61} include:

- in microfinance for: the development of industry legislation and regulations, the introduction of international best practice, the design and management of pilot schemes, the design and management of a microfinance fund, and for the design, implementation and evaluation of all microfinance components of specific projects financed by ADB;

- in voluntary rural mobility: for project component design and implementation management;

- in agroindustry and rural enterprise development: for improving SME legislation to allow enterprises autonomy and greater freedom of operation, the design and management of SME support services pilots, support for SOE reform, and a continuation and possible expansion of support for credit lines, guarantee mechanisms and financial institution building; and

- in rural infrastructure: for improving the design of workfare programmes and increasing the benefit share of the poor, for piloting greater participation of communities and the private sector in infrastructure project design and maintenance, and for developing high quality poverty measurement systems that allow assessment of none income and long term benefits.

Mechanisms

Policy Dialogue, Indirect Funding, Direct Funding and Technical Assistance

In general, ADB’s assistance to PRC in these areas would follow already established policies and procedures and no change would be necessary. If SIF or CDF type approaches were developed at a provincial level, then new organisations may be necessary for implementation\textsuperscript{62}.

Parallel Funding

Parallel funding will require new mechanisms. It is not the purpose here to design a project, but the following ideas are recommended for consideration. Although there are no known existing examples of the concept described below, there are examples of all of its components, and it is wholly consistent with the goals of learning from the aid effectiveness research and introducing international best practice at the project level.

Challenge Funding

Using the parallel funding structure outlined above, the Government and ADB could establish a PRC Poverty Reduction Challenge Fund. The fund would start small. It would use OCR resources to fund public and acceptable private sector goods at OCR rates with matching funding being reallocated from existing budgetary resources to poverty reduction “subprojects”. (There are many parallels here with credit lines). The funding would be competed for at a local level (provincial or county)

\textsuperscript{61} See Chapters 3 through 6 for greater detail for each of the sectors examined under the TA.

\textsuperscript{62} See sections above for illustrative management and funds flow diagrams
through submissions of poverty reduction subprojects. On a case by case basis the reallocated resources need not be large. It would not be necessary to fund major public goods such as expressways. Other smaller scale public goods, for example hospitals could be funded. This would be a competitive process with eligibility criteria at two levels:

- the overall success factors in poverty reduction projects would need to be reflected to the extent applicable to a particular subproject in the project design;

- the specific criteria, frameworks and other guidelines for rural infrastructure, agroindustry (where there is market failure or there are high costs or barriers to market entry), microfinance, and voluntary rural mobility would need to be complied with.

167 However, at detailed project design, serious consideration should be given to including criteria, frameworks and guidelines for other types of poverty reduction intervention including health, education and urban poverty, though these could be developed later.

168 The fund could initially (or later) leverage in other ODA resources, both for funding economic growth and for complementing domestic resources freed up by the challenge. However, the introduction of such resources would need to be on the basis that the resource provider accepts the criteria for fund use and does not impose separate criteria.

169 The fund would not need to address absolute poverty only. In PRC the domestic programmes are focused on this and the achievement of the 8-7 targets. Rather the fund should address relative poverty, and particularly with the challenge process should seek to fund successes that can be rolled out and that will operate in an environment of minimum risk (particularly in relation to governance).

170 At full development, the fund would be self-sufficient, using interest income to cover costs and debt service including foreign exchange risk. Although the fund would be managed on sound banking principles, aiming to match maturities, it would be able to use mismatched repayments provided the risk was covered. In due course the fund could use commercial money to supplement OCR resources.

171 The advantages of this type of approach are:

- it is dynamic, fosters diversity, allows great flexibility in subproject design, and can be pioneering in the poverty reduction subprojects it supports;

- emphasis can be given to different priorities as they emerge (for example resettlement would not need to be funded initially);

- the overall loan size for ADB is large, but it funds many small economic growth and poverty interventions;

- elements of success can be transferred into existing government programmes over time to make them sustainable and better targeted;

- it affords the opportunity for rapid learning; and
it can address relative poverty and urban poverty (if required).

172 The principal risk is associated with ensuring that the reallocated funding is truly additional funding. This will require not only the appropriate assurances from government but also transparent accounting and preferably independent audit.

173 There are no known examples of poverty reduction challenge funds with the broad sectoral single country base and parallel funding mechanisms suggested here incorporated into them. However, the challenge fund concept itself is well established and has been pioneered on a sectoral multi-country basis by DFID, the UK bilateral assistance agency. Challenge funding encourages more imaginative proposals and is based on genuine competition. Specific proposals are evaluated against set criteria and the best attract funding. Examples of recently launched challenge funds include:

- the Civil Society Challenge Fund which is open to any non-profitmaking organisation or network which has the objective of poverty eradication and provides matched funding up to about USD 400,000 for most kinds of initiative that deliver benefits to the poor and give a voice the poor by boosting their role in policy making locally, regionally and nationally and build sustainable know-how and capability;

- the Business Partnership Tourism Challenge Fund which is open to business and civil society organisations and aims to encourage the testing and piloting of new approaches to tourism strategies and activities for the benefit of the poor in countries where there is already existing dependence on tourism, government commitment to pro-poor policies and opportunity for developing business and employment for the poor by developing local supply chains and supporting small enterprise. Funding up to USD 160,000 a year is available on a non-matched basis.

- the Financial Deepening Challenge Fund which aims to widen the range of products available in poor countries (initially in Africa and South Asia), extend services to the poor and improve the efficiency of financial intermediation. The outcomes are expected to be the development of new financial products and markets, strengthened capacity in financial institutions and improved operational infrastructure and regulatory and legislative framework.

174 Most challenge funds use a three stage application process. Applicants initially submit a concept note for review and concept clearance. Selected applicants are then invited to submit full proposals for review. Any clarification or additional detail required is requested and a final decision is taken. Successful applicants are required to follow detailed accounting and reporting procedure to account for funds put at their disposal.

Replication Funding

175 Not all provincial governments will be able to participate effectively in the challenge. Progressive thinking and open-mindedness to new approaches will be required. In order to address poverty reduction more widely, a second fund (the “Replicator Fund”) should also be considered. This fund would actively promote the use of substitution funds for replicating successful subprojects including in provinces and autonomous regions not availing of challenge funds.
Management Structure and Funds Flow for Challenge and Replicator Funds

176 Figure 2.3 illustrates how this idea would work in practice. In summary, donors and the government will pool funds into a Challenge and Replicator fund. The fund would have an appointed manager, a role to which LGOP would be suited. LGOP would be responsible for promoting the fund, evaluating concept notes and proposals, selected projects to be funded, monitoring the project cycle and ensuring projects are properly implemented including ensuring that accounting and reporting requirements are met. LGOP would also be responsible for ensuring that any cofinancing and parallel was available from provincial or local governments and for ensuring that parallel funding commitments were met. Funds would flow from LGOP to the provincial or local governments funding parallel initiatives on loan terms and conditions similar to those on which it obtains funds plus a margin to cover Challenge and Replicator fund operating costs.

Figure 2.3 Illustrative Management Structure and Funds Flow for a Challenge Fund

Summary of Opportunity

177 The opportunities for ADB described above are summarised below.
<table>
<thead>
<tr>
<th>Policy Dialogue</th>
<th>Microfinance</th>
<th>Voluntary Rural Mobility</th>
<th>Agroindustry and Rural Development</th>
<th>Rural Infrastructure</th>
<th>Multisectoral</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Microfinance institution regulation</td>
<td>Rationale for voluntary rural mobility</td>
<td>Improving the enabling environment for SMEs</td>
<td>Private sector participation and regulatory reform</td>
<td>Application of SIF and CDF approaches</td>
</tr>
<tr>
<td></td>
<td>Liberalisation of interest rates</td>
<td>Settler selection, land acquisition and tenure, and resource adequacy</td>
<td>Development of support services for SMEs</td>
<td>Community participation</td>
<td>Combining and blending funding resources</td>
</tr>
<tr>
<td></td>
<td>Intermediaries for delivery</td>
<td>Transparency of conditions</td>
<td>SOE reform</td>
<td>Workfare programmes benefits for the poor</td>
<td>Increased civil society and NGO participation</td>
</tr>
<tr>
<td></td>
<td>Focusing on the working and near poor</td>
<td>Household registration</td>
<td>Measuring poverty impact and programme effectiveness</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Learning from best practice</td>
<td>Best practice guidelines</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Direct Lending</th>
<th>Components of Projects (including SIFs/CDFs)</th>
<th>Components of Projects (including SIFs/CDFs)</th>
<th>Components of Projects (including SIFs/CDFs)</th>
<th>Components of Projects (including SIFs/CDFs)</th>
<th>Components of Projects (including SIFs/CDFs)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Microfinance Fund</td>
<td>Microfinance</td>
<td>Producer microfinance</td>
<td>Community Microfinance</td>
<td>All types of microfinance</td>
</tr>
<tr>
<td></td>
<td>Pilot schemes</td>
<td>Settler microfinance</td>
<td></td>
<td></td>
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</tbody>
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<table>
<thead>
<tr>
<th>Indirect Lending</th>
<th>Projects or components of projects through fund mechanisms</th>
<th>Projects or components of projects through fund mechanisms</th>
<th>Projects or components of projects through fund mechanisms</th>
<th>Projects or components of projects through fund mechanisms</th>
<th>Projects or components of projects through fund mechanisms</th>
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<table>
<thead>
<tr>
<th>Parallel Lending</th>
<th>Projects or components of projects through fund mechanisms</th>
<th>Projects or components of projects through fund mechanisms</th>
<th>Projects or components of projects through fund mechanisms</th>
<th>Projects or components of projects through fund mechanisms</th>
<th>Projects or components of projects through fund mechanisms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Development of regulations</td>
<td>Project component design and implementation</td>
<td>Piloting support service development</td>
<td>Piloting participation</td>
<td>Piloting SIF/CDFs</td>
<td></td>
</tr>
<tr>
<td>Introduction of international best practice</td>
<td></td>
<td>Project design and implementation</td>
<td>Developing poverty measurement</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Project design and implementation</td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tbody>
</table>
Priorities

178 FCPMC believes that ADB is a potential implementation partner for poverty reduction projects. FCPMC’s response to the strategy has been generally positive. FCPMC sees the strategy as innovative with many new ideas. It recognises that not all ideas may be accepted now, but takes a long-term view with the expectation that policies will evolve, and opportunities that may be difficult to operationalise now may become possible in the future. Policy dialogue is therefore an important component for FCPMC as well as ADB.

179 Following the completion of the 8/7 programme, which FCPMC expects will result in absolute poverty in PRC being largely eradicated, the focus will be on consolidating the gains made. The overall approach envisaged currently is that LGOP will tackle the remaining pockets of absolute poverty in remote regions (through resettlement where necessary) continuing to use a household level approach with emphasis on sustainability and environmental protection; and in parallel, as absolute poverty is reduced, increasingly pursue regional development initiatives that will strengthen the economic growth of western PRC and address relative poverty.

180 In this context, FCPMC sees the continuing roles of LGOP as being the provision of advice to the Government on poverty reduction and continuing responsibility for the co-ordination of line ministries and departments involved in poverty reduction programmes. These are roles that it essentially has at present, but they do not preclude new or strengthened roles where such are justified in PRC’s overall chosen approaches. FCPMC itself is interested in pioneering new approaches outside those of the existing programmes, as it has done with the World Bank’s poverty reduction projects, and thus it finds the new approaches in the strategy with ADB interesting opportunities to include in its future role. The strategy itself envisages this developmental role for LGOP along-side bringing about improvements in targeting and sustainability of existing programmes. Additionally, it is the Consultant’s view that tackling poverty in non-poverty counties should come a priority for LGOP, given the evidence that on average more than 30 percent of the poor reside in non-poverty counties and more than 50 percent reside in non-poverty counties in some areas.

181 FCPMC is interested in how to operationalise the strategy in the subsectors studied and there is also interest in the multisectoral approaches considered and in the way the funding mechanisms could operate. FCPMC has expressed its initial views about the use of OCR funding and non-lending services. Specifically, it believes that:

- on direct funding63:
  - direct funding of development of multisectoral interventions at the provincial level along the lines of the SIFs and CDFs of the World Bank where there is an opportunity to blend ORC resources with soft resources from other donors, government and private sector funding, but at a level

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63 See para 102 for definitions of direct, indirect and parallel funding.
where provincial priorities and poverty characteristics can be taken into account is possible now;

- direct funding of poverty components of economic growth projects and projects targeted at the working and near poor, again using blended resources where appropriate such as has been done for the Shanxi Roads Project, with the caveat that the additionality (and thus the origin) of crowded in local budgetary funds is clear is possible now;

- direct funding of microfinance, where donor participation can provide a fresh window to re-establish credit discipline and ensure better targeting of resources at the poor, including piloting new initiatives on a sustainable scale, and including funding across all productive sectors, urban and rural for agricultural producers, small- and medium-scale enterprises (SMEs) and artisans, community infrastructure, and under some circumstances, migrant workers or voluntary resettlers is possible now on pilot basis;

- direct funding of microfinance at a national level through the establishment and participation in an apex fund that in turn would establish and expand a mutually supportive membership of organisations, and provide wholesale finance and other support services to develop self-sustaining microfinance organisations following pilot outlays in order to demonstrate the full potential of microfinance, and the creation of a suitable enabling environment for microfinance institutions is possible in foreseeable future;

- on indirect funding:

  - indirect funding through agreements with rich coastal provinces to finance economic infrastructure and other public goods linked to conditionality on the establishment or strengthening of “dragonhead” relationships with poorer inland provinces and autonomous regions is possible now as a complementary mechanism to the existing "East-West Co-operation Programme";

  - indirect funding through commercial bank credit lines to ABC and other commercial banks, but with greater emphasis on funding “dragonhead” relationships at the enterprise level, the justification for this essentially private sector funding being that of assisting market entry through the provision of long term capital is possible now

  - indirect funding through SME-type credit lines as a countermeasure to rising rural and urban unemployment and as a poverty avoidance strategy, again the private sector nature of the support being justified by the relatively underdeveloped nature of SMEs and the difficulties they

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64 ADB reports that the West Henan Agricultural Development Project is an example of this where poor families are being assisted to move out of subsistence level agriculture into high value commercial crops and livestock. Models that include company plus farmers with farmers having a stake in the processing company also appear to be viable in West Henan.
face in accessing resources is possible in foreseeable future if there are intermediaries involved;

- indirect funding for the provision of credit guarantees for reforming and privatising state owned enterprises linked to the freeing-up of budgetary resources from SOEs and into poverty reduction may not be possible in the foreseeable future;

- on parallel funding:

  - parallel funding of public goods at the provincial level, linked to the use of matching funds at a provincial level for poverty reduction, but with proactive involvement of ADB in the poverty reduction components and a focus on multisectoral poverty reduction programmes rather than a poverty-related component of a larger project is possible later;

  - parallel funding of public goods in the same way, but through a national level challenge funding mechanism that would foster competition for resources through good governance and would subsequently promote and roll out successful programmes and projects is possible later.

182 In addition, FCPMC will welcome a structured programme of policy dialogue and further technical assistance as soon as possible. Its view is also that pilot funding from ADB for poverty reduction should be on the programming agenda, and should be used to test the funding mechanisms above that are considered "possible now". Where appropriate some testing can be carried out in association with the infrastructure pilot project provided it does not bias research results.

183 On the components that are "possible later", the deferral is primarily because they involve new mechanisms that will require more consultation at a national and provincial level. Additionally, the approach will depend on that nature of the first initiative. If this is a pilot project that embraces many components of the strategy (as suggested by the Consultants) then it would be possible to test a mini Challenge Fund. If it is more fragmented with several separate initiatives, then testing with a single province or autonomous region may be more appropriate.

184 Regarding the other components, FCPMC’s view is that SME financing is possible through intermediaries. FCPMC’s reservations about credit guarantees refer to their doubts that PBC and the Ministry of Finance will accept this type of intervention. However, the Government launched pilot interventions of this type in Sichuan and Liaoning in late November 1999 and has recently set up some 60 Credit Guarantee Institutions. Further dialogue may well be productive.

185 The Ministry of Finance is of the view that while generally the TA has identified ways and means on approaches to rural poverty reduction and that these are illustrated by actual examples, the use of OCR funding for poverty reduction still needs testing in practice even if OCR funds are directed at poor beneficiaries that are not the absolute poor because the Ministry believes that it will be difficult to raise sufficient resources domestically or internationally to soften OCR resources. The Ministry has pointed out that at the time of reporting, domestic interest rates are in any case lower than OCR rates, and so even if commercial borrowing were effected
Strategies for Supporting Rural Poverty Projects

for poverty reduction, domestic funding would be cheaper than OCR funding although it is unlikely to be available for the long-term. It is the consultant’s view that these constraints can be addressed through modifications to ADB’s products.

186 The provincial and autonomous regional governments in PRC are also open to new approaches. In Guangxi, Yunnan and Guizhou, for example, it was found during the TA that officials at all levels had positive views about the World Bank’s South West Poverty Reduction Project and were willing to experiment further with new approaches and evolutions of those pioneered under the project for economic and social infrastructure development, crop diversification, labour migration, and microfinance. These developments would not have been possible without both external finance and project design and management expertise. The governments of Gansu, Ningxia, Guangxi, Guangdong have long been strong advocates of voluntary resettlement. Although there are estimated to be 5.0 million people in need of resettlement, present provincial and autonomous regional government resources cannot fund this. The same is true for agroindustrial development. Although it was found in all of the case studies visited that the governments of Yunnan, Guizhou and Inner Mongolia recognised and were strong supporters of dragonhead enterprise development, shortfalls in financing were repeatedly cited as a major constraint to development.

187 Consultations with beneficiaries during the fieldwork for the TA demonstrated enthusiasm for many of the new paradigms. In the World Bank South West Poverty Reduction Project beneficiaries who had received assistance under all aspects of the project were enthusiastic about the results. Apart from productive sector gains through irrigation, crop diversification, credit for livestock development and rural road development providing better access to markets, beneficiaries also described quality of life gains from clean water supply, schools and clinics developed under the project. Without exception, beneficiaries cited the labour migration programme as being the most beneficial component of the project. In Yunnan, applicants for the voluntary migration programme greatly exceed the number of available places. In the microfinance fieldwork in Ankang in Shaanxi province beneficiaries clearly recognised the advantages of village level microfinance operations, and particularly cited the high level of transaction costs (in terms of travelling time and inconvenience) associated with borrowing from RCCs. Farmers interviewed during the agroindustry case studies were all enthusiastic about dragonhead organisations and considered the contractual arrangements equitable and were able to spread their risk by selling part of their production on the open market. They identified the need for long term financing for the development of some crops. Similarly, beneficiaries of dragonhead enterprises appreciated the provision of technical extension services by the enterprises and the Bureau of Agriculture.

Views on Microfinance

188 There is wide and well-understood consensus in PRC on the main issues related to successful microfinance development. All parties recognise a need for a regulatory framework and interest rates that allow microfinance organisations to be self-sustaining. Recent roundtables on microfinance organised by UNDP and CIDA

See sections that follow on risk management and ADB’s marketability and entry point in para’s 211 - 225.

57

have helped to create a common basis for discussion of the issues and have been attended by the consultants. PBC as the responsible body has concluded that microfinance should be channelled through the Rural Credit Co-operative (RCC) system that is currently mainly responsible for farm credit and rural savings. The Government believes that using existing institutions for the development of microfinance is simpler, more efficient and can capitalise on existing skills and experience.

However, PBC and RCC system reformers recognise that present RCC practices in farm finance differ from international best practice in microfinance and that type of seasonal finance provided is very different in character from microfinance for non-farm businesses. Several initiatives are underway that indicate that PBC is serious about developing microfinance in PRC. Specifically, a pilot initiative with RCCs is introducing joint liability groups (along the lines of the Grameen model) as part of the overall improvement of the quality of RCC operations. PBC recognises that there are other international best practices that can also be introduced into RCC’s normal lending operations, that these will also have applicability to future microfinance operations and that RCCs could benefit from external technical assistance and training in the development of their microfinance activities.

Also, recognising that microfinance institutions need higher interest rates for self-sustainability, PBC is currently focused on the issue of interest rate liberalisation. On a trial basis higher rates are being charged by those RCCs that are piloting the joint liability groups. Other measures, such as the determination of the nominal rate only by PBC are also under consideration, but no firm decision has yet been taken.

Founded in the decision that the Government wishes to use RCCs as the microfinance channel is the current PBC view that it is not imperative to develop a separate legal basis for microfinance at this time, and conversely that it wishes to make the best use of RCCs rather than establish new institutions. There are clearly advantages to using the RCC network as a means of protecting depositors and efficiently allocating savings resources in the microfinance context. This does not exclude the possibilities, according to PBC, of establishing new funding mechanisms that might be channelled through this system, particularly if they use blended funds to achieve reasonable overall costs, nor the possibility of extending RCC outreach in new ways.

FCPMC’s view is that ADB could proceed to become involved with microfinance on a pilot scale outside the RCC system as many NGOs and bilateral donors have already done. However, these interventions are regarded by PBC as “reasonable” but “illegal” and therefore may not attract ADB support at this stage. There is a strong lobby from bilateral donors and NGOs for such initiatives to continue, particularly in the light of the recent closure of the Rural Credit Foundations, and there are more than 260 microfinance projects in existence, mostly externally funded. Few if any of these existing projects are self-sustainable, and both the legislative framework and the interest rate issue need to be addressed before the environment is suitable for fully fledged microfinance operations outside RCCs. This
may not preclude piloting further initiatives with significantly greater self-sustainability with PBC’s consent\(^{66}\).

193 The Domestic Consultants are of the view that microfinance per se is feasible, and that the necessary interest rates for self-sustainability will be tolerated by borrowers. Their view is that some start-up support will be required prior to microfinance institutions attaining financial self-sufficiency as generally evidenced by international experience and experience in PRC. All consultants have reservations about ADB’s participation in microfinance outside the legal framework and believe further policy dialogue is necessary with PBC on this issue.

**Views on Voluntary Mobility**

194 FCPMC is the principal advocate of voluntary rural mobility and has been assisted with its mobility programmes by the World Bank. FCPMC’s view is that in the remotest, environmentally marginal areas it will remain difficult to provide economic and social infrastructure on a sustainable basis. For those remaining in these isolated pockets of poverty, integration into the mainstream economy and participation in the benefits of wider economic growth will not be possible. FCPMC believes therefore, that as last resort measure, voluntary rural mobility is the best option. FCPMC recognises that good governance and guidelines are needed to ensure that migrant and host populations are, and are seen to be, fairly treated in all regards and that any losses suffered are compensated for. The TA addresses the issues of the conditionality under which international donors might find it acceptable to finance voluntary rural mobility and if so what components of such projects would be most appropriate for hard loans given international concerns\(^{67}\).

195 FCPMC is also involved in labour mobility projects with World Bank support, managed by the Western China Human Resources Development Centre. It believes that assisting migrant labour to obtain jobs in more prosperous regions is a legitimate role for government because there is both a lack of information on job opportunity and the capacity to organise such mobility spontaneously in the poorest regions. FCPMC is of the view that support for certain components of labour mobility with OCR funds is feasible.

**Views on Agroindustry and Rural Enterprise**

196 The MOA is interested in promoting farmer’s links with processors and stimulating the development of rural co-operative organisations. Overall the MOA is focused on improving both processing and marketing to enhance value added and thus stimulate economic growth. It believes that there are still many opportunities to develop region and locality specific agroindustries linked to as yet unexploited local production. The Ministry recognises that OCR funding can be used for agroindustries that are able to withstand commercial interest rates, with its long-term nature being beneficial to their establishment in new areas where it will take time to build up to full capacity. MOA also recognises that there are systemic constraints that make market entry difficult for agroindustrial enterprise. These include a low level of farmer education, a lack of infrastructural support, and a lack of advisory service support for

\(^{66}\) See Chapter 3 for consideration of the options

\(^{67}\) See Chapter 4 for this analysis.
enterprises. ADB support in addressing these issues would be welcome, possibly through pilot initiatives that helped to refine the poverty linkages and funding mechanisms.

197 Similar views on the systemic constraints and the good opportunities for use of OCR funds are held by the Chinese Service Centre of Poverty Alleviation that has some years of experience in assisting the development of agroindustry in poor rural areas. The experience of the Centre has indicated that the autonomy of the management enterprise and arms length financing are important factors in enterprise success. The Centre also stresses the need for both management and farmer training, good access to market information, and environmental awareness as important components of long-term success. The Centre would also welcome piloting initiatives that demonstrated the effectiveness of poverty linkages with agroindustry.

198 The TVE Bureau envisages that agro-industries will be central to future TVE development and that a variety of linkages with farmers will be developed that can impact on poverty (dragonheads, marketing channels, brand-driven industries and new-product driven industries). Ownership structures and linkages will also be diverse, using contracts of sale, joint shareholdings with farmers, production contracts, and price guarantee mechanisms. The Bureau shares the views of others about the causes of previous limited success: use of low technology, low value added, and lack of liberalised pricing, but is also able to cite successful examples. It shares the view that infrastructure and technical support are still inadequate and that autonomy and freedom from local government interference are essential for success.

199 ABC has an established relationship with ADB and is participating as a channel for credit lines in several ADB-financed OCR projects with poverty reduction as a secondary objective. ABC believes there is a strong demand for the funding of “dragonhead” industries in western PRC and that if OCR funds are blended with other funds (such as state poverty reduction funds) OCR interest rates are not problematic and OCR funding has the advantage that it is long-term at a time when long-term resources are difficult to secure on the domestic market. ABC also considers that ADB has a strong role to play in non-lending services such as technical assistance and training. Although FCPMC has reservations about ABC as an intermediary, these reflect its experience with the subsidised loan programme. The proposals for ABC’s potential involvement under any ADB financed project are based on market principles that put ABC’s criteria of enterprise viability first but still have poverty reduction impact. Accordingly, the dialogue with ABC should be maintained.

200 The Ministry of Finance has pointed out that there has been mixed experience with funding of agroindustry under previous World Bank and ADB credit lines and that management capacity and the adequacy of own financial resources in processing enterprises have been serious constraints to enterprise viability.

Views on Rural Infrastructure

201 The food for work (FFW) component of the 8/7 programme is under the management of SDPC. It is intended that food for work will continue beyond the end

68 See Chapter 5 for the detailed proposals.
of the 8/7 programme and will be expanded in scale. Future operations will include more environmental conservation and an urban programme is to be started. Improvements in the management system are also envisaged to increase the efficiency with which funds are spent and thus increase poverty impact. The FFW programme is expected to continue in poverty counties but with village and household level targeting. SDPC is currently of the view that OCR funding cannot be used except for electricity and telecommunications, and this then only in faster growing towns. However, SDPC recognises that the process could be accelerated by the use of external funds and that there is a trade-off between the pace of development and the cost of funds (poverty alleviation funds being a scarce resource). On participation, SDPC views the use of poor labour in construction and maintenance as participation and has yet to consider the use of participatory methods in planning rural infrastructure.

202 SDPC’s position needs to be revisited in the context of the TA findings on infrastructure. Some of the mechanisms in the strategy, such as parallel funding, are particularly suited to infrastructure. Important subsectoral issues also include, for example, the funding of rural infrastructure in non-poverty countries where more than 30 percent of the remaining poor reside, and the use of cross subsidisation (as is common in other countries) to spread the costs of infrastructure development across all users rather than linking repayment ability to each user. Additionally, the findings from the pilot project can also be used to advance the case for OCR funding or parallel funding in due course.

203 FCPMC believe it is possible to justify funding some rural infrastructure with OCR resources. Electricity, water supply, irrigation and communications all have potential. Rural roads are more problematic if cost recovery is linked directly to them rather than recovered from users of a wider road network. It is recognised that SDPC is not in concurrence with the general view and the pilot project will be pivotal in demonstrating how income and other poverty reduction effects justify (or do not justify) OCR funding. The subsector strategy will present the foundations for new approaches, but there is general consensus that domestic research will be necessary to persuade SDPC.

Policy Dialogue Development

204 It will be useful to have an agenda, participation list, timetable and mechanism matrix for the policy dialogue that can also form part of the ADB’s Partnership Agreement on poverty with the PRC government. The dialogue needs to take place at both a national and provincial level because many of the initiatives will be pursued at provincial level. The dialogue should also involve existing poverty reduction agencies so that improvements can be made in the existing programmes (even though these will not be funded by ADB) and the agencies that are likely to be the implementing or executing agencies for future ADB projects.

205 The following tables set out the proposed matrix. The timeline is based on FCPMC’s views of what is possible now and the findings in the four sectors on the priorities for OCR lending and TA that it is judged can take place without significant impediment to the use of OCR resources for the lending components.
## Poverty Policy

<table>
<thead>
<tr>
<th>Sector</th>
<th>Subject</th>
<th>Dialogue Partners</th>
<th>Timeline</th>
<th>Mechanisms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poverty Policy</td>
<td>Poverty definition</td>
<td>LGOP; SSB; Provincial governments; PRC researchers; Other donors</td>
<td>Early to mid 2001</td>
<td>Series of ADB financed provincial level workshops; Continuous dialogue with LGOP</td>
</tr>
<tr>
<td>Poverty Policy</td>
<td>The poverty line</td>
<td>LGOP; SSB; Provincial governments; PRC researchers; Other donors</td>
<td>Early to mid 2001</td>
<td>Series of ADB financed provincial level workshops; Continuous dialogue with LGOP</td>
</tr>
<tr>
<td>Poverty Policy</td>
<td>Phasing out of the subsidised loan programme</td>
<td>LGOP; PBC; ABC; PRC researchers; Other donors</td>
<td>Early to mid 2001</td>
<td>UNDP Microfinance Roundtable Meetings; Continuous direct dialogue with LGOP, ABC and PBC</td>
</tr>
<tr>
<td>Poverty Policy</td>
<td>Initiating SIF, CDF and parallel funding approaches</td>
<td>LGOP; Ministry of Finance; Selected Provincial governments; Line ministry representatives; Partner donors</td>
<td>Early to mid 2001</td>
<td>Series of ADB financed provincial level workshops; Continuous direct dialogue with LGOP and one or two selected pilot provinces</td>
</tr>
<tr>
<td>Poverty Policy</td>
<td>Initiating the Challenge and Replicator Fund mechanisms</td>
<td>LGOP; Ministry of Finance; Partner donors;</td>
<td>Mid to end 2002</td>
<td>Initial discussions on principles with a view to inclusion in the 2003 or 2004 programme</td>
</tr>
</tbody>
</table>
### Multisectoral Approaches

<table>
<thead>
<tr>
<th>Sector</th>
<th>Subject</th>
<th>Dialogue Partners</th>
<th>Timeline</th>
<th>Mechanisms</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Application of SIF and CDF approaches</td>
<td>LGOP; MoF; PBC; SSB; Provincial governments; PRC researchers; Other donors</td>
<td>Mid 2001</td>
<td>Series of ADB financed workshops and continuous dialogue with others</td>
</tr>
<tr>
<td></td>
<td>Combining and blending funding resources</td>
<td>LGOP; MoF; PBC; SSB; Provincial governments; Other donors</td>
<td>Late 2001</td>
<td>Dialogue with LGOP and others on specific opportunities</td>
</tr>
<tr>
<td></td>
<td>Increased civil society and NGO participation</td>
<td>LGOP; MoF; PBC; ABC; PRC researchers; Other donors</td>
<td>Mid 2001</td>
<td>Series of ADB financed workshops and continuous dialogue with others</td>
</tr>
</tbody>
</table>

### Microfinance

<table>
<thead>
<tr>
<th>Sector</th>
<th>Subject</th>
<th>Dialogue Partners</th>
<th>Timeline</th>
<th>Mechanisms</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Creation of the legal and regulatory framework</td>
<td>PBC; LGOP; PRC researchers; Partner donors</td>
<td>Early 2001 on-going to conclusion possibly over several years</td>
<td>Regular dialogue with PBC System Reformers; UNDP Microfinance Roundtable</td>
</tr>
<tr>
<td></td>
<td>Interest rate deregulation</td>
<td>PBC; LGOP; PRC researchers; Partner donors</td>
<td>End 2000 on-going</td>
<td>Regular dialogue with PBC System Reformers; UNDP Microfinance Roundtable</td>
</tr>
<tr>
<td></td>
<td>Development of MFO and MFF concepts</td>
<td>PBC; ABC (Head Office and selected provincial branches; Selected RCCs; LGOP; Partner donors</td>
<td>Mid 2001 for MFOs and 2002 for MFF</td>
<td>Regular dialogue with ABC and RCCs UNDP Microfinance Roundtable</td>
</tr>
<tr>
<td></td>
<td>Adoption of microfinance best practice</td>
<td>PBC; ABC (Head Office and selected provincial branches; Selected RCCs; LGOP</td>
<td>Mid to end 2001</td>
<td>Regular dialogue with ABC and RCCs UNDP Microfinance Roundtable</td>
</tr>
</tbody>
</table>
### Voluntary Rural Mobility

<table>
<thead>
<tr>
<th>Sector</th>
<th>Subject</th>
<th>Dialogue Partners</th>
<th>Timeline</th>
<th>Mechanisms</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The rationale</td>
<td>LGOP; Western China Human Resources Development Centre; Governments of Gansu, Guandong, Guangxi, Hubei, Jilin, Ningxia, Shaanxi, Shanxi</td>
<td>End 2001</td>
<td>Regular dialogue with LGOP; Possible LGOP presentation in Manila to ADB staff</td>
</tr>
<tr>
<td></td>
<td>Land acquisition and tenure</td>
<td>LGOP; Western China Human Resources Development Centre; Governments of Gansu, Guandong, Guangxi, Hubei, Jilin, Ningxia, Shaanxi, Shanxi</td>
<td>End 2001 on-going possibly over several years</td>
<td>Regular dialogue with LGOP</td>
</tr>
<tr>
<td></td>
<td>Household registration</td>
<td>LGOP; Western China Human Resources Development Centre; Governments of Gansu, Guandong, Guangxi, Hubei, Jilin, Ningxia, Shaanxi, Shanxi</td>
<td>End 2001 on-going possibly over several years</td>
<td>Regular dialogue with LGOP; Regular provincial visits</td>
</tr>
<tr>
<td></td>
<td>Adoption of best practice guidelines</td>
<td>LGOP; Western China Human Resources Development Centre; Governments of Gansu, Guandong, Guangxi, Hubei, Jilin, Ningxia, Shaanxi, Shanxi</td>
<td>Early 2001 on-going possibly over several years</td>
<td>Regular dialogue with LGOP; Regular provincial visits</td>
</tr>
</tbody>
</table>

### Agroindustry

<table>
<thead>
<tr>
<th>Sector</th>
<th>Subject</th>
<th>Dialogue Partners</th>
<th>Timeline</th>
<th>Mechanisms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agroindustry and Rural Enterprise</td>
<td>Participation in east west cooperation</td>
<td>LGOP; Provincial governments</td>
<td>Late 2001</td>
<td>Roundtable discussions</td>
</tr>
<tr>
<td>Agroindustry and Rural Enterprise</td>
<td>Improving the enabling environment for SMEs</td>
<td>LGOP; TVE Bureau; Ministry of Agriculture</td>
<td>Late 2001</td>
<td>Roundtable discussions</td>
</tr>
<tr>
<td>Agroindustry and Rural Enterprise</td>
<td>Creation of SME support services</td>
<td>LGOP; CSCPA; TVE Bureau; Ministry of Agriculture; Selected provincial governments; ABC</td>
<td>Late 2001</td>
<td>Roundtable discussions; Provincial tour</td>
</tr>
<tr>
<td></td>
<td>Support for SOE reform</td>
<td>State Economic and Trade Commission (STEC)</td>
<td>2003</td>
<td>Direct dialogue to explore opportunity for ADB following experience current government pilot project</td>
</tr>
</tbody>
</table>
## Poverty Interventions by Sector

In the context of the four areas studied under this TA (which specifically excludes social sectors) and the priorities of the government and ADB, the types of intervention that can be provided by sector are summarised below. In all cases the relevant policy dialogue agenda applies, the projects can all be components of SIFs, CDFs and parallel funded projects, and the TA coverage specified in the summary of opportunity is applicable.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Types of Project Applicable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agricultural Support Services</td>
<td>Producer microfinance</td>
</tr>
<tr>
<td>Fisheries</td>
<td>Producer microfinance, “Dragonhead” and SME Credit Lines, Support for reforming SOEs in sector</td>
</tr>
<tr>
<td>Industrial Crops and Agroindustry</td>
<td>Producer microfinance, “Dragonhead” and SME Credit Lines, Support for reforming SOEs in sector</td>
</tr>
<tr>
<td>Irrigation and Rural Development</td>
<td>Resettlement infrastructure, Small-scale rural infrastructure, Community and individual microfinance</td>
</tr>
<tr>
<td>Electric Power *</td>
<td>Support for reforming SOEs in sector</td>
</tr>
<tr>
<td>Non-Agricultural Industry*</td>
<td>Producer microfinance, “Dragonhead” and SME credit lines, Support for reforming SOEs in sector</td>
</tr>
<tr>
<td>Ports and Shipping*</td>
<td>Support for reforming SOEs in sector</td>
</tr>
<tr>
<td>Railways *</td>
<td>Support for reforming SOEs in sector, Small-scale infrastructure</td>
</tr>
<tr>
<td>Roads and Road Transport</td>
<td>Rural roads and other small-scale rural infrastructure, Resettlement infrastructure and access</td>
</tr>
<tr>
<td>Education *</td>
<td>As part of SIF, CDF and parallel funding mechanisms</td>
</tr>
<tr>
<td>Health *</td>
<td>As part of SIF, CDF and parallel funding mechanisms</td>
</tr>
<tr>
<td>Urban Development / Housing *</td>
<td>SME credit lines, microfinance</td>
</tr>
<tr>
<td>Water Supply and Sanitation</td>
<td>Village water supply and other small-scale rural infrastructure, Community and individual microfinance</td>
</tr>
<tr>
<td>Capital Market Development *</td>
<td>Enterprise financial support (credit, equity, guarantees), SME credit lines, Support for reforming SOEs</td>
</tr>
<tr>
<td>Development Finance Institutions *</td>
<td>Microfinance, Enterprise financial support (credit, equity, guarantees), SME credit lines, Support for reforming SOEs</td>
</tr>
<tr>
<td>Privatisation *</td>
<td>Enterprise financial support (credit, equity, guarantees), SME credit lines, Support for reforming SOEs</td>
</tr>
<tr>
<td>Multisector *</td>
<td>As part of SIF, CDF and parallel funding mechanisms</td>
</tr>
</tbody>
</table>

Items marked * are or can be partially applicable to urban poverty.
Poverty Typology

207 The terms of reference call for a poverty typology to be developed by economic sector. Following discussion with ADB staff and careful consideration of the findings about the status of poverty in PRC\textsuperscript{69}, the typology has been developed for PRC at two levels. Firstly, a broad typology by household type has been developed. This maps back to the various types of asset base used in the wider definition of poverty advocated in this report. While it must be recognised that the characteristics of poverty are specific to individuals and this must be taken account of in detailed project design and implementation, the typology above provides the basis for the overall prioritisation of economic and social (including welfare) poverty interventions in any particular project component. It shows that where possible a multisectoral approach (even to specific types, such as the urban unemployed) is desirable so that poverty constraints on all members of the household can be addressed. The typology is split by simplified categories of rural and urban households and summarises in general terms the asset base to be improved by gender and for children, the workforce, and the elderly and infirm. For completeness the typology includes reference to interventions that are outside the sectors studied under this TA.

Income Poverty Revisited

208 The household typology provides a broad indication of the types of intervention that should be priorities for household types as a whole. However, there is also considerable variation within household types. For example, for the workforce of now unemployed former SOE employees, the generalised priorities are skill or vocational training, job placement and microfinance. But, within this group there will be individual variation because of individual circumstance. While the majority can be expected to have the group characteristics, some other means of distinguishing those who should and those who should not be the beneficiaries of specific interventions is needed. Further definitions of poverty can be helpful here.

209 ADB has defined different types of poverty as follows\textsuperscript{70}:

- the \textbf{absolute poor}\textsuperscript{71} are those for whom targeted government poverty programmes will be necessary in the long-term to meet their subsistence food and clothing requirements;

- the \textbf{vulnerable poor} are those whose basic food and clothing needs have been barely met but who are in danger of falling back into poverty were a medical emergency, natural disaster, or some other unexpected event to occur;

<table>
<thead>
<tr>
<th>Asset Class Status</th>
</tr>
</thead>
</table>

\textsuperscript{69} See appendix A6 for details in “PRC Poverty Policy Approaches and Experience”


\textsuperscript{71} The “absolute” poor based on the UNDP definition are those without sufficient assets to meet basic human needs (adequate shelter, clothing and food supply).
## Household Typology

<table>
<thead>
<tr>
<th>Household Typology</th>
<th>Type</th>
<th>G</th>
<th>Asset Class Status</th>
<th>Priority Poverty Reduction Interventions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rural Poor in Very Remote Mountainous Areas</td>
<td>Children</td>
<td>F</td>
<td>B N P F S H</td>
<td>Social Infrastructure, Normal Social Welfare Programmes</td>
</tr>
<tr>
<td></td>
<td>Workforce</td>
<td>M</td>
<td></td>
<td>Social Infrastructure, Normal Social Welfare Programmes</td>
</tr>
<tr>
<td></td>
<td>Elderly and Infirm</td>
<td>F</td>
<td></td>
<td>Social Infrastructure, Normal Social Welfare Programmes</td>
</tr>
<tr>
<td>Other Rural Poor</td>
<td>Children</td>
<td>F</td>
<td></td>
<td>Social Infrastructure</td>
</tr>
<tr>
<td></td>
<td>Workforce</td>
<td>M</td>
<td></td>
<td>Infrastructure, Enterprise Development, Microfinance</td>
</tr>
<tr>
<td></td>
<td>Elderly and Infirm</td>
<td>F</td>
<td></td>
<td>Social Infrastructure, Normal Social Welfare Programmes</td>
</tr>
<tr>
<td>Rural Poor in Voluntary Resettlement Areas</td>
<td>Children</td>
<td>F</td>
<td></td>
<td>Social Infrastructure</td>
</tr>
<tr>
<td></td>
<td>Workforce</td>
<td>M</td>
<td></td>
<td>Infrastructure, Enterprise Development, Microfinance</td>
</tr>
<tr>
<td></td>
<td>Elderly and Infirm</td>
<td>F</td>
<td></td>
<td>Social Infrastructure, Normal Social Welfare Programmes</td>
</tr>
</tbody>
</table>

G = Gender, F = Female, M = Male, B = Basic Needs, N = Natural Resources, P = Physical Assets, F = Financial Assets, S = Social Assets, H = Human Resources
### Strategies for Supporting Rural Poverty Projects

<table>
<thead>
<tr>
<th>Household Typology</th>
<th>Type</th>
<th>G</th>
<th>Asset Class Status</th>
<th>Priority Poverty Reduction Interventions</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>G,B,N,P,F,S,H</td>
<td></td>
</tr>
<tr>
<td>Unregistered Migrants</td>
<td>Children</td>
<td>F</td>
<td></td>
<td>Back to School Programmes, Food for Education</td>
</tr>
<tr>
<td></td>
<td></td>
<td>M</td>
<td></td>
<td>Back to School Programmes, Food for Education</td>
</tr>
<tr>
<td></td>
<td>Workforce</td>
<td>F</td>
<td></td>
<td>Registration, As for Registered Migrants</td>
</tr>
<tr>
<td></td>
<td></td>
<td>M</td>
<td></td>
<td>Registration, As for Registered Migrants</td>
</tr>
<tr>
<td></td>
<td>Elderly and Infirm</td>
<td>F</td>
<td></td>
<td>Registration, As for Registered Migrants</td>
</tr>
<tr>
<td></td>
<td></td>
<td>M</td>
<td></td>
<td>Registration, As for Registered Migrants</td>
</tr>
<tr>
<td>Registered Migrants</td>
<td>Children</td>
<td>F</td>
<td></td>
<td>Access to Normal Social Welfare Programmes</td>
</tr>
<tr>
<td></td>
<td></td>
<td>M</td>
<td></td>
<td>Access to Normal Social Welfare Programmes</td>
</tr>
<tr>
<td></td>
<td>Workforce</td>
<td>F</td>
<td></td>
<td>Migrant Support Programmes, Microfinance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>M</td>
<td></td>
<td>Migrant Support Programmes, Microfinance</td>
</tr>
<tr>
<td></td>
<td>Elderly and Infirm</td>
<td>F</td>
<td></td>
<td>Access to Normal Social Welfare Programmes</td>
</tr>
<tr>
<td></td>
<td></td>
<td>M</td>
<td></td>
<td>Access to Normal Social Welfare Programmes</td>
</tr>
<tr>
<td>Unemployed Former SOE Workers</td>
<td>Children</td>
<td>F</td>
<td></td>
<td>Access to Normal Social Welfare Programmes</td>
</tr>
<tr>
<td></td>
<td></td>
<td>M</td>
<td></td>
<td>Access to Normal Social Welfare Programmes</td>
</tr>
<tr>
<td></td>
<td>Workforce</td>
<td>F</td>
<td></td>
<td>Skill / Vocational Training, Job Placement, Microfinance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>M</td>
<td></td>
<td>Skill / Vocational Training, Job Placement, Microfinance</td>
</tr>
<tr>
<td></td>
<td>Elderly and Infirm</td>
<td>F</td>
<td></td>
<td>Access to Normal Social Welfare Programmes</td>
</tr>
<tr>
<td></td>
<td></td>
<td>M</td>
<td></td>
<td>Access to Normal Social Welfare Programmes</td>
</tr>
<tr>
<td>Other Urban Poor</td>
<td>Children</td>
<td>F</td>
<td></td>
<td>Back to School / Food for Education</td>
</tr>
<tr>
<td></td>
<td></td>
<td>M</td>
<td></td>
<td>Back to School / Food for Education</td>
</tr>
<tr>
<td></td>
<td>Workforce</td>
<td>F</td>
<td></td>
<td>Skill / Vocational Training, Job Placement, Microfinance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>M</td>
<td></td>
<td>Skill / Vocational Training, Job Placement, Microfinance</td>
</tr>
<tr>
<td></td>
<td>Elderly and Infirm</td>
<td>F</td>
<td></td>
<td>Access to Normal Social Welfare Programmes</td>
</tr>
<tr>
<td></td>
<td></td>
<td>M</td>
<td></td>
<td>Access to Normal Social Welfare Programmes</td>
</tr>
</tbody>
</table>

G = Gender, F = Female, M = Male, B = Basic Needs, N = Natural Resources, P = Physical Assets, F = Financial Assets, S = Social Assets, H = Human Resources
the working poor are those whose basic food and clothing needs have been met but who lack adequate income earning opportunities, education, health and housing to ensure quality of life gains;

the near poor are those whose basic food and clothing needs have been met and who have made progress in terms of education, health, and housing to ensure quality of life gains but who continue to struggle to gain access to capital and credit to reach a new level of income and non-income security for their family.

Relating these definitions to income is, without further research, a little arbitrary, but a pragmatic approach is to regard the absolute and vulnerable poor as those below or close to the income poverty line. There is sense in this because the poverty line is defined in relation to basic needs. The working poor and near poor are those who have relatively low incomes but are not immediately above the poverty line.

Examination of recent data complied by ADB on poverty in PRC is interesting in this regard.

Rural Poor Population in the PRC, 1997

<table>
<thead>
<tr>
<th>Annual income per capita (Yuan)</th>
<th>% of Total</th>
<th>Total Population (million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;600</td>
<td>3.75</td>
<td>32.49</td>
</tr>
<tr>
<td>601-1000</td>
<td>10.98</td>
<td>95.13</td>
</tr>
<tr>
<td>1001-1500</td>
<td>20.35</td>
<td>176.31</td>
</tr>
<tr>
<td>1501-2000</td>
<td>19.52</td>
<td>169.12</td>
</tr>
<tr>
<td>2001-2500</td>
<td>14.93</td>
<td>129.35</td>
</tr>
<tr>
<td>2501-3000</td>
<td>10.35</td>
<td>89.67</td>
</tr>
<tr>
<td>&gt;3000</td>
<td>20.12</td>
<td>174.31</td>
</tr>
<tr>
<td>Total</td>
<td>100.00</td>
<td>866.38</td>
</tr>
</tbody>
</table>

Urban Poor Population in the PRC, 1997

<table>
<thead>
<tr>
<th>Annual income per capita (Yuan)</th>
<th>% of Total</th>
<th>Total Population (million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;2000</td>
<td>13.10</td>
<td>45.18</td>
</tr>
<tr>
<td>2001-2500</td>
<td>22.67</td>
<td>78.19</td>
</tr>
<tr>
<td>2501-3000</td>
<td>15.07</td>
<td>52.00</td>
</tr>
<tr>
<td>3001-3500</td>
<td>13.11</td>
<td>45.23</td>
</tr>
<tr>
<td>3501-4000</td>
<td>4.38</td>
<td>15.11</td>
</tr>
<tr>
<td>4001-4500</td>
<td>3.57</td>
<td>12.33</td>
</tr>
<tr>
<td>4501-5000</td>
<td>4.21</td>
<td>14.53</td>
</tr>
<tr>
<td>5001-5500</td>
<td>2.49</td>
<td>8.60</td>
</tr>
<tr>
<td>5501-6000</td>
<td>4.27</td>
<td>14.75</td>
</tr>
<tr>
<td>6001-6500</td>
<td>10.62</td>
<td>36.67</td>
</tr>
<tr>
<td>6501-7000</td>
<td>2.98</td>
<td>10.27</td>
</tr>
<tr>
<td>&gt;7000</td>
<td>3.51</td>
<td>12.11</td>
</tr>
<tr>
<td>Total</td>
<td>100.00</td>
<td>344.97</td>
</tr>
</tbody>
</table>

Observation from the tables shows that if LGOP works with the poorest ten percent of the population as is now the intention, these will have income of below
Yuan 1,000 in rural areas and below Yuan 2,000 in urban areas and that these can be regarded as the absolute and near poor. Under the forthcoming poverty partnership agreement, it could be reasoned, for example, that the working poor and near poor constituted those with incomes of up to Yuan 1,500 in rural areas and Yuan 2,500 in urban areas. This would broaden ADB’s client base to many who could take advantage of OCR resources (though microfinance for example) without detracting from ADB’s pro-poverty strategy. The table below summarises how the interventions relate to this typology.

<table>
<thead>
<tr>
<th>Class of Poor</th>
<th>Typical Interventions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Absolute</td>
<td>Social Infrastructure</td>
</tr>
<tr>
<td></td>
<td>Food for education</td>
</tr>
<tr>
<td></td>
<td>Back to school programmes</td>
</tr>
<tr>
<td></td>
<td>Resettlement</td>
</tr>
<tr>
<td></td>
<td>Migration</td>
</tr>
<tr>
<td></td>
<td>Migrant support programmes</td>
</tr>
<tr>
<td></td>
<td>Rural Infrastructure</td>
</tr>
<tr>
<td></td>
<td>Normal social welfare programmes</td>
</tr>
<tr>
<td>Vulnerable</td>
<td>Social Infrastructure</td>
</tr>
<tr>
<td></td>
<td>Back to school programmes</td>
</tr>
<tr>
<td></td>
<td>Rural Infrastructure</td>
</tr>
<tr>
<td></td>
<td>Normal social welfare programmes</td>
</tr>
<tr>
<td></td>
<td>Enterprise development</td>
</tr>
<tr>
<td></td>
<td>Microfinance</td>
</tr>
<tr>
<td>Working</td>
<td>Rural Infrastructure</td>
</tr>
<tr>
<td></td>
<td>Skill/vocational training</td>
</tr>
<tr>
<td></td>
<td>Job placement</td>
</tr>
<tr>
<td></td>
<td>Enterprise development</td>
</tr>
<tr>
<td></td>
<td>Microfinance</td>
</tr>
<tr>
<td>Near</td>
<td>Rural Infrastructure</td>
</tr>
<tr>
<td></td>
<td>Enterprise development</td>
</tr>
<tr>
<td></td>
<td>Microfinance</td>
</tr>
</tbody>
</table>

**Risk Management**

**Types of Risk**

213 Foreign exchange risks will need to be managed, either by borrowers or by funds (such as the Challenge Fund and the MFF) or by engaging a third party. On a non speculative basis, value at risk techniques to assess potential losses and hedging mechanisms including restructuring of the foreign currency portfolio, swaps and forward contracts could be used to manage risk more effectively than the passive approach of adding a margin and hoping for the best.

214 Two main types of risk exposure arise from borrowing OCR funds. These are pricing risk and foreign exchange risk. Both need to be taken into account in the management of borrowed resources.

**Pricing Risk**

215 Pricing risks are associated with the possibilities that the costs of funding assets may be greater than the returns or afford inadequate returns and that OCR rate may change in relation to rates on assets being funded with OCR resources. The main risks arise from:
Strategies for Supporting Rural Poverty Projects

- adverse movements in domestic interest rates that narrow spread that it is commercially possible to achieve on OCR funds; and
- mismatches in the term structure of corresponding assets and liabilities.

216 In addition to having different maturity structures, assets and liabilities also have different repricing dates (the dates on which interest rates change). If assets and liabilities are not perfectly matched in terms of both the amounts and the repricing dates then there is interest rate risk.

217 For example, in a simple case where the amounts if assets and liabilities are the same to the next liability repricing date, risk can arise there is commitment to continue to lend at a certain rate for a period beyond the repricing date because the rate on the liabilities funding the asset will change for the next period. There is uncertainty about what the OCR rate will be in the next time period, and if OCR rates rise the spread will be reduced, while if they fall the spread will be increased.

218 Although OCR interest rate movement cannot be controlled, the repricing gap can be managed. There is an option to minimise risk. Risk minimisation can be achieved through a zero gap to the next repricing date (that is all interest rates on all assets and liabilities are known). There are two approaches to manage the repricing gap. Firstly the amount of assets and liabilities for specific repricing dates can be adjusted in order to reduce the gap to zero or close to zero. Secondly, interest rate swap contracts to transform variable rates to fixed rates.

Foreign Exchange Risk

219 Foreign exchange risk is the risk that changes in the value of foreign currencies relative to the Yuan or other foreign currencies result in losses for OCR borrower. Exposures can arise in relation to both the realisation of assets held in foreign currencies by the borrower and the liquidation of liabilities denominated in foreign currencies. The main foreign exchange risk with OCR lending lies in the latter.

220 Borrower’s of OCR funds pay interest on and repay the principal of foreign currency loans in foreign currency. On disbursement, OCR loans may be converted to Yuan, on lent in Yuan, and earn interest in Yuan. As a result, the borrower is exposed to foreign exchange risk from any deterioration in the value of the Yuan against the foreign currency borrowed.

221 Foreign exchange risk is the most difficult OCR associated risk to manage. This arises because of the shortage of viable instruments in the PRC financial markets to hedge the risk. While this is recognised, financial deepening in PRC will continue and new instruments will become available.

222 There are two approaches to the management of foreign exchange risk:

- the foreign exchange exposure can be reduced by modifying the relative amounts of different currencies borrowed; and
- either in combination with the first option or otherwise, the risk can be hedged through:
• forward contracts to fix the price of the repurchase of foreign exchange;
• option contracts for the right to buy or sell foreign exchange at its option at a predetermined price; and
• swap contracts on either or both of interest and principal.

Mechanisms for Management

223 Being able to define the risk with certainty enhances the attractiveness of OCR lending products. Risk is best managed at a national treasury level where there is greater expertise and more ready access to the products in the international marketplace that active risk management. In February 1999, the World Bank introduced new loan and hedging products to assist borrowers with precisely this. The new products available from the World Bank are:

• a fixed spread LIBOR based loan with increased flexibility for borrowers to tailor loan maturities and to manage interest and currency risks over the life of the loan; and

• free-standing hedging products linked to borrower’s existing IBRD borrowing to assist borrowers in managing their currency, interest rate and commodity price risks on their entire IBRD portfolio if so wished.

224 The new products are being accompanied by technical support from the World Bank that will:

• promote borrower understanding of the new loan and hedging products and informed decision-making about their use;

• provide legal support for borrowers to understand the terms of derivatives agreements entered into as part of hedging strategies;

• promote an active dialogue on asset and liability management (ALM) issues and assistance to borrowers to build institutional capacity to implement them.

225 These products are a major step forward in the risk management of ODA funds. They address the interest rate risk management fully, and create the possibility to reduce foreign exchange risk through adjusting the overall borrowed currency structure within the foreign exchange borrowing portfolio. Prices for these elements of risk management can be fixed helping to determine with more certainty what on-lending rates within the country should be.

226 However, foreign exchange risks could be removed and ADB funds made more attractive in PRC if the resources were raised domestically and the lending was in local currency. While this idea is not new, it has yet to be implemented and it merits regular reconsideration. Any foreign bank, wanting to expand its portfolio in PRC and compete within the domestic interest rate structure would endeavour to raise its resources domestically. If ADB was able to take this approach, for example through Yuan bond issues, it would immediately be significantly more competitive in the PRC market place.
Improving ADB’s Marketability and the Entry Point

Based on the above analysis there are considerable opportunities for ADB to participate in poverty reduction in PRC. However, there are several actions that ADB can and should take to improve its marketability given the already strong presence of the World Bank in this market place. Specifically, it is recommended that:

- ADB review the possibility of raising resources domestically in PRC, which would render it the advantage of being able to offer long-term resources without foreign exchange risk and make it most competitive with alternative sources of domestic finance where loan term remains an issue.

- ADB review its policy to consider the possibility of giving more flexible repayment terms for poverty projects, for instance low start repayments where the benefits of investments (particularly in social sectors) may be in the long-term;

- ADB reviews the possibilities for new products for fixed spread lending and hedging with a view to putting in place such products\(^\text{72}\);

- ADB considers establishing strategic alliances with other ODAs (particularly those with soft funding available) during the formulation of its poverty reduction strategy agreements with governments on a country by country basis, including PRC\(^\text{73}\);

- ADB revisits its poverty strategy to ensure that mechanisms such as parallel funding are articulated and form an integral part of the strategy, and that the strategy explicitly recognises that ADB’s operations may be equally effective if directed at the working and near poor rather than the absolute poor in the instances where there is good governance;

- ADB reviews its modus operandi for poverty projects and gives consideration to the establishment of a multisectoral task force or improved means to carry out multisectoral projects that will allow it to be effective in SIF and CDF type interventions.

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\(^\text{72}\) While it is recognised that variable rates generally create uncertainty for borrowers, ADB itself needs to charge in relation to its costs of borrowing. This is transparent under the single currency LIBOR based system. Although there is volatility in LIBOR and in the foreign exchange rate this is easier to hedge under the single currency LIBOR system that it is under ADB’s pooling system where it is difficult for borrowers to measure the foreign exchange impact. Governments also are generally in the LIBOR market for other borrowings, and should be better equipped to manage the risk here than with the pool based system. Where they are not, ADB can consider providing technical assistance to enhance this capacity.

\(^\text{73}\) There are significant advantages for other smaller donors in teaming up with ADB because they have the opportunity to see their lesser resources go further and greater prospects for roll-out and sustainability of their projects. The most important factor in co-financing is that the partners work together on the project from the outset through conception and design so a shared vision of the project is built. IFAD is probably the most experienced co-financing organisation because it does not implement it own projects. ADB could apply the IFAD methodology to the partnerships.
Next Steps

228  It would be advantageous for ADB to package these features together for a special poverty reduction initiative in PRC (and possibly other major borrowers with reservations about OCR lending such as India) ahead of the wider institutional reform that would be necessary to operationalise such changes throughout ADB. The relevant Programmes Department and the Poverty Unit could jointly spearhead such an initiative.

229  It is clear from the foregoing analysis in this Chapter and the more detailed findings on the four sectors chosen that are summarised in the following four Chapters and supported with the academic and case study evidence from PRC and around the world in the supporting appendices, that OCR interest rates can be disabused as a constraint on borrowing ADB funds for poverty reduction projects. While there are limits on the use of those funds, and FCPMC has reached clear conclusions about what is possible now and what is possible later, there is an immediate and wide range of opportunity. Although there are many areas of policy dialogue to be covered, policy change is not a prerequisite for all interventions, and policy change on a pilot basis would be acceptable for all.

230  A sensible approach is to pilot a variety of the recommendations as a lead in to selecting and expanding ADB-financed poverty reduction programmes in PRC in the future. For example, such a “Poverty Reduction Pilot Project” could:

- initiate a SIF/CDF type programme in one province or autonomous region,
- support a series of MFOs in a second,
- undertake some direct lending to “dragonhead” enterprises, and
- provide a further agroindustrial credit line to ABC.

231  Where appropriate these can focus on the 22 poverty blocks that LGOP envisages will be at the centre of their new Poverty Reduction Programme.

232  Initiatives on funding poverty components of other projects would continue independently. Provincial level piloting has been a common means of introducing new approaches in PRC in the past and such a project would provide a good foundation for roll out of successful components in the future and this is the recommended approach for operationalisation of the components of the strategy that are possible now.

233  ADB Poverty Partnership Agreement with PRC which is due to be completed by the end of March 2001 should take account of these priorities together with others emerging from its on-going poverty analysis process which includes this and other TAs, preparation of a comprehensive poverty profile, and consultations with NGOs and others.

Operationalisation of LGOP’s Perceived Priorities

234  It is recommended that operationalisation concentrates on the four components of the proposed pilot project. This will give focus and can proceed in
parallel with the policy dialogue. Because of their pilot nature, these interventions would not require national level policy changes, but rather specific clearances from government to carry out particular activities.

**A SIF/CDF Type Programme**

235 The main steps for operationalisation are:

- identify potential funding partners for lending and TA in implementation (LGOP for PRC and ADB for donors);
- obtain agreement from the Ministry of Finance to include a pilot provincial level SIF/CDF in the country programme (ADB and LGOP);
- organise a series of provincial level workshops in relatively reformist provinces in central and western PRC to explain the concepts and determine the level of interest (LGOP with ADB participation/small scale TA);
- rank provinces for consideration and reach agreement to move to design with the first ranked province (LGOP with ADB participation/small scale TA);
- identify national and provincial level executing and implementing agencies (LGOP in consultation with ADB);
- design provincial SIF/CDF (ADB TA or component of TA for larger poverty reduction pilot project) using the conceptual framework, design concerns, project framework, learning matrix ideas for the 90s\(^74\) and using participatory public private sector consultation;
- appraise provincial SIF/CDF using ADB standard procedures for multisectoral projects;
- implement using ADB standard procedures for multisectoral projects.

236 Note that a CDF can include a SIF project, and a CDF or a SIF can include elements of any or all of the four areas covered in this report.

**A Series of MFOs**

237 The main steps for operationalisation are:

- obtain clearance from PBC to pilot the MFO concept (International Workshop, LGOP and ADB);
- obtain in principle agreement from RCCs and or ABC for participation (LGOP and ADB);
- identify potential funding partners for lending and TA in implementation (LGOP for PRC and ADB for donors);

\(^{74}\) See Figure 1 in appendix A5.
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- obtain agreement from the Ministry of Finance to include a series of pilot MFO developments in the country programme (ADB and LGOP);

- review RCCs and or ABC provincial branches for implementation capacity and willingness to innovate and select three branches in central and western PRC (PBC and or ABC);

- identify existing microfinance projects that can be assimilated (if any) (LGOP);

- design pilot MFO project (ADB TA or component of TA for larger poverty reduction pilot project with RCCs and or ABC and LGOP) using the conceptual framework, design concerns, project framework, learning matrix ideas for the 90s\textsuperscript{75} and using participatory methods;

- appraise pilot MFO project using ADB standard procedures for financial sector projects;

- implement using ADB standard procedures for financial projects.

\textsuperscript{75} See Figure 1 in appendix A5.
TA for MFO Regulation

Although PBC believe that it is not appropriate at the present time to develop MFO legislation and regulation it is worth noting what TA could be provided by ADB if this were to be encompassed in a future agenda. The first steps would be to review the existing legislation relating to banking and financial institutions to: to determine what additional empowerment, if any, it is necessary to give PBC in order that it can regulate and supervise MFOs; and what amendments to the commercial banking law would be required to encompass MFOs; and as an alternative, what would be the requirements of separate legislation for these institutions.

For regulation and supervision it will be appropriate to use as far as possible the powers already granted to PBC and determine if it is necessary to amended existing legislation or create a separate MFOs Law. The basic provisions of any such law must provide that PBC may: draft and promulgate regulations on the banking activities of MFOs including but not limited to regulations on credit activities, depositor protection and prudential requirements; issue and revoke licences for MFOs; inspect and supervise bank MFIs including ensuring compliance with laws on banking activities and provisions of operating licences; and deal with breaches in the regulations and other laws governing the banking activities of MFIs directly or by reference to other authorities as appropriate. It will be preferable that this is done with the minimum of amendment to existing legislation and that to the greatest extent possible the legislation is enabling rather than prescriptive so that the powers for the issuing of regulations and defining and executing supervision practices are vested in PBC.

The requirements for the legislation on the operations of MFIs are more complex. Again it will be important to ensure that the legislation is enabling and that the prescription of detail is a matter of regulatory ordinance not legislation. The principal requirements are: empowerment of PBC to issue establishment and operation licences; the conditions to be met for obtaining an establishment and operating licence including: capital requirements, qualifications of founding members, qualifications of directors, compliance of the charter with the MFO law and other laws, and feasibility of business plan, the process of application for a bank MFI licence including the documentation required, the period allowed for consideration of the application, provision for payment of licensing fees; the specific business registration requirements and conditions to be met prior to commencement of operations including approval of charter, paying-up of capital, publication of licensing provisions, and establishment of suitable premises; the conditions under which a licence may be revoked, including falsification of information, failure to commence business operations within a specified period, voluntary or enforced liquidation, reconstitution or merger, or other non-compliance with regulations or legislation that is not rectified with a prescribed period; the coverage of the charter including: the MFO name and location of its head office, the scope of its activities, the duration of its operations, its authorised capital, procedures for changing authorised capital and for share issue and disposal, the responsibilities and powers of the Board of Directors, the procedures for the appointment and dismissal of directors, the rights and obligations of shareholders, accounting principles and internal controls, procedures for winding up, and procedures for amending the charter; changes in the charter or operations that require PBC approval; rights and conditions for setting up transaction offices, subsidiaries and administrative units; the qualifications of directors, excluded persons and delegation of director’s powers; internal and external audit requirements; rights to take deposits and to borrow, rights to extend and terminate credit; the rights of depositors and borrowers; rights to undertake other kinds of banking business and to incur off balance sheet liabilities (if any); provisions for the regulation of credit and exposure restrictions such as limits on loans to related persons, exposures to single parties, individual shareholdings, and determination of with prudential ratios from time to time by PBC; risk provisioning requirements including loan classification and general and specific provisions; statutory reserves and deposits; financial and accounting policies including reporting requirements and deadlines and public disclosure; provisions for special controls, bankruptcy, dissolution and liquidation and the conditions under which PBC may impose such controls or course of action and the powers of PBC therein; penalties and the process for dealing with violations; and bank confidentiality.

ADB has recently assisted Cambodia and Bangladesh with the development of such legislation and its pilot implementation and could make a valuable contribution to this in PRC.
**Direct Lending to “Dragonhead” Enterprises**

238 The main steps to operationalisation are:

- obtain agreement from the Ministry of Finance to include direct lending to dragonhead enterprises in the country programme (ADB and LGOP);

- design the facility based on ADB’s private sector lending procedures and eligibility criteria that ensure poverty reduction impact (ADB small-scale TA or component of TA for larger poverty reduction pilot project with ABC and LGOP);

- identify local partner for execution (Chinese Service Centre for Poverty Alleviation, TVE Bureau of Ministry of Agriculture) and fund establishment of project office and TA for promotion of facility and screening of proposals;

- appraise using ADB standard procedures for private sector projects;

- implement using ADB standard procedures for private sector projects.

**Agroindustrial Credit Line to ABC for “Dragonhead” Enterprises**

239 The main steps to operationalisation are:

- obtain in principle agreement from ABC for participation (LGOP and ADB);

- obtain agreement from the Ministry of Finance to a credit line to ABC in the country programme (ADB and LGOP);

- design the facility based on ADB’s financial sector lending procedures and the same eligibility criteria that ensure poverty reduction impact (ADB TA or component of TA for larger poverty reduction pilot project with ABC and LGOP);

- appraise using ADB standard procedures for financial sector projects;

- implement using ADB standard procedures for financial sector projects.

**Other Opportunities**

**Developing Parallel Funding**

240 Successful development of the parallel funding opportunity would be a pioneering step in poverty reduction for both the Government of PRC and ADB and it is strongly recommended that both give further consideration to this mechanism. The mechanism does not have to be tested in a poor province, because even rich provinces have substantial numbers of poor people and rich provinces are more inclined to borrow from ADB than poor ones because they have better ability to repay OCR loans. Nor does the mechanism have to leverage poverty reduction funding on a dollar-for-dollar basis. Even if the use of OCR funds to substitute for other domestic commitments resulted in 50 cents in the dollar being transparently and additionally
transferred to poverty reduction spending, the additionality would be substantial bearing in mind the crowding out that is currently believed to take place.

241 The main steps to operationalisation could be:

- obtain agreement from the Ministry of Finance to include a pilot provincial level parallel funding loan in the country programme (ADB and LGOP);
- organise a series of provincial level workshops in eastern and central PRC to explain the concepts and determine the level of interest (LGOP with ADB participation/small scale TA);
- rank provinces for consideration and reach agreement to move to design with the first ranked province (LGOP with ADB participation/small scale TA);
- identify national and provincial level executing and implementing agencies (LGOP in consultation with ADB);
- design a parallel funding project (ADB TA) using conventional methods for the OCR loans and the conceptual framework, design concerns, project framework, learning matrix ideas for the 90s76 and using participatory public private sector consultation for the parallel poverty reduction component;
- appraise both the OCR component and the parallel poverty reduction component using ADB standard procedures but ensuring that the poverty reduction linkage is transparent, poverty reduction investments are covenanted;
- implement using ADB standard procedures for multisectoral projects including as appropriate TA support for the parallel poverty reduction project.

242 Developing parallel funding is in the Consultant’s view the most important recommendation in this report, and ADB and the Government of PRC are urged to give pilot testing of the idea priority.

Special Facility for Small-scale Infrastructure

243 In the event that neither the CIF/CDF approaches succeed, there is the possibility to set up a small-scale rural infrastructure fund. As stated in chapter 6, this is not the preferred option. The reason for a fund is that individual investments on projects are likely to be small and thus difficult for ADB to programme and appraise. A fund on the other hand could have local appraisal procedures and could support small-scale rural infrastructure facilities of all types at the provincial level if there is a transparent poverty reduction effect. As with other pilots, a fund that worked initially with one province would be a satisfactory way to commence.

244 The main steps to operationalisation would be:

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76 See Figure 1 in appendix A5.
• obtain agreement from the Ministry of Finance to include a pilot provincial level small-scale infrastructure fund in the country programme (ADB and LGOP);

• organise a series of provincial level workshops in eastern and central PRC to explain the concepts and determine the level of interest (LGOP with ADB participation/small scale TA);

• rank provinces for consideration and reach agreement to move to design with the first ranked province (LGOP with ADB participation/small scale TA);

• identify national and provincial level executing and implementing agencies (LGOP in consultation with ADB);

• design the organisation, operational procedures of the fund and the eligibility criteria for investment to be supported (ADB TA), and the terms and conditions of funding and repayment;

• appraise using ADB standard procedures;

• implement using ADB standard procedures for multisectoral projects including as appropriate TA support for the parallel poverty reduction project.

245 It is stressed that in the Consultant's view a SIF/CDF type programme is preferable to this type of fund.
Rural and Microfinance Development

Findings for Rural and Microfinance

International Experience ¹

246 Poverty can be defined as a lack of the human, social and physical capital required for economic well being, and poverty reduction as the transfer to and accrual by the poor of human, social and physical capital to the point at which their economic well being can be assured. Microfinance can transfer physical, human and social capital, and represents a potentially efficient and sustainable poverty reduction mechanism. Efficiency is important because of scarcity of resources. Sustainability is important because accrual of human, social and physical capital by the poor is a long-term process.

247 A useful conceptual link between poverty reduction and microenterprises can be made, since many poor people are employed in such enterprises. A financial systems approach advocates sustainable provision of financial services to microenterprises to address poverty reduction, income improvement, productivity growth and sustained employment.

248 Microfinance methodologies incorporate innovations that reduce lending costs and risks and serve poor clients without normal collateral requirements on a sustainable basis. These innovations characterise microfinance and include: small loans for short periods with frequent repayments and little or no collateral; incentives for good repayment; high real interest rates that cover costs; large loan portfolios per loan officer with financial incentives for good performance; decentralised and simple lending procedures and close client supervision; and high loan repayment rates, often of 95 percent of more.

249 Proponents of using agricultural development banks for microfinance delivery hope to take advantage of their rural infrastructure and experienced personnel, rather than going to the time and expense of creating new microfinance institutions. However, the vast majority of these banks have failed to serve the rural poor and be self-sustaining, because of their project-based programmes, subsidised loan interest rates, high transaction costs, lack of savings services and overall lack of attention to their own sustainability. The success of the exceptions has required a dynamic agricultural sector; macroeconomic equilibrium and a sound fiscal system committed to reform; a legislative, regulatory and supervisory framework; and an autonomous and healthy institution with good loan portfolio quality, independent programme design and implementation, competent staff, and an appropriate information system. In PRC, the only candidate for this role, the Agricultural Bank of China (ABC) is

¹ The reader is referred to appendix A7, "International Rural and Microfinance Approaches and Experience" for the detailed arguments that justify the findings and a wide range of supporting illustrative case study experience.
currently characterised by a lack of autonomy, poor quality loan portfolio, lack of expertise in microfinance, and unsuitable information system.

250 Banks specialising in microfinance have started to make their appearance internationally. Most of these are NGOs that have made or are making the transformation into banks. The advantage of this approach is the firm commitment the new bank brings to microfinance. The disadvantage is that the transformation from NGO to bank is a slow, difficult and costly process requiring investment in information technology, changing the corporate culture and overcoming minimum capital barriers established under local law. Given their generally small size and limited capacity for sustainability, only a small fraction of NGOs can make the transition. There are no existing specialist microfinance banks in PRC and no clear candidates for a transformation into a specialist microfinance bank.

251 Commercial banks typically cite high risk, high costs, low profitability and cultural barriers as the chief reasons that prevent their entry into microfinance. Commercial banks also face some internal constraints. However, commercial banks have organisational and structural features that lend themselves to successful microfinance operations: they are regulated institutions under prudent management; many have the branch networks to enable them to reach a large number of clients; they have well-established internal controls and administrative and accounting systems; their private capital ownership structures tend to encourage sound governance structures, cost-effectiveness, profitability, and sustainability; they have access to their own sources of funds (deposits and equity); and their ability to offer loans, deposits, and other financial products make them attractive to microfinance clients. The main lessons of commercial banks that have successfully entered the microfinance market are: committed and visionary leadership is required; profit must be the principal motivation; there must be a strategic fit between the bank and the new market; successful microfinance operations require a different set of operating procedures, extensive investments in appropriate information technology, training, staff incentives, a wide network of bank offices and hours of operation convenient for microfinance clients; and managers need to focus on operational efficiency and delinquency control as part of profit generation. The model of the commercial bank that establishes a new microfinance subsidiary is of interest in the PRC context because of the lack of a good fit between microfinance operations and the existing corporate culture of PRC commercial banks, and the lack of existing microfinance institutions large enough to be capable of moving into this role.

252 NGOs have developed methodologies that are key to the success to date of microfinance in addressing poverty reduction. However, many NGOs have experienced serious problems of sustainability, suggesting there may be serious flaws in the NGO approach. The most successful and advanced microfinance providing NGOs transform themselves into regulated financial institutions. Using NGOs as a major component of broad-based provision of microfinance services in PRC is problematic, because of the quasi-legal status of existing microfinance projects in the country and the small size of all existing pilot microfinance projects.

253 Specialised non-bank financial intermediaries for microenterprises may take the form of finance companies, private financial funds, or other legal forms. Their common characteristic is that they are not considered banks under local legislation and so are exempt from minimum capitalisation requirements and the strict
regulatory and supervisory regime applied to banks. Recognition that microfinance organisations have special organisational and operational characteristics that flow from the unique nature of their loan portfolios is important in the PRC context.

254 Credit Unions do not exclusively target the poor or define their mission as serving the poor. However, they feature many of the characteristics of good microfinance providers and have competed successfully with other microfinance providers because they: tie savings to loans to maintain balanced growth; can establish operational self-sustainability in rural areas; are part of a world-wide network that has created its own industry standards; can react to financial market reforms and to new demands and competition; and depend upon each other to achieve economic benefits. Lessons include: self-help groups, independently established, can be operated in a financially prudent, self-sustaining manner without the imposition of regulation from outside; and such institutions serve a valid financial intermediary role in rural areas.

255 Village banks are intermediaries between the sponsoring agency, which makes one loan to the village bank, and the member/borrowers. Credit to members is linked to savings, and loan sizes to the amount saved by each borrower. Evaluation of village banking programmes indicates that their benefits are both economic and social. The village bank model is of interest in the PRC context because it offers a way to link a larger organisation, such as a commercial bank, with a specialised microfinance institution based at the local level.

256 Government and donor programmes for provision of financial services to the poor are operated in many countries. These may evolve into microfinance banks or a variety of other organisational types. These types of programmes tend to suffer all the problems attributed to government-operated subsidised credit programmes, including high default rates, lack of sustainability and the suppression of the development of a viable rural financial infrastructure. In the PRC context, such programmes have in most areas outworn any emergency or humanitarian justification they may originally have had and in most areas are now preventing the development of a permanent financial infrastructure.

PRC Experience 2

257 ABC was set-up and disbanded three times before the rural reform in 1978. Prior to this it was government’s agricultural policy instrument rather than commercial bank. Since 1978 it has been a state-owned bank with branch outreach to all counties and most townships nation-wide. ABC’s Clients are mainly township and village enterprises (TVEs), state-owned enterprises (SOEs) and other collective enterprises. It also serves individual farmers and private enterprises. ABC was been associated with poverty lending through its earlier involvement in directed credit of various types. Much of this was transferred to the Agricultural Development Bank of China (ADBC) following its establishment in 1995, but in 1998 lending under the government’s subsidised lending programme for poverty reduction was transferred back to ABC. Initially officials from PADOs continued to control the lending, but in

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2 The reader is referred to appendix A8, "PRC Rural and Microfinance Approaches and Experience" for the detailed arguments that justify the findings and a wide range of supporting illustrative case study experience.
1999 control was essentially passed to ABC. The persistence of historically poor credit discipline in the programme and subsidised interest rates has led to problems for ABC management and staff because of ABC’s commercial orientation and strong internal accountability for lending performance. As a result, the general trend has been a disinclination to lend to the rural poor, this being reflected in ABC’s loan portfolio generally.

258 ADBC is a policy bank, established in 1994 to deliver the government's subsidised poverty lending programme, other subsidised credit schemes, and for financing SOEs for the purchase and storage of grain, cotton, and edible oil. The subsidised credit operations were transferred back to ABC in 1998. ADBC’s operations are now primarily confined to acting as a conduit for government lending to agriculturally related SOEs. It does not take deposits from the public and lends under terms determined by government.

259 In the 1950s, at their establishment, RCCs were real co-operative organisations. Later they were subordinated to PBC and then ABC. In 1996, RCCs again separated from ABC and were put under PBC supervision. RCCs cover most townships and have outreach to villages through agents (usually the village accountant or village head) who are engaged to deliver financial services. With their separation from ABC, PBC has required RCCs to create apex organisations at the county level to supervise lower level RCCs and has set up its system of management through its Cooperative Finance Organisation Management Department to administer, supervise and regulate RCCs at all levels. RCCs clients are farmers, TVEs and rural private enterprises including individuals. RCCs have been mandated by the State Council to allocate more than 50 percent of credit to farmers, but in practice this has proved hard to realise because non-financial transaction costs for farmers are high and RCCs prefer to make larger loans to better-off farmers and enterprises. RCCs are exploring new ways to deliver service to farmers both through experimental linkages with microfinance projects and new lending mechanisms such as the use of joint liability groups. However, RCCs interest rates remain state controlled, management is weak, and the use of joint liability groups for production lending to relatively better-off farmers will not bring them closer to the poor.

260 Informal finance developed after the reform in 1979. Rural Credit Foundations (RCFs), ‘Hui’s (informal rotational savings and credit associations) other forms of informal lending developed rapidly especially in areas where there were economic opportunities and formal financial institution’s services were unable to meet the demand or did not have outreach. RCFs grew rapidly in the 1980s and 1990s, financed by collectives and farmers, and it is estimated that that in 1998 their loan portfolios were more than four times that of the formal financial sector. RCF’s clients were mainly farmers. RCFs were ordered to close or merge with RCCs by PBC in 1999 for reasons of financial prudence and ceased operation almost immediately. The extent of ‘Hui’s is not possible to estimate with accuracy because they are illegal. They are reported to be widespread in rural areas, meeting demands for credit with relatively low total transaction costs for borrowers. Members of ‘Hui’s are typically small business people or those with spare capital to invest at higher risk for higher return. Interest rates are generally two to three times the official rates charged on a flat rate basis making the effective rates significantly higher. Two percent per month flat rate is reported as normal.
Microfinance schemes are of four types comprising those sponsored by: NGOs, government, formal financial institutions and donors. The schemes are diverse and although loan sizes are generally small (less than RMB 2,000) and in line with the expected size for "microfinance", scheme operation varies greatly and few, if any schemes, operate in accordance with international best practice, though some are striving to do so. There are more than 260 pilot microfinance schemes in PRC. Other than the few that are operated through formal financial institutions (ABC or RCCs) they are illegal, but the government has tolerated their development because there is genuine interest in developing microfinance in PRC, and based on the initial success of some pilot microfinance projects, “microfinance” has come to be regarded in PRC as a potentially effective tool for poverty reduction.

Analysis shows that although the formal financial system is characterised by its legality and good outreach throughout PRC (in some cases down to village level), and its ability to offer a range of services to its clients including the legal taking of deposits, microfinance is not well suited to ABC’s business strategies, as ABC is now undergoing a transformation into a regular commercial bank; microfinance is not at all suited to ADBC, as ADBC has now been assigned very different policy lending responsibilities by government; RCCs may be the most appropriate existing player in the formal rural financial sector to undertake microfinance operations, but are not ready because their internal policies, procedures, systems and corporate culture are not appropriate; and it is not politically possible for RCFs to undertake microfinance operations because of the recent government moves to close them or merge them with RCCs.

Pilot microfinance schemes sponsored by NGOs, formal financial institutions and donors have demonstrated the relevance and viability of microfinance in PRC and that outreach of microfinance can be extended to the poorest areas and to poor farmers. However, these projects have no legal status and there is an acute lack of microfinance policy, legislative, regulatory and supervisory frameworks. Most NGOs, formal financial institutions and donor microfinance programmes charge the maximum loan interest rates permitted under law, these are insufficient to achieve full financial self-sustainability, but most government poverty reduction projects rely on highly subsidised government funds and charge interest rates on loans far below the level at which these projects can be made self-sustainable.

Examination of operational issues demonstrates that: a focus should be put on training microfinance management and field staff in microfinance international best practice; accounting and information systems need to be upgraded; a variety of microfinance methodologies should be encouraged, not restricted to group lending, in order to provide competition and consumer choice and to continue to evaluate the best methods for various regions and groups; loan and savings products and service delivery methods need to be perfected in order to respond to the demands of the potential market in an efficient way; and additional sources of funds for microfinance need to be developed. These matters can be readily addressed through technical assistance and training.

The principal issues are about how to roll out successes in the context of finite NGO and donor funding, PBC’s understandable reluctance to create new formal microfinance institutions, and the limitations of the existing formal financial sector to take on this role effectively. These are the core issues that affect
microfinance and effective poverty reduction lending in PRC. To develop microfinance as a tool for poverty reduction, and to let formal financial institutions be involved in microfinance, the following three conditions are critical: the legal status of microfinance institutions should be regularised and a framework of policy, regulation and supervision concerning microfinance should be established; the interest rate ceiling should be abolished to allow microfinance institutions to attain financial self-sustainability; and a grassroots network appropriate for microfinance needs to be developed (regardless of whether it is attached to an existing formal financial institution) to allow organisational and methodological flexibility to suit different areas and to assist to break up the financial monopoly that currently exists in rural areas.

Policy Dialogue Issues

266 With 15 years experience in poverty reduction lending programmes, significant experimentation over five years with microfinance techniques and numerous pilot microfinance projects country-wide, there is rich experience with microfinance in PRC that, in combination with international experience, can be used to extract lessons for the future direction of microfinance. PRC still needs some experimentation with international best practice but more importantly it requires policy decisions on how best to implement the lessons already learned.

267 Policy dialogue can bring the attention of the PRC government to the potential for the financial sector in general, and microfinance in particular, to open up a window for a financial systems approach to microfinance that emphasises its financial intermediary role rather than its role as a means to disburse funds to a target population. The lessons from microfinance pilot projects in respect of organisation, methodology, governance and financial management are already well known: the barriers to adoption are political and bureaucratic rather than technical.

268 The focus of policy dialogue should be on:

- creation of a policy, legal, regulatory and supervisory framework for microfinance. This is likely to be possible only on an incremental basis, given the current government position that such an environment is not required. The initial focus of policy dialogue in this area should be the legal status of the pilot microfinance projects already existing in PRC, coupled with the necessary regulation and supervision regime under which such microfinance programmes should be covered.

- interest rate deregulation for microfinance programmes and re-focusing microfinance on providing financial services to the bankable poor rather than using microfinance as a method for disbursing funds for poverty reduction. A shift from a poverty reduction approach to a financial systems approach, at least for those areas that do not have a high population of hard core poor, will bring benefits in terms of improved market functioning, increased financial intermediation, improved efficiency in the use of financial resources and reduction of the drain on government funds. It will free up resources for application to hard core poor populations, which can be approached on a welfare basis if appropriate.
• the participation of NGOs and other non-bank financial institutions (NBFIs) in microfinance. This can be addressed through the linking of NGO microfinance programmes with large financial institutions, while at the same time maintaining a link with the donor through its provision of technical assistance and/or funding.

• adoption of microfinance international best practice in the government’s own poverty reduction programme.

Microfinance Institution Regulation

269 The PRC financial sector is characterised by a growing body of law and regulatory documentation for banks and other major financial institutions, including the Banking Laws of PRC, Banking Laws for Commercial Banks of PRC, Insurance Laws of PRC and Billing Laws of PRC, which were promulgated for implementation in 1995; and Management Regulations of Financial Institutions, which was published in 1994. PBC has published Management Regulations for Rural Credit Co-operatives, Management Regulations for County-level Apex Institutions of Rural Credit Co-operatives and Ten Opinions regarding Rural Credit Co-operatives to Improve and Strengthen Farmer Assistance Services. However, it has no Law on Credit Co-operatives, even though RCCs are defined as rural co-operative economic organisations.

270 The vast majority of pilot microfinance projects in the country have no proper legal status. They have been tolerated to date by the government in view of their utility in experimenting with microfinance as a tool in poverty reduction. The central government’s stringent action to close the RCFs has served to highlight the shaky legal ground on which the pilot microfinance projects stand, however, and has provoked something of a crisis of confidence among donors. A change in policy within government, in the absence of a legal basis for microfinance, could mean the sudden closure of these projects.

271 There is no legislation dealing with microfinance in terms of financial service provision, and PCB has issued no policies on microfinance. The position of PBC is that it is not imperative to develop a legal basis for microfinance institutions, but that microfinance must be done on a legal basis.3 In practice, this means that pilot microfinance programmes will remain in their present legal limbo until such time as the government decides to close them down or have them taken over by a formal financial institution.

272 At present, the development of microfinance in PRC is politically driven, with primary importance placed on its utility as a mechanism for poverty reduction through distribution of subsidised loans. This stands in contrast to some other countries, notably Bolivia and Peru, that have provided a legal basis for microfinance as financial intermediaries and has created multiple self-sustainable financial institutions that make up a part of the permanent rural financial infrastructure. This may be difficult in the PRC context as the position of microfinance as financial intermediation is not yet accepted in PRC.

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3 See para 23 in appendix A8, "PRC Rural and Microfinance Approaches and Experience".
273 Other countries, such as Bangladesh and Thailand, have passed legislation specific to one or a few specific institutions (Grameen Bank and BAAC respectively) that are designed to allow the operation of those microfinance specialist institutions on a proper legal basis. This is more likely to be the case in PRC in the short and medium term.

274 Notwithstanding the current government view that there is no need to provide a legal basis for independent specialised microfinance institutions, there are in fact good reasons for doing so. Reasons include:

- providing a clear basis for differentiation and classification of microfinance programmes, for example between those that mobilise deposits (either mandatory or voluntary) and those that do not, as a basis for determining which programmes should come under PBC supervision;
- providing guidance for microfinance programme design and methodology, including development of a system of performance standards and prudential risk management which are neglected at present; and
- preventing local occurrences of the RCF type, where local operations outside the scrutiny of PBC undertook inappropriate use of depositor’s funds and caused disruption to the local financial markets.

275 The current high number of microfinance schemes operating in the country, including those of government poverty alleviation offices as well as those of donors, means that there is an acute need for microfinance policy, legislative, regulatory and supervisory frameworks in PRC. This is, unfortunately, an area of concern for microfinance in most countries: the rapid development of microfinance as a widespread force in rural finance has found most legal and regulatory frameworks lacking.

276 Legislation needs to provide for the legal existence and operation of all types of microfinance institutions and programmes. Some distinction should be drawn between institutions and programmes that mobilise savings (bank Microfinance Institutions or MFIs) and those that do not, in order to eliminate most programmes from strict regulation and supervision requirements that bank MFIs will require. Legislation also needs to empower PBC to deal with the microfinance sub-sector of the financial sector.

277 The requirements of the law regarding PBC are relatively straightforward. The law must provide that PBC may:

- draft and promulgate regulations on the banking activities of bank MFIs including but not limited to regulations on credit activities, depositor protection and prudential requirements;
- issue and revoke licences for bank MFIs;
- inspect and supervise bank MFIs including ensuring compliance with laws on banking activities and provisions of operating licences; and
deal with breaches in the regulations and other laws governing the banking activities of bank MFIs directly or by reference to other authorities as appropriate.

278 To the greatest extent possible the legislation should be enabling rather than prescriptive so that the powers for the issuing of regulations and defining and executing supervision practices are vested in PBC with no need for further reference to government.

279 The requirements for the legislation on the operations of bank MFIs are more complex. Again it will be important to ensure that the legislation is enabling and that the prescription of detail is a matter of regulatory ordinance not legislation. ADB can assist in this through TA.

**Interest Rate Liberalisation and Sustainability**

280 Sustainability of the poverty reduction effort is an ideal that is universally held, because of the need for a long-term effort to successfully lift people out of poverty. There is a difference, however, between sustainability of the poverty reduction effort and MFI self-sustainability. Sustainability of poverty reduction could theoretically be achieved while charging prices below the total cost of providing services ("subsidised" prices), provided that a permanent and reliable source of external funding is obtained. Should the external source of funding disappear (due to a change in donor or government programmes, for example), the poverty reduction effort would soon fail.

281 The belief that the poor cannot or will not pay for financial services that they value has been exploded by the success of microfinance programmes for the poor world-wide. Those that continue to argue against MFI self-sustainability therefore tend to think that: government are concerned about the poor and will continue to support poverty reduction programmes at or above current levels; and the poverty reduction effort is too important to be left to independent organisations that may value profit over lifting people out of their poverty, particularly the poorest who are the most difficult to serve. Those that advocate MFI self-sustainability argue that: any external source of funds is inherently unreliable, and history demonstrates the likelihood of external funding disappearing; subsidies encourage inefficiency: by reducing the pressure on MFIs to survive, they stifle innovation in service delivery; subsidies limit the scale of microfinance (and poverty reduction) activities, since they prevent access to commercial funds such as deposits, forcing reliance solely on the limited resources of governments and donors; and government cannot implement successful microfinance programmes because: government workers are not paid on a performance basis, government is inherently bureaucratic, inefficient and/or corrupt, and borrowers assume that loans are in fact disguised grants if they come from government.

282 Some questions still exist regarding the trade-off between achieving significant outreach and achieving MFI sustainability. Viable institutions exist that provide very small loans\(^4\), and evidence suggests there is no correlation between

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\(^4\) This is generally accepted as a proxy for the poverty level of the clients served.
loan size and the financial sustainability of the MFI. While it is more difficult for institutions to provide very small loans, examples can be found that have innovated delivery systems that are efficient enough to deliver these services at prices clients are prepared to pay. The determining factor in achieving financial self-sustainability for such MFIs is the price of their services: those that charged prices that covered the full cost of provision achieved sustainability; those that chose to set lower prices, did not.

283 However, some contend that MFIs that have self-sustainability as their goal will not target the poorest of the poor, or those in remote regions that are difficult and expensive to serve. No definitive answer has yet been found on this issue. However, it is clear from experience in PRC and internationally that credit alone is not enough to lift people from poverty: credit is only effective when borrowers can access investment opportunities that return a higher return than can be achieved without credit. In some very remote areas, where markets are ineffective or do not exist and the local economy is at subsistence level, credit alone cannot make a difference in reducing poverty. These areas require: a welfare approach to combat immediate hunger, cold and disease; and upgrading of health, education and physical infrastructure (roads, markets and so on) to increase potential access to investment opportunities.

284 Notwithstanding arguments about the ability of microfinance institutions to reach the poorest of the poor, it has been clearly proven that microfinance institutions can serve the relatively less poor. These people, who make up the bulk of those currently reached by existing government poverty reduction lending, can be more effectively and efficiently served using best practice microfinance methodologies.

285 Subsidised poverty reduction lending in PRC in 1998 achieved an official loan recovery rate of only about 60 percent. On a total effort of RMB 10 billion, this means that RMB 4 billion was lost, with little impact on poverty. This argues for a split between a sustainable microfinance programme funded with RMB 6 billion, coupled with a welfare programme directed at hard core areas costing RMB 4 billion. The combination would have every likelihood of achieving greater impact on poverty than the current programme.

Learning from Best Practice

286 Pilot microfinance programmes have implemented microfinance best practice in their schemes and have experimented with variations in organisation and methodology in order to discover what works best in the local environment. As much as possible, given the restrictions on interest rates and savings mobilisation, these pilot programmes have striven to provide microfinance services to the poor on a sustainable basis. Some programmes, notably the Funding the Poor Co-operative Project (FCP) pioneered by the Chinese Academy of Social Sciences (CASS) project, have achieved operational sustainability in spite of restrictions on interest rates.

287 However, the funds that are channelled to the poor through these pilot projects are a small fraction of the total amount of funding for poverty reduction lending. The vast majority of loans for the poor are available under the government
poverty reduction lending programme, which is not run in accordance with microfinance principles.

288 Different local governments have experimented in various ways with the “GB Model”, on what is essentially a trial and error basis, repeating many of the mistakes that have been committed by other programmes internationally and in PRC. The lack of co-ordination of approach and the resulting patchwork of schemes reflects a lack of understanding of the clear lessons that can be learned from microfinance experience to date in PRC and worldwide.

289 Therefore there is a need to standardise the approach of the poverty reduction lending programme to reflect microfinance best practice. In this process, clear distinction needs to be made between farm lending for seasonal production that is the current focus of PBC in promoting RCCs as providers of "microfinance", which is not true microfinance, and the more general development of microlending in urban and rural environments. This involves far more fundamental changes in organisational culture and operations than the introduction of joint liability lending and it is unlikely that microfinance will be successful in PRC until other best practices are adopted.

Intermediaries for Delivery

290 At present, there are no specialist microfinance banks in PRC. None of the existing rural financial institutions has the optimum combination of grass-roots network, appropriate corporate culture, policies, methodology and information systems that are required for successful provision of microfinance services. Such attributes are required for successful operation of microfinance programmes: results from many years of attempting to provide rural areas with loans through inappropriate institutions have been mixed at best, with high default rates and poor poverty reduction impact. There is therefore an urgent need for specialist microfinance provider(s) in PRC that can start providing microfinance services using proven methodologies over a wide area of the country relatively quickly.

291 ABC, the only state-owned bank that could be considered as a potential rural microfinance bank, is unsuitable for transformation into such a bank for many reasons. These include: large size and high overhead cost structure; poor quality portfolio, particularly its loans to state-owned enterprises (SOEs); loan work-out strategies, including moving poorly performing loan assets to a subsidiary asset management company, are just in the beginning stages of implementation; inappropriate policies and operating procedures and information systems; staff and management who have little expertise in lending to very small borrowers; a branch network that, although the best of all the state-owned banks, is not as extensive in the rural areas as would be required of a microfinance bank; and most importantly, lack of an appropriate corporate culture.

292 The organisational culture of ABC is already in transformation, between the state-directed banking culture of the past (especially in the prefecture- and county-level branches in the interior) and the new, commercial banking culture (especially in the newly prosperous coastal regions). For all these reasons, ABC is not in an ideal position to take on the role of state-owned microfinance bank in the near to medium future.
293 RCCs are also not well positioned for direct microfinance operations. They suffer many of the drawbacks that ABC suffers: in particular they lack an organisation at the local level, a methodology of operations suitable for microfinance, and experience in microfinance operations. Perhaps most importantly when considering a nation-wide poverty alleviation programme, RCCs have no organisation above the county level. It is unlikely that PBC will find it efficient to deal with the many RCCs individually and so higher level apex organisations will be needed.

294 RCCs have the advantage that they have already been selected by government as the main vehicle for lending to small farmers, as evidenced by the fact that in the rural financial reform programme, PBC set a goal of at least 50 percent of RCC’s lending portfolio to farm households. In addition, they have an interest in microfinance as evidenced by their current experiments with microfinance with Desjardins in Luanping county, Hebei Province.

295 The feasibility of using NGOs as a major component of broad-based provision of microfinance services on even a regional basis in PRC is problematic, because of the quasi-legal status of existing microfinance projects in the country, the small relative size of all existing pilot microfinance projects and the difficulties of scaling up such projects within a reasonable period of time. The pilot microfinance projects cannot be considered a viable alternative for mass coverage of the poor areas of the country with microfinance services in the near to medium term.

296 Currently there are 266 pilot microfinance projects in operation in PRC, approximately 90 percent of which are funded by external donors, some of which are NGOs. Not one of these pilot projects has yet achieved financial self-sustainability. This is not to imply that lessons cannot be learned from these pilot projects, nor that many might not achieve financial self-sustainability given the right environment: many of them embody best microfinance practice and have achieved enviable success given their limited scope. It is, in fact, their limited scope that makes them unsuitable as candidates for implementing a national microfinance programme.

297 International experience has shown that transformation of state-owned agricultural development banks is difficult. Successful transformations such as that of Bank Rakayat Indonesia (BRI) have taken place in the context of a broader devolution of the government’s control over the financial sector. In other circumstances, reforming state-owned development banks, particularly on issues such as removal of interest rate subsidies and rigid targeting of certain population groups, can prove insurmountable.

298 Upgrading NGOs or other NBFIs to specialist microfinance banks has been an option in some countries such as Bolivia, Dominican Republic and El Salvador. International experience highlights the difficulties of programme expansion and of
making the transition from non-bank to bank, and in particular the time and expense
required to make such a transformation.

299 The PRC Government and PBC have a strong view that new institutions
should not be created in the financial and government sectors without extremely
persuasive arguments. This is generally a wise policy and one that has the sympathy
of all observers who have seen institutions proliferate in an uncontrolled fashion in
some countries.

300 However, the closure of the RCFs has in fact left a gap in the rural financial
infrastructure that most properly should be filled with a new type of institution. It is a
mistake to think that one institution can be all things to all people: for example, a
commercial bank with a clear mandate to pursue market opportunities and make
profits cannot be realistically expected to be equally good at providing very small
loans to poor people in remote areas. Different organisational structures, corporate
cultures, operating methodologies and accounting and information systems are
sometimes required for different tasks.

301 Transformation of institutions from one type to another, from one task to
another, is possible: international examples can be found. In the PRC context,
however, the paucity of large rural financial institutions with a firm commitment to
microfinance coupled with extensive experience in microfinance operations makes
selection of a candidate for such a transformation difficult.

302 Reconciling the need for organisations suited to the provision of microfinance,
and the reluctance of PBC to allow the formation of new financial sector
organisations, could be addressed by forming linkages between small, local
microfinance organisations (new and/or existing) and large national (or potentially
national) financial organisations. This parallels the village bank model used by BRI in
Indonesia7 or the model of some commercial banks that have entered the
microfinance market through subsidiaries8, and appears to offer the most practical
course of action in PRC at present.

**OCR Lending Opportunities**

303 The overarching goal of any microfinance initiative supported by ADB in PRC
will be poverty reduction. The purpose of any particular microfinance project or
project component will be to lend on a self sustainable basis to the bankable poor in
order to enable them to benefit from better access to assets. The bankable poor that
are targeted and the assets that are accessed will vary. For example, microfinance
can be used to support:

- farm production in poor areas either on a stand-alone basis or in connection
  with agroindustry where the clients will be farmers who are diversifying out of
  traditional production to higher value crops or more intensive cropping (in this
case replacing the present subsidised loan scheme);

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7 See paras 48 to 52 and 136 to 142: “Transformation of a State-owned Development Bank – BRI,
Indonesia” and the box “Badan Kredit Desas (BKD)” in appendix A7 “International Rural and
Microfinance Approaches and Experience”.

8 See paras 69 to 73 in appendix A7 “International Rural and Microfinance Approaches and Experience”.
non-farm production in poor areas either on a stand-alone basis or in conjunction with pillar or other industries where the clients will be rural entrepreneurs diversifying or expanding their income sources;

development of small-scale rural infrastructure in poor areas where the clients can be village groups who want to finance water supply or better access but need time to pay;

connection to infrastructure where the income streams of the poor will afford payment over time but will not allow a lumpsum payment, for example in connection to electricity supply;

voluntary resettlers who need capital resources and production and consumption finance during the establishment period at the settlement site;

migrant workers who need initial capital to fund their relocation and the costs of setting-up home in the new location of their work; and

the urban poor who wish to start or expand small-scale businesses.

304 The real significance of microfinance is that it is a proven method of providing the poor with access to better physical and financial assets, and at the same time, particularly with infrastructure investments, can contribute to quality of lives gains that have positive effect on the human resource and social capital dimensions of poverty.

Direct Lending Opportunities

305 The use of commercially priced resources for microfinance is well established, although most schemes have received some start-up assistance in grant form9 and the use of OCR funding is not an issue for established microfinance operations. Microfinance cuts across sectors as well as being a sector itself. On a cross-sectoral basis, the impact of ADB’s present approach to poverty reduction through indirect mechanisms can be extended and enhanced, to provide not only trickle-down benefits to the poor but also more direct benefits through the inclusion of microfinance components in larger projects. Components can be included in SIFs and CDFs when these mechanisms are established, and more immediately in other projects for rural enterprise generally, the development of community infrastructure, and small-scale productive infrastructure or equipment, and for migrants in voluntary resettlement schemes or migrant workers.

306 However, a mechanism is needed for delivery and the situation is complex. ADB’s draft Microfinance Development Strategy states that “ADB should not go beyond policy related operations in countries where the policy environment is not conducive for sustainable development of microfinance”.10 The present PRC disbursement-oriented approach characterised by lack of policy, legal, regulatory and supervisory frameworks for microfinance; a restrictive interest rate regime that

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9 See appendix A3 for some examples.
prevents achievement of MFI self-sustainability; extensive government involvement and programme targeting; and an environment where independent, competitive MFIs are actively discouraged certainly qualifies as being an environment that is not conducive for sustainable development of microfinance. With this logic, ADB should refrain from actively participating in the microfinance sector in PRC outside of policy related operations.

307 It is not clear that this approach would pay dividends in terms of development of an environment that is conducive to microfinance operations. ADB is more likely to have an impact on PRC government policy if it works with the government to jointly develop projects that work, rather than opt for a distanced approach focused exclusively on policy matters. A dialogue only approach, while having the advantage of taking the moral high ground, is not as practical as an engagement approach. It is recommended that the microfinance proposals here are piloted in the context of larger ADB projects in PRC, to allow more international best practice to be tested and appropriate design modifications to be made. This will not commit ADB at a national level, but will take principle and practice forward together.

308 The national level subsidised loan poverty reduction programmes cannot be supported using OCR funds in their present form because of issues including transparency, targeting, sustainability and the price of OCR funds. However, a new mechanism could enable ADB to work both with the government on its poverty reduction programmes on a selective basis. This will involve the development of microfinance organisations (MFOs) to extend the outreach of ABC/RCCs and the development of an apex funding organisation (a microfinance fund or MFF) to channel the combine resources of donors, government and banks.

Parallel Lending Opportunities

309 The parallel lending opportunities essentially embrace all of the above direct lending opportunities if they feature as components that will be financed by a provincial government that has freed-up resources for poverty reduction activities through the parallel lending mechanism.

Mechanisms for Implementation

Components of Projects including SIFs and CDFs

310 This will be done on an individual project by project basis. Where ADB is funding a project that can usefully include a microfinance component (for producers, or communities or resettlers or migrants) this should be considered at the design stage and appropriate MFOs can be incorporated. These “pilots” can proceed ahead of the development of MFOs generally and the MFF, but should follow the best practice guidelines derived under the TA.
The MFO and MFF Structure

Microfinance Organisation (MFO) Development

311 Given the conflicting and inter-dependent factors that must be reconciled to achieve an effective mechanism for the use of microfinance international best practice in poverty reduction programmes, a new mechanism is suggested. This mechanism draws from the village bank model, such as that followed by BRI in Indonesia, and the model of commercial banks that have established subsidiaries to penetrate the microfinance market, such as the Bank of Nova Scotia in Guyana.

312 At the village level and below, a specialist microfinance organisation (MFO) is required that:

- utilises best international practice to effectively provide microfinance services that clients want, such as savings and small credit;
- operates on self-sustainability principles; and
- has appropriate organisational structure, corporate culture, operating methodologies and accounting and information systems for microfinance.

313 The village-level MFOs could be existing pilot projects that scale up to achieve self-sustainability, or new microfinance organisations, established by donors, government or third parties, possibly following a standard organisational and methodological model approved by PBC. MFOs would be licensed by PBC, through the sponsoring formal financial institution, to engage in microfinance activities, including lending and marketing of savings services, as an agent for the sponsor.

314 The sponsor would be a larger organisation that can: channel funding to the microfinance provider; provide a variety of savings services; and supervise and monitor the microfinance operations.

Sustainability

315 MFOs would need to be given a mandate by PBC to charge higher than commercial rates for microfinance loans; an estimated effective rate of 18 to 20 percent would be required for full financial self-sustainability\(^\text{13}\) (this is the World Bank’s estimate of the interest rate required on microfinance loans to enable achievement of full financial self-sustainability). The rates should apply on an exception basis only to loans provided by the licensed MFOs, and not to other players in the financial sector.

316 If problems are foreseen with a sudden change of interest rate regimes from a highly subsidised rate under the poverty alleviation programme to a commercial rate, the rate change could be phased in over a period of one to two years. Rates on ABC poverty reduction lending could be raised from the current 3 percent to say 6

\(^{13}\) PBC has indicated that it is prepared to tolerate nominal interest rates up to double the current ceilings, plus reasonable services charges, for microfinance institutions.
percent then 9 percent flat rate in consecutive years, paving the way for acceptance of market rates on the order of 12 percent flat rate in the third year.

**Long, Medium and Short Term Prospects**

317 In the long term, microfinance services on a financial systems basis would be best provided by independent microfinance institutions, operating in a policy, legal, regulatory and supervisory environment conducive to multiple organisations competing to provide financial services that the rural population wants and needs. Given the recent history of closure of RCFs and the negative attitude of PBC toward such an approach, this must be considered only a long-term vision. In the long term, the government could allow the proposed MFOs to separate from the supervising financial institution and operate on their own.

318 This scenario has been given a recent boost by the bilateral WTO agreement between PRC and the USA. Under the agreement, PRC has committed to full market access in five years for US banks. Foreign banks will be able to conduct local currency business with PRC enterprises starting 2 years after PRC’s accession to the WTO, and with PRC individuals from 5 years after accession. Foreign banks will have the same rights as PRC banks within designated geographic areas, with all geographic restrictions removed in five years. The WTO agreement increases the likelihood of accelerated financial sector reform and opens up the potential for independent rural microfinance institutions.

319 In the medium term, the RCCs are most likely the best choice for provision of microfinance services on a national scale, given the mandate to serve small farmers, their village level network and their seeming interest in microfinance as evidenced by their experiments with microfinance with Desjardins in Luanping county, Hebei Province. In the context of the proposed linkage between MFOs and large financial institutions, the RCC Apex organisations at county level would be the best choice for the monitoring organisation (RCCs at the township level are unlikely to have the capability to supervise microfinance organisations). The RCC Apex would report to PBC at the county level.

320 The major drawback to the RCCs is their lack of an organisation above the country level, either at national or provincial level. This makes it difficult for PBC to have a direct dialogue with the RCCs, and is the prime reason why the RCCs are not used in the poverty reduction programme. PBC has indicated that it would like the RCCs to develop an organisation at the provincial or national level: until they do so, they are unsuitable for use in the rollout of a microfinance programme of national scope.

321 In the near term, therefore, ABC is the only choice for such a rollout. As a commercial bank, ABC is unlikely to be fully committed to microfinance, at least initially. However, county level branches of ABC could act as agents for the government to supervise the operations of sponsored MFOs, on a fee basis. Standard contracts would be signed between the ABC county level branch and the individual MFO for supervision. Fees could be established on the basis of the size of

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the MFO’s lending portfolio: this parallels the arrangement that BRI has with its village banks in Indonesia. Once ABC sees the profitability of a properly run microfinance organisation, it may wish to become involved in microfinance on more than just an agent basis.

322 The establishment of MFOs with independent organisational structures, operational methodologies and accounting and information systems provides for the potential future independence of these organisations. The tie between ABC and an individual MFO could be cut whenever the MFO qualifies on its own for registration as a microfinance institution under the then current PBC regulations.

**Targeting**

323 The MFOs would be engaged in microfinance activities in areas that are capable of supporting their activities on a self-sustainable basis. They would replace traditional government poverty reduction lending programmes operated by ABC in their areas, with ABC direct lending phased out on a region-by-region basis. MFOs and ABC poverty alleviation lending could not co-exist, given the disparity between their interest rates. Past an initial period of establishment, the MFOs should be self-sustaining. This would free up resources for application to poverty reduction activities in other, more “hard-core” poor areas.

324 MFOs could be established to provide microfinance services for regions with high populations of ethnic minorities, with specialist services in alternative languages, for example. Demographic data on areas of operation of individual MFOs could be taken into account during the design of individual MFO microfinance programmes, emphasising (for example) lending to poor women or ethnic minorities if such special targeting was proved to be warranted. The MFO approach enables a region-specific targeting programme that individually tailors microfinance services to the needs and desires of the local population.

325 MFOs could be established by government, ABC or donors, including ADB. Support for the establishment of an MFO would require funding, technical assistance to the MFO and training to the staff of the ABC branch in charge of supervision and monitoring. Such technical assistance and training would have to extend over the full start-up period, likely to be around five years.

326 The ABC county level branch contracted to monitor the MFO would report to the PBC at county level on MFO operations. The county level PBC would be empowered to conduct site inspections and review licenses in case of poor performance, operations outside the MFO license or suspected irregularities.

327 The proposed system does not allow any scope for local government to allocate lending quotas or select households eligible for lending. This will prevent leakage of funds for investment in government economic growth projects and will reduce loan losses by ensuring that borrowers are selected only in accordance with the MFO’s lending criteria. Local PADO microfinance operations would be eliminated in areas where MFOs are established, and retained or established where subsidised lending poverty reduction programmes continue or welfare-based programmes are started.
Funding for microfinance could be provided from a number of sources for a number of purposes. Funding for MFO start-up could come from government poverty alleviation funds, donors, or ABC itself. In the medium term, RCCs could also be permitted to set up MFOs for their own networks. During the start-up period, microfinance providers are unable to cover their costs and funding therefore should be on a concessional or grant basis, at least for operating costs. The provision of start-up support needs to be linked to a business plan for the MFO setting out levels of performance achievement on a time-bound basis. Support should be tapered off until the MFO is fully financially self-sustaining at the end of the start-up period.

Funds for onlending would come from ABC (in satisfaction of government poverty alleviation quotas) and possibly from a new Microfinance Fund (MFF) mechanism that uses a blend of donor funds (refer below). ABC would channel funds mobilised from deposits (on a standard charge-out equivalent to the cost of deposits) to the MFO, as required to fund their lending programme. Excess funds mobilised by the MFO would be deposited with ABC, as would the individual deposits of the microfinance clients.

The transformation of a microfinance programme into an MFO could take place at any time, or following the end of the donor’s programme cycle (in much the same way that the World Bank Qinghai Mountain project was transferred to ABC). Donors that are already supporting an existing microfinance programme may wish to continue that support after the microfinance programme comes under the supervision of the ABC, either at the same or reduced levels.

For new MFOs, funding for start-up could come from donors or from government, using poverty alleviation funds. Funds for MFO onlending would come from ABC, with these funds qualifying for satisfaction of government poverty alleviation programme quotas.

**Institutional Channels for ADB Participation**

To facilitate donor involvement in MFO start-up, the government may wish to consider the establishment of an MFF at the national level. The MFF could operate as a clearinghouse for start-up funding, funds for onlending and technical assistance for microfinance organisations and their sponsors organisations. The small size of most MFOs, at least initially, mandates against an individual approach, both by government and by donors. In addition, by pooling OCR funds from ADB, commercial rate funds from other sources, and concessional or grant funds from bilateral and other donors, on a long-term strategic partnership basis, the net cost of funds for support of microfinance development in PRC can be lowered. ADB and other donors could negotiate matching funding for the MFF by government, thus leveraging external and domestic funds into microfinance development through a fund that would be independent in its decision-making from any one government department.

The MFF would be well placed to provide risk management on the funds under its supervision, undertaking swap, hedging and forward contract operations as required to protect the fund against future exchange rate and interest rate fluctuations. These technical assistance, fund design and implementation and risk management services are examples of how ADB’s expertise could be used to
maintain project-level engagement with the PRC government at the same time as it undertakes policy dialogue on microfinance.

334 The Foreign Capital Project Management Centre (FCPMC) would be a logical government agent to take a proactive role in the establishment of the MFF. FCPMC may not be able to operate the fund, since many donors may require independence from government as a prerequisite for participation, but could fill the role of implementing agency for the establishment of the fund and serve as the prime government liaison for the fund once established.

Management Structure and Funds Flow

335 Figure 3.1 illustrates simply how the above ideas could work in practice. In summary, donors, the government and banks (ABC and RCCs) will pool funds into MFF. PBC would have an oversight role for MFF in addition to its normal oversight roles for ABC and RCCs. FCPMC will have a supporting role for MFF in assisting with the syndication of funds and in the identification of MFOs at the local level. Funds would flow from MFF to ABC or RCC’s and then to eligible MFOs for lending to clients. Oversight of MFOs would be through ABC and RCCs with reporting to PBC.

Figure 3.1 Illustrative Management Structure and Funds Flow for MFF
Summary of Opportunities for the Use of OCR and TA Funds

OCR Funding

336 Accepting that it is proven internationally that OCR type funds blended with other resources can be utilised successfully for microfinance it is recommended that OCR funding is applied in the following order of priority because of ease of implementation:

- pilot schemes for the rural enterprise, producer, community and settler microfinance as components in other projects testing the MFO modality; and
- wider implementation, initially in one or two provinces using a combination of the MFO and the MFF modalities.

337 Components of SIF, CDF, and parallel-funded type projects should follow as soon as these mechanisms are developed by the government and ADB using the same modalities.

TA Funding

338 TA funding contributions will be required from ADB for the design of any of the proposed interventions with OCR funds into components of projects (including SIFs and CDFs), credit lines, guarantee funds and microfinance. The contributions would be applied under ADB's normal procedures for project preparation technical assistance (PPTA). Implementation will require advisory and operational technical assistance (AOTA) for development of the legislative and regulatory environment and capacity building for MFO establishment.

339 There is an opportunity for ADB to assist with the drafting of MFI legislation once this becomes part of the government's policy agenda. The principal requirements of such legislation to be developed under that TA would be:

- empowerment of PBC to issue establishment and operation licences;
- the conditions to be met for obtaining an establishment and operating licence including: capital requirements, qualifications of founding members, qualifications of directors, compliance of the charter with the bank MFI law and other laws, and feasibility of the business plan;
- the process of application for a bank MFI licence including the documentation required, the period allowed for consideration of the application, provision for payment of licensing fees;
- the specific business registration requirements and conditions to be met prior to commencement of operations including approval of charter, paying-up of capital, publication of licensing provisions, and establishment of suitable premises;
- the conditions under which a licence may be revoked, including falsification of information, failure to commence business operations within a specified period, voluntary or enforced liquidation, reconstitution or merger, or other
non-compliance with regulations or legislation that is not rectified within a prescribed period;

- the coverage of the charter including: the bank MFI name and location of its head office, the scope of its activities, the duration of its operations, its authorized capital, procedures for changing authorized capital and for share issue and disposal, the responsibilities and powers of the Board of Directors, the procedures for the appointment and dismissal of directors, the rights and obligations of shareholders, accounting principles and internal controls, procedures for winding up, and procedures for amending the charter;

- changes in the charter or operations that require PBC approval;

- rights and conditions for setting up transaction offices, subsidiaries and administrative units;

- the qualifications of directors, excluded persons and delegation of director’s powers;

- internal and external audit requirements;

- rights to take deposits and to borrow;

- rights to extend and terminate credit;

- the rights of depositors and borrowers;

- rights to undertake other kinds of banking business and to incur off balance sheet liabilities (if any);

- provisions for the regulation of credit and exposure restrictions such as limits on loans to related persons, exposures to single parties, individual shareholdings, and determination of with prudential ratios from time to time by PBC;

- risk provisioning requirements including loan classification and general and specific provisions;

- statutory reserves and deposits;

- financial and accounting policies including reporting requirements and deadlines and public disclosure;

- provisions for special controls, bankruptcy, dissolution and liquidation and the conditions under which PBC may impose such controls or course of action and the powers of PBC therein;

- penalties and the process for dealing with violations; and

- bank confidentiality.
In parallel, regulations, reporting policies and procedures that will apply to bank MFIs and the procedures for inspection should be developed. Inter alia, the regulations should define:

- in specific numerical terms the requirements for: risk weighted capital adequacy, provisioning requirements, statutory reserve requirements, lending to deposit ratios, and single borrower and other exposure limits;
- the format, frequency and deadlines for reporting; and
- the frequency of inspection, the procedures to be followed and the inspection reporting formats.

Under separate TA arrangements support for the establishment of MFOs would include capacity building technical assistance on a grant basis improve such areas as:

- development of business plans and strengthening of organisational structure,
- microfinance programme design and development,
- microfinance lending operations and portfolio management,
- financial and risk management, and
- accounting and information systems.

Training would be required for the ABC township level branches and later RCC apexes in areas related to their monitoring and supervisory capacity including:

- understanding MFO business plans, MFO financial statement analysis, microfinance institution operations, financial and risk management of MFOs, and accounting and information systems of MFOs.

TA would also be required for the establishment of the MFF in due course. This would include both design and implementation support covering:

- conduct of a consultative process with the founding members and stakeholders in MFF to draw up its mandate and constitution;
- registration of MFF and establishment of its oversight Board;
- drafting of MFF regulations and the eligibility criteria for participating MFOs;
- design and documentation of MFF policies and procedures;
- establishment of MFF accounting, MIS, and risk management systems;
- promotion of MFF services;
- review of MFO applications for financial and technical support;
- management of financial and technical services provided;
• reporting to the oversight Board; and
• periodic syndication of further funding.
Voluntary Rural Mobility Development

Findings for Voluntary Rural Mobility

International Experience

344 Rural mobility is defined as the movement of people to areas of under-utilised agricultural potential. This has also been called “settlement”, “resettlement” and “land colonisation”. This analysis focuses on government assisted or supported projects for rural mobility on a voluntary basis. Spontaneous resettlement has been the dominant form of resettlement where people have moved because of exhaustion of natural resources (as in shifting cultivation) or because of the availability of new land. In some resettlement the mobility process is often initially spontaneous with government later supporting it. Even where government is the initiator, spontaneous settlement has always taken place in parallel.

345 Government assistance has involved providing access to credit to finance migration, resettlement and the start-up of new activities; the provision of infrastructure in settlement areas; and protection for the rights of settlers to land use and use of other assets. Government support can be in all three areas or can be selective, but normally infrastructure is provided.

346 Most government sponsored or supported schemes have been carried out with the economic objective of improving agricultural productivity and thus generating better incomes for the rural poor. But there have also been political objectives, often dominant ones. In Africa for example, much resettlement has focused on giving back colonially occupied land to farmers. In Latin America, the underlying concern has often been about territorial sovereignty or providing plantation labour, and more recently about stemming civil unrest from the landless. In Asia, in Indonesia the transmigration programmes relieved population pressure but also asserted sovereignty over outer islands. The Malaysian FELDA programme had the parallel objective of increasing export revenues from industrial crops while in Sri Lanka settlement has been primarily about developing newly irrigated land to stem the tide of rising unemployment and unrest.

347 The areas in which sponsored or supported settlement has been made have been generally previously uninhabited or sparsely inhabited because of inaccessibility or because for some reason they were not suitable for habitation due to disease infestation or lack of water. Settlers have usually been recruited on a family by family basis from different communities where there is unemployment or poverty. It has been unusual for whole communities to be relocated in voluntary resettlement. (This is not of course the case in involuntary resettlement where the

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1 The reader is referred to appendix A9, "International Voluntary Rural Mobility Approaches and Experience" for the detailed arguments that justify the findings and a wide range of supporting illustrative case study experience.
normal cause is the loss of land to a community as a result of large-scale physical infrastructure development such as dams). Voluntary resettlers can face a range of problems: particularly lack of familiarity with local agronomic practices, lack of access to credit, and lack of community leadership and social infrastructure. While natural resources and physical capital are normally available, there have been significant weaknesses in addressing the need to develop human, financial and social capital in many projects, and these risk factors need to be mitigated if poverty reduction is to be effective.

Voluntary resettlement is complex and international experience shows that the overall phasing of the programmes will involve: planning and site selection; infrastructure construction and settler recruitment; a transition period of three to five years while new agricultural systems are established requiring human capital development and financial support; the development of mature social capital in the settler community; and the phasing out of special government support.

Ex post estimates of economic rates of return for settlement projects show mixed results. Low rates of return have been encountered where plot sizes for settlers have been too small and where annual crops (with low value added) have been the basis of their new livelihood. There is little available analysis of actual with and without project income for settlers and this appears to have been generally overlooked in the research. The environmental impact of settlement projects has only recently received attention, but early projects involved much deforestation.

Overall benefits are also difficult to assess because there are multiplier effects. Settlement catalyses regional development and growth in non-farm activity. The research shows that there are economies of scale. For example, in Malaysia, a settlement of 2,500 families at full development could provide employment for the whole labour force while a settlement of 400 families could provide employment for only about 70 percent of the labour force. The development of market infrastructure and non-farm employment opportunities has also been shown to increase multiplier effects.

Demonstrated factors of success in resettlement are good project management whether parastatal or otherwise; a flexible production system with crop diversification opportunities, good natural resources and good extension services; the creation of supplementary employment opportunities during the initial stages, for example through food for work programmes, to help with infrastructure construction; secure title for settlers; and access to credit for production and consumption.

Costs to government for resettlement are high and have ranged from USD 5,000 to USD 20,000 per family. Evidence shows that some cost reduction can be achieved by private sector involvement in infrastructure development because of greater efficiency. Allowing spontaneous settlement also reduces costs for government as can site selection if there is proximity to existing communications or market infrastructure. Careful planning and phasing can minimise cost overruns while access to credit for settler housing can reduce infrastructure costs.

Cost recovery has been a challenge for resettlement projects as it is for many infrastructure projects. The evidence shows that short-term lending has a better repayment rate than long-term lending and that repayment capacity is improved if
annual crops are not the main source of settler income and opportunities for non-farm employment are fostered. A major cause of default has also been from settlers leaving the settlement area emphasising the importance not only of income, but the development of other assets necessary for a stable community to evolve. Some argue that settlers need to receive grant support, but other more innovative mechanisms have also been successful in developing settler resources. In Indonesia for example, transmigrants were given the opportunity to work as wage labourers to accrue resources prior to settlement. Unwillingness to repay has also been found in some settlement schemes. Using land title as collateral or making repayment a condition of acquiring land title have both been found to be effective means of encouraging good repayment rates. Centralised marketing and marketing co-operatives have also proved to be useful means of deducting repayments at source.

354 A review of the ADB Guidelines for Involuntary Resettlement shows that many of the guidelines are also applicable for successful voluntary resettlement and can be useful to PRC policy makers. Specifically, it is concluded that: resettlement should only be carried out when there is no other option; displaced people should be at least as well off after resettlement as before; resettlers must be fully informed about all aspects of resettlement and compensation; appropriate patterns of social organisation must be promoted, particularly existing social institutions of resettlers; and the full costs of resettlement including compensation should be included in the analysis so that the overall net benefits can be assessed. Additionally to the guidelines: settlers should be informed about the resource potential of the area they are moving to; the selection process should be free from political favouritism; host populations should be adequately compensated for loss to new settlers; and spontaneous settlement and private sector involvement should be encouraged.

PRC Experience

355 Since 1949 there have been three types of resettlement in PRC. There has been involuntary resettlement mainly associated with infrastructure development, particularly reservoir development such as for the Samen Gorge Power Plant and the Three Gorges Project. There has been spontaneous resettlement in response to famines in the 1960s and more recently in the search for employment in the more developed eastern coastal regions. There has also been voluntary rural resettlement sponsored by government.

356 There are some early cases from the 1960s, but the “3-Xi” programme, which began in 1982, is the first large-scale voluntary rural resettlement programme. This programme moves poor people from resource poor areas in Dingxi and Xihaigu on the loess plateau to the more fertile Hexi area. This has increased output in the Hexi area, reduced poverty in the Dingxi and Xihaigu areas and improved the environmental conditions in the latter. In the 1980s and 1990s the governments of Gansu and Ningxia have also had resettlement programmes and had moved 630,000 people by the end of 1998. In Guangxi about 106,000 people have been moved from remote mountainous areas to better conditions in 22 counties.

The reader is referred to appendix A10, "PRC Voluntary Rural Mobility Approaches and Experience" for the detailed arguments that justify the findings and a wide range of supporting illustrative case study experience.
Guangdong Province has resettled about 187,000 people from remote mountain areas. Hubei, Shaanxi, Jilin and Shanxi Provinces also have voluntary resettlement programmes.

357 In many remote mountainous areas, the resource base is poor and poverty has been exacerbated by population growth. At the end of 1999 there were still 34 million people in absolute poverty in PRC, 90 percent of whom lived in such areas. For historical reasons, this population is dominated by minority nationalities. The population pressure has resulted in over cultivation and deforestation leading to soil erosion and desertification. The alternatives facing government for these areas are to assist the poor on the spot through the provision of improved technology and introduction of environmental protection measures, but there are limits to this in view of the population pressure; assisting farmers to become migrant workers, which provides a temporary solution for as long as the migration lasts; and resettling farmers, which if successful provides a permanent and self-sustaining solution. Voluntary resettlement is thus the government’s preferred, but last resort option. It is estimated by LGOP that the remaining number of poor who need to be resettled is 5 million.

358 Land is available for resettlement. There are 13 million hectares of cultivable wasteland, 111 million hectares of land suitable for afforestation and tree crops and 4.5 million hectares of state farm land that can provide areas for resettlement.

359 Resettlement is impeded because the development of under-utilised land cannot take place spontaneously in PRC. Aside from the investment costs, the current property rights system makes acquisition of large blocks of land difficult; the household registration system restricts movement and lack of registration results in lack of access to social services; and farmers in poor mountainous areas do not have the information to take advantage of opportunity and may not have the skills to farm in new areas. These barriers cannot be overcome by market mechanisms at the present time, so the involvement of government is necessary.

360 To manage resettlement, the provinces involved have set up leading groups at provincial, municipal, county and township level to oversee the process. Implementing agencies are also appointed to carry out the work. These vary and may be quasi government organisations or corporations. The fieldwork indicates that within county resettlement is relatively easy, but that trans-county and trans-regional settlement is more difficult to implement because there is more than one local government administration involved. In the newly resettled communities, governance structures sometimes follow those of local government and sometimes are special structures, at least initially. The dominant form of resettlement is where government develops the resettlement areas and organises the process.

361 Criteria for settlement areas are centred on adequate land availability, the development of infrastructure at reasonable cost, and the convenience of overall access to the area. The criteria used to choose settlers, apart from poverty and a willingness to relocate, focus on their ability to work and minimum primary education requirements. County authorities allocate settlement places to townships and villages and villagers apply for resettlement. Applications are reviewed and approved at county level and representatives from villages are given the opportunity to visit the resettlement area and report back. Potential settlers are then free to decide if they...
actually want to move. Contracts between settlers and local governments are not usual for within county settlement, but are common for trans-county and trans-regional settlement.

362 The extent of site development varies. In Ningxia water storage and irrigation systems are developed, land levelling carried out, utilities installed, paved roads laid and social infrastructure completed before settlement takes place. Basic housing is also constructed. In Guangxi, cultivable land and dwelling plots are designated and utilities, roads and social infrastructure constructed, but housing is not provided. Funding for the start-up of activities has increasingly been provided through loans rather than grants in recent years.

363 Voluntary rural resettlement has demonstrated positive economic effects. Evidence from Ningxia and the World Bank’s “Northern Irrigation” project shows substantial increases in production and output, gains in per capita incomes and substantial accumulation of assets by the settlers. There is also evidence on the development of non-farm business activity.

364 There is evidence that settlers are able to re-establish their culture in new locations, for example the Muslim Hui people of Ningxia have built mosques in many settler villages. The drop-out rate for settlers is low. Although 10 percent return to their native village at some point, eventually only two percent do not return to the new settlement.

365 In some areas there is evidence of positive environmental impact with the mountain villages improving land use and land allocation. In others there is not. This appears to depend mainly on the local government. In the resettled areas, newly irrigated land has helped to arrest desertification.

366 Funding has come from various sources: special funds from central government, food for work appropriations, subsidised loans, local fiscal funds, assistance from richer provinces, and the World Bank. Overall investment per capita appears to range between 1,450 and 1,650 yuan. Cost recovery has not yet predominated in any schemes although loan funding for productive activities has been more prevalent in recent years.

367 For the future, there are some identifiable problems for the consideration of policy makers arising from experience of resettlement in Gansu, Ningxia and Guangxi. In the outmigration areas: while it is reasonable of the host area to stress the aptitude and physical fitness of settlers, care needs to be taken to ensure that those left behind are not only the most vulnerable, otherwise reducing poverty for some only increases it for others; and greater attention can be paid to improving the environment in the outmigration areas through helping remaining villages to reorganise the use of resources. In the host areas: the problem of permanent residence registration for the trans-county and trans-regional settlers needs to be resolved by government; and where settlers rent land or have a limited period of use rights, first options for renewal should be granted to allay settlers concerns that they may have given up their original land only to be later dispossessed of the land on which they have settled. In the economic environment: market risks faced by settlers can be better addressed by fostering investment in agroindustry and providing support services for its development including vocational training for settlers; and
market mechanisms can be more widely applied in Gansu and Ningxia, for instance, water fees can be raised step by step. The international experience can assist in providing insights into best practice elsewhere and how elements of it may be applied to address these issues.

Policy Dialogue Issues

The international experience and the PRC experience appear at first sight to be at odds with regard to the success of voluntary rural mobility. This is because there are fundamental differences in the objectives and the methods. In fact the PRC programme is unique, and open dialogue about how the programme could be improved in relation to international guidelines is important in the efforts to improve its effectiveness. The specific areas in which the present programme can be improved are in settler selection, the provision of tenure for settlers, support for settlers in relocation and the transition period after settlement, production financing, and access to social infrastructure.

The major impediment to ADB involvement in voluntary rural resettlement in PRC is the government's unwillingness to improve the settlement process, but ADB's own concerns that if it finances any aspect of voluntary rural resettlement it will suffer reputational damage along the lines of that suffered by the World Bank in connection with the Qinghai project in 1999. From the PRC government view point the dialogue needs to focus on the rationale for voluntary rural mobility in PRC so that the international community can judge on an informed basis the need to resettle many remaining poor and whether or not there is any over-riding political motivation other than poverty reduction.

ADB, of course, has concerns about human rights issues including specifically whether or not voluntary resettlement projects are affected by the ILO Convention No 122 on Employment Policy that states there should be "freedom of choice of employment and the fullest possible opportunity for each worker to qualify for, and to use his/her skills and endowments in a job for which he/she is well suited, irrespective of race, colour, sex, religion, political opinion, national extraction or social origin". Internationally and in PRC this can really only be judged on a project by project basis in terms of the freedom access to voluntary resettlement programmes. There are constraints on total freedom of choice on employment in PRC because of the lack of labour mobility, but this is a general issue rather than specific to voluntary resettlement, and voluntary resettlement creates labour mobility where previously there was none.

The Rationale for Government Assisted Voluntary Rural Mobility

PRC has a remarkable record in poverty reduction since it embarked on economic reform twenty years ago. The number of the absolute poor has dropped from 270 million in 1978 to about 42 million in 1998. The achievement is largely the outcome of economic growth ushered in by substantially greater economic freedom for farmers that enabled them to take advantage of economic opportunities. However, most of the remaining poor have been unable to take advantage of these

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3 See appendices A9 and A10 for the analysis from which the policy dialogue agenda is derived.
because they either lack agricultural resources or live in remote, isolated and resource poor areas.

372 Minority nationalities are dominant in the remaining poor population. The reasons why national minorities have historically moved to these resource-poor areas vary greatly, but they are generally associated with political persecution and escaping from conflict.

<table>
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<tr>
<th>Hui Minority People in Jingyuan County, Ningxia Hui Autonomous Region</th>
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<td>In 1862 a large scale Hui minority uprising broke out in Shaanxi and Gansu provinces. The rebel army fought with the Qing armies for nearly ten years but was eventually defeated. In order to reduce the density of Hui population in the uprising areas to prevent future unrest, in 1871, General Tsao evicted native Han people from an area comprised of four counties in today’s administrative jurisdiction in Ningxia and Gansu and forcefully resettled 9,480 Hui minority people from Shaanxi. The resettlement area is mountainous and isolated with scarce land resources. Current residents in Jingyuan county are almost 100 percent Hui minority and offspring of these settlers.</td>
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<td>Source of information: Jingyuan Xianzhi, Ningxia People’s Publishing House, 1995</td>
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373 Prior to 1949, although living standards were low, those in the remote mountains were unlikely to have had any incentive to move out because income differences in other areas were not large and fear of war and persecution persisted. After 1949, although fears of persecution were allayed, moving out of remoter regions became increasingly difficult, especially after the collectivisation of rural land in the mid-1950s.

374 Under collective ownership of land, only members born or married into a collective had the right to the land. Homesteads were provided only to members of the collective. There was widespread rural poverty in the collectivisation period because of policies that discouraged incentives for production. After the household responsibility system replaced collective production in the early 1980s, the incentives were realised and productivity dramatically increased. However, the transfer of the usufruct right was not permitted until recently, and as a result, labour mobility within rural areas currently occurs only on very limited scale.

375 The institutionalisation of the sharp differences in per capita resource endowment at the beginning of the collectivisation in the mid-1950s, has translated into modern day large income differences across villages as those resources have been more fully exploited. Studies have found that in the period of collective management of land, income differences within a village were small due to the egalitarian allocation of incomes, but there were large income differences between villages and regions\(^4\). The differences were due mainly to different resource endowments though management efficiency also played a role. As time passed, lack of mobility combined with population pressure resulted in increased resource use in mountainous areas and decline into absolute poverty. In some areas resources have

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been over-exploited and induced environmental impacts have reduced water supply and made agriculture extremely difficult.

**Difference in Land Endowment**

The differences in land endowment among villages are striking in Guangxi. While the average per capita area of cultivated land (including terraced land) managed by rural households was 1.20 mu in 1995 (China State Statistical Yearbook 1996, p.367) for the whole Guangxi Zhuang Autonomous Region, the figure was 1.67 mu in Tianlin county and only 0.69 in Dahua Yao minority autonomous county. In many mountainous villages in Dahua, per capita land is less than 0.3 mu. Furthermore, although both counties are largely mountainous, the mountains in Tianlin have good soil that can easily be used to grow fruit trees or timber. In Dahua, however, the mountains are mostly rocky with only a thin layer of soil.

Source of information: field visit to Guangxi.

376 It is population immobility has given the remaining absolute rural poverty in PRC a regional concentration. This differs from other countries reviewed that have operated voluntary resettlement programmes because in these the poverty addressed through this approach has occurred in a portion of the population of any given community, often the landless.

377 In 1983-84, restrictions on rural non-farm activities were relaxed in PRC. This led to an industrialisation movement that provided off-farm employment opportunities for many rural households. The institutional changes contributed greatly to the reduction of poverty in PRC. However, in the remote and resource poor areas, non-farm employment opportunities are almost non-existent. They are unable to produce for the outside markets, particularly because of poor transportation conditions, and there is low demand in local markets.

378 Since the mid- to late-1980s, spontaneous migration of the rural labour force to urban areas has occurred on a large scale. This has helped lift many households, at least temporarily, out of poverty. However, families in the remotest poverty-stricken rural areas have been less able to participate in labour migration because it is difficult to obtain information on the urban job market.

379 Labour migration is included as one of the components of the World Bank's Southwest Poverty Reduction Project, in which the project extended credits, found jobs, and organised transport for labourers from poor areas to work in urban areas. Although this approach produces immediate poverty reduction outcomes through income generation for the migrants and remittances to families left at home, it is a solution only for as long as the migrant stays away. Many return because taking families along is nearly impossible. Even when a migrant can accumulate savings, there is little economic opportunity to invest in at home and so the risk of return to poverty is high for returning migrants. Further, a minimum of nine-years of schooling

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is often required for urban jobs, which excludes many people from poor areas. The religious beliefs of minority people sometimes also can hinder their mobility, as in the case of Hui minority people in Ningxia.

Historically, Chinese governments of all dynasties have used resettlement as a way to reinforce territorial sovereignty. The same tactic was used by the government of the PRC. For example: after the civil war was over in 1949, the government resettled demobilised soldiers in the remote border areas and during the Cultural Revolution, millions of urban youth were sent to rural areas, many of them to the border areas in Heilongjiang, Xinjiang, Guangxi, Yunnan and Tibet. Needless to say, these resettlements were primarily politically motivated.

Review of international experience with voluntary resettlement also shows strong political motivation. In Africa, for example, many of the prominent post-independence resettlements programmes were intended to eradicate the colonial image of the former European-owned plantations; others were intended to experiment with socialist ideas of co-operative farming. Land was not scarce. In Latin America, alleviating class tensions between landlords and landless labourers motivated government support to the Amazon colonisation programmes in several countries including Brazil, Colombia and Bolivia. The landless labourers were not necessarily unemployed and desperately poor in the cases of both Latin America and Africa. Although they owned little or no land, many of them had been tenants or hired as wage-earning estate labourers. In Indonesia, the government resettled Indonesians on the outer islands in order to reinforce territorial sovereignty. In the mainly economic motivated resettlement programmes in Malaysia and Sri Lanka, output growth and/or foreign exchange earnings to improve the balance of payments were the main objectives.

The recent resettlement efforts in PRC are in sharp contrast to both international programmes and PRC’s own past. They are solely for the purpose of poverty reduction targeted at the absolute poor for whom resettlement is the only real option for permanent escape from poverty.

The Shanxi Poverty Reduction Voluntary Resettlement Programme was the first of such programmes in PRC. In the first ten years of the programme from 1983 to 1992, the government invested 200 million yuan annually and resettled more than 500,000 people from dry and arid Hexi, Dingxi in Gansu and Xihaigu in Ningxia to newly irrigated areas within the same province or region. The programme is now in the second ten-year phase with continued central government financial support. The goal is to resettle another 680,000 people. The World Bank also supported the voluntary resettlement of the poor in this area through two projects (the Gansu Pro vincial Development Project and the Northern Irrigation Project) that resettled 135,000 upland poor to newly irrigated area. These resettlement programmes are strictly voluntary and are increasingly popular with the number of applicants far exceeding the available resettlement places.

Only one-third of children receive the mandated nine-years basic education in the western provinces. Hui people are Muslims, but it is difficult to find Muslim restaurants in most cities.
Another example is found in the southwest of PRC. Guangxi Zhuang Autonomous Region has a concentration of minority nationalities and is primarily mountainous. Through years of development, millions of people living in mountainous areas have been lifted out of poverty, but in 1993 there were still five million absolute poor, 80 percent of which lived in remote Karst mountain areas. Fertile soil in these areas is extremely scarce. 250,000 people had per capita land of less than 0.3 mu and 500,000 people had per land of less than 0.5 mu. Further, because of the hydrogeology, water storage is difficult. Between 1993 and 1996 the Guangxi government invested 3.6 billion yuan in building 122 resettlement areas and resettling 102,000 people. In 1997 with financial assistance of 60 million yuan from Guangdong Province, it successfully resettled another 20,000 people.

To sum up there are serious barriers to rural mobility presented by the land tenure system and lack of information on opportunity. Assisted labour migration is possible for some but generally addresses only the income aspects of poverty reduction for the period of the migration. Such labour migration is also infeasible for many. As a consequence, resettlement which addresses the formation of human, social, physical and financial capital for the poor in areas of better resource endowment is a viable and proven last resort and a better economic and social alternative to providing welfare support indefinitely in the remotest areas. Because of the nature of existing land tenure system, spontaneous resettlement is not possible, thus the government involvement in the relocation is regarded as not only necessary but also imperative. Provided best practice guidelines are followed, there is no logical impediment to the participation of ADB or other donors in resettlement projects in PRC.

Characteristics of Settlers

Because of the emphasis on the reduction of natural resource related and area specific poverty, settlers are chosen from areas where resettlement is the last resort. Because the minority nationalities are dominant in the poor population in these areas, the main beneficiaries of the resettlement programmes are minorities. In Ningxia, for example, the settlers are mostly Hui minority people. In Guangxi the settlers mostly belong to Zhuang and Yao minorities.

Within chosen beneficiary villages, selection criteria favour families with least land and relatively abundant labour. They are often required to possess a certain amount of human capital and/or physical capital. In Guangxi settlers are chosen among villagers possessing less than 0.3 mu land per capita. In Ningxia, the practice is to mix households of different levels of income and competence. Including relatively well-to-do families has the effect of demonstration to poor households.

Note that PRC has a more or less egalitarian land distribution system so when there is land scarcity it applies to the whole village. A potential pitfall of the labour requirement is that originating villages may be left with the most helpless households. One village (Fanxiatun) of Dahua county in Guangxi used to have 14 households, 11 of which either moved or about to move with government support. In the remaining three, one is a household of the elderly, the second is a household of the handicapped, and the third is a household of orphans.
388 Common to all settlement projects, due to initial difficulties in settlement areas, settler drop-out is observed. However, the PRC experience shows that dropping out can be substantially reduced if proper information is provided to settlers about what to expect during the transition period and what earning potential exist after the transition period. In Ningxia, for example, in the 1980s during early resettlement period, farmers had to be persuaded to participate in the resettlement programme. Resettlement places were often not filled and the drop out rate was high. In the 1990s, however, there has been more enthusiasm for resettlement. The reason is that early settlers now have much higher living standards than those remaining in the old village.

389 In most cases, resettlement projects are organised within a county or prefecture where the host population and the settlers belong to the same nationality. Where they are different, efforts are made by the government to ensure that people from one minority nationality are kept together.

390 Where international funding is potentially involved, resettlement policies will need to cater for those who are left behind as well as those that are moved and the risk of leaving villages with populations of the socially disadvantaged must be avoided. Additionally, the terms and conditions of settlement must be completely transparent. Settlers must be given an accurate indication of what to expect in the settlement area, the resources that will and will not be provided and the expectations of the government in terms of the amount and timing of repayment for any assistance provided.

Land Acquisition and Tenure Arrangements in Settlement Areas

391 Land acquisition is difficult in PRC because nearly all usable land is already claimed, mostly by farmer collectives. Nonetheless, there is still space for resettlement. This land comes from three sources.

- Idle state farms and labour camps. In the 1950s the government waged campaigns to cultivate wastelands and establish state farms. Some of the farms were later used as re-education labour camps for the rightists in the late 1950s and 1960s. During the Cultural Revolution, a large number of state farms were set up for urban youths, as well as cadre schools and labour camps. Many of the state farms are in financial difficulties and most of the labour camps and cadre schools are abandoned.

- Potentially cultivable land. It is estimated that PRC still has half a billion mu of uncultivated land that can be used for agriculture if irrigated. These lands are located mainly in the northeast and northwest regions. For example, large areas of semi-desert along the Yellow River in Gansu and Ningxia can be readily cultivated with water from the Yellow River. The land has not been used because the surface of the land is above the river so that traditional flood irrigation is impossible.

- Potentially usable uplands. It is estimated that PRC has 111 million hectares of upland that are suitable for growing trees but remain unused.
392 In Ningxia, for example, settlement areas are on newly created irrigated land using pumped water from the Yellow River to irrigate previously semi-desert areas. Although the land was previously owned by agricultural collectives, it had not been cultivated before and had little value without irrigation. It was transferred to government at no cost and permanent user rights have been granted to settlers.

393 Such lands do not exist in Guangxi. Resettlements mainly take place on state farms or undeveloped uplands that belonged to collectives. In the case of state farms, the lands are either idle or have low productivity. In the case of upland areas, the lands are usually under-utilised because of poor access. However, since the lands are already owned and in some cases cultivated, there is a cost and sometimes prolonged negotiation.

394 Buying land on a commercial basis for a large-scale settlement project is bureaucratically impeded because regulations require that land acquisition of more than 1,000 mu for commercial/economic development purposes must be approved by the central government. However there are cases of within-county or within-prefecture resettlements in Guangxi where settlement agencies paid 20 to 50 yuan to acquire each mu of uncultivated upland and around 6,000-7,000 yuan for each mu of paddy land. The land was first transferred to the county government from the original owners and then the land use rights were transferred to the settlers.

395 In the cases of cross-prefecture settlement in Guangxi, the project areas in general are close to major urban centres. The land has a higher market value and is owned either by local villages or state farms. Therefore, land acquisition mainly takes the form of long-term lease, usually 50 years. The annual rent per mu of cultivable upland is around 20-50 yuan.

396 For international involvement in settlement projects host populations will need to be fully compensated for lost resources and settler populations will need to be assured of heritable tenure. If the policy of resettlement is supported by central government, then measures to ensure that land acquisition for this purpose is not bureaucratically impeded would be appropriate.

**Relocation and the Transition**

397 The PRC experience with housing provision is diverse. In early settlement projects in Ningxia, settler households were given a lump-sum of 200 yuan per person for building basic shelter. As the households accumulated assets, they shifted to houses built with clay bricks, and eventually to more permanent cement and brick houses. In more recent resettlements, settler households are only given a certain amount of land with no other financial assistance and house building is the sole responsibility of settlers without government support. The main reason is there are more applicants for resettlement than resettlement places and no incentive is needed to induce resettlement.

398 The lack of credit to finance the resettlement is a major problem facing the poorest households in Ningxia. For example, in Yanjiashan, one of the poorest villages in Jingyuan County, all households expressed desire to move to a settlement village in Hongsipu where a settlement area is designated for Jingyuan, but most of the villagers will not be able to move because they can not afford it. Although they
are willing to borrow to move knowing that incomes will be higher to enable the repayment, they are not able to get credit.

399 In Guangxi, government still provides some form of support. In Redstar Farm of Dahua, for example, large tents were provided to initial settlers in 1993, then settler households built their own houses with 1,500 bricks loaned to them by the settlement agency. In the most generous case of Liulong Farm of Tianlin County, a permanent house is provided at no charge to each settler household under the sponsorship of Guangzhou Municipal Government in the richer Guandong Province.

400 In Ningxia in the early stages of resettlement, settlers were given the right to keep the house and land in originating villages. They had the option to go back to the village if unsatisfied with conditions in the settlement area. In recent years, the policy has changed. A settlement family has to give up the right in the originating village once it moves to the settlement area. In Guangxi, farmers are still allowed to keep the land and house in originating villages. In periods of settler uncertainty about settlement areas, the retention of original land for a period still plays an important role in encouraging participation.

401 Off-farm employment is an important way to finance the transition, in both PRC and other countries. For example, in Redstar Farm of Dahua County in Guangxi where Longyan is the main crop, it took three years for the fruit trees to mature. In the first three years (1993-1996), settler households relied on migratory work to support their families and to accumulate money to build their houses. Off-farm work continues to be an important source of income for settler households. In Lucaowa, Ningxia, on average there is one migrant worker in each household and migrant incomes account for one third of total incomes.

402 In Ningxia, loans are not available to settler families. Settlers have complete freedom in choosing what crops to grow and what production method to use. In Guangxi, however, loans are extended to families through state or non-state development companies. Loans are in greater demand in Guangxi because tree crops are the most suitable and profitable cash crops but take time to mature. Production loans are channelled through companies instead of directly to individual households because individual households do not have sufficient asset to use as collateral and recent reforms in the banking system have made collateral necessary for obtaining loans. Microfinance is not observed in settlement areas in Guangxi.

403 There is a diversity of arrangements for relocation and transition period in PRC. From an international perspective, adequate physical and financial capital need to be assured for all settlers either through grant or loan mechanisms or a combination of the two. Use of migrant labour schemes, wage labour provision for settlers in the construction of infrastructure in the settlement areas and microfinance are all viable opportunities to ensure settlers can accumulate sufficient capital.

Social Infrastructure

404 While the provision of social infrastructure such as schools and health facilities is an integral part of any large settlement project in the world, access to social service by settlers in smaller settlement projects is a problem in Guangxi, PRC. The root of the problem is whether settler households will be able to obtain
local household registration, or *hukou* in Chinese. Without *hukou*, children of settler families can only be admitted to local schools with extra fees. This problem is unique in PRC because of the uniqueness of the household registration system.

405 With the intervention of government, most within-county or within-prefecture settlement programmes in Guangxi have been able to obtain *hukou* for settler households. However, in cross-prefecture settlements such as Kailida in Nanning suburb, the problem of *hukou* is not resolved and many of the settlers have not been able to pay the higher fees for their children to go to school.

406 Clearly for international participation in any resettlement equality of access to education and health services between settlers and the host population is a prerequisite.

**Cost Recovery**

407 Cost recovery has featured in settlement schemes in PRC although the obligation of settlers to repay have not always been transparent. However, on a scheme by scheme basis government should evaluate the relative costs of long-term provision of welfare support to remote rural areas (which it has an obligation to provide) and the savings that will be effected as a result of resettlement, and give consideration to whether some part or all of the savings should not be transferred to settlers through the provision of infrastructural resources or other resettlement assistance.

408 Given the extremely high return to resettlement and the apparent inability of many poor farmers to afford the settlement cost, an opportunity exists for extending credit to settlement families and recovering the loan a few years later. An indication of the willingness to pay is found in the unofficial transaction of lands in settlement areas. Some households who do not have resettlement allocation buy out those who do for the right of resettlement. For example, in Longhu Development Zone in Yinchuan, Ningxia, it is estimated that approximately 10 percent of existing settler families in that zone obtained settlement rights by buying out previously settled households, the majority of whom went back to their originating villages with the payment.

409 Another indication is the rapid rate of asset accumulation in settlement areas. In Lucaowa resettlement area in Ningxia, the government has invested 26.3 million yuan since 1983. In 1999 this area has accumulated public assets 28.1 million yuan and private assets 154.8 million yuan. The amount of assets owned by an average household was 64,000 yuan in contrast to a government settlement subsidy of 300 to 400 yuan in the beginning.\(^1\)

410 In Ningxia there is no loan component in the resettlement programme, thus cost recovery is not a problem. In contrast, loans are an essential part of the Guangxi resettlement programme. The proportion of loan in total settlement cost varies and is vaguely defined sometimes. In the Redstar Farm in Dahua, six years into resettlement, an average household owed 18,000 yuan to the company, according to

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\(^1\) See appendix A10, "PRC Voluntary Rural Mobility Approaches and Experience" for details.
the settlement management. However, settlers were not clear about the amount of debt. One family thought that the 15,000 bricks given to them for building houses were free, but management claimed that they are repayable. In Liulong of Tianlin County, farmers did not know the amount that they owe and whether or not they had loans to be repaid. A company officer said that each household owed about 15,000 yuan. In both cases, no clear repayment timetable was made.

411 International experience with cost recovery often states that making the loan repayment requirement explicit in the beginning is essential in successful cost recovery later on. The practice in Guangxi goes against this principle. The justification in Gaungxi is that farmers would be scared and refuse to participate in the resettlement had they known that they would be heavily indebted. This is a legitimate concern but hardly the best approach. Providing credible information on what to expect from settlement is likely to work better.

412 As default is often the result of withdrawal of indebted settlers from the resettlement areas, insistence on evidence of commitment before disbursement of loans may increase the stability of settlers. In Colombia, for example, settlers must have cleared a certain amount of land before being eligible for production loans.

413 The over-indebtedness of settlers is also a major reason for loan defaults. Over-indebtedness is often caused by over-lending. Resettlement agencies often force loans onto settlers so that participation in resettlement automatically incurs debt. For example, settlement agencies generally insist a high standard to the quality of housing in the settlement areas and do not permit traditional housing. As a result, the settlers are granted a housing loan that they would have otherwise avoided by building temporary housing. To minimise indebtedness, additional means of financing resettlement need to be considered. For example, allowing settlers to take advantage of migratory opportunities can help finance the resettlement and the repayment of loans.

414 To prevent the default from well-to-do farmers, it is important to design appropriate mechanisms for loan recovery. The following methods have been used in various countries and can be considered for PRC:

- use of land title or land use rights as collateral. In Brazil, for example, settlers receive title to the land that they cleared, and then use the title as collateral for loans. A pre-requisite for this to work is to make the land alienable so that eviction can be enforced. In other countries, such as Vietnam, land use rights are used as collateral.

- assets purchased with loans can also be effectively used as collateral as they are in many countries.

- use loan repayment as pre-condition for land ownership. This method was used in Kenya, Malaysia and Sri Lanka. When used alone, this did not have the effect of preventing large-scale default in Kenya and the indefinite postponement of loan repayment elsewhere. In addition, because land title is withheld from farmers indefinitely, long-term investment from settlers is discouraged.
Voluntary Rural Mobility Development

- centralised marketing. A centralised marketing agent purchases output from settlers and automatically withholds loan repayment from proceeds. Where applicable, this has been the most successful and most commonly used approach to loan recovery around the world. However, the applicability of centralised marketing is limited to crops that need central processing, such as oil palm, sugar cane, and vegetables and fruit for processing. For grains and fruits and vegetables for fresh markets, centralised marketing is not appropriate. The negative side of this approach is that settlers lose the opportunity to develop skills and acquire knowledge that will enable them to become independent operators. Exploitation is also to be avoided by the marketing monopoly.

- marketing co-operatives. In many African countries, marketing co-operatives were set up and supported by the resettlement agency. In Kenya, the resettlement agency entrusted collection of payments to the co-operatives on the scheme, paying the co-operative a commission of 1%. Since most of the settler’s sale must go through their co-operative, the latter have the means to deduct any payment due.\(^\text{12}\)

415 Centralised marketing has been the choice of Guangxi in loan repayment. It is an appropriate choice because the crops are mostly cash crops that need to find markets elsewhere. Other loan repayment methods should also be considered on a scheme by scheme basis. Whichever loan repayment method is used, a general principle should be that repayment should be insisted from the beginning. The water and electricity charges should also be calculated and announced at an early stage. The introduction of new charges or raising charges at later stages in the project can be disastrous, as is shown by an example in Sri Lanka. Water charges initially were 50% of the operation and maintenance cost. The Mahaweli Authority of Sri Lanka attempted to increase the charge to full operation and maintenance cost within 5 years. However, payment of water charges in one of the project areas deteriorated from over 90% of amounts due in 1985 and 1986, to 38% in 1998, 25% in 1989, and 5% in 1990\(^\text{13}\).

OCR Lending Opportunities

Direct Project Lending Opportunities

Components of Projects Including SiFs and CDFs

416 There are direct lending opportunities for OCR resources for resettlement projects in PRC. In this context it is considered inappropriate to consider such projects as "integrated rural development" rather than "resettlement" projects. They will be resettlement projects and must be treated as such in order to ensure that resettlement guidelines are applied, and as such it will be necessary for ADB to embrace them as resettlement projects and to accept the theoretical rationale for


resettlement. Funding in resettlement projects is by and large channelled to: land acquisition and development, settler housing, production costs in the resettlement area, relocation expenses for settlers, provision of public services such as health and education and utilities, and project management costs. ADB is able to fund all of these components other than land acquisition which its policies prohibit. Therefore, if ADB does participate in resettlement projects it will be for components of those projects with a contribution from the PRC national or local government for a portion of the local costs including land acquisition. The use of OCR funds would focus on the development of productive infrastructure and the provision of credit for settlers.

More specifically, the opportunities would involve the development of productive infrastructure that is able to withstand OCR rates and where the sources of loan repayment are clear. These include:

- access roads where it is possible to levy user charges and could include toll highways close to the resettlement area if there are clear and evaluated benefits to the resettlement area from such roads;
- land improvement, irrigation works, water and electricity supply in resettlement areas provided there are clearly defined means for cost recovery and operation and maintenance in line with ADB’s usual practice;
- market facilities in resettlement areas provided that users pay and cost recovery mechanisms are clearly defined; and
- finance for agroindustry and rural enterprise that will benefit settlers.

All such projects will have to ensure that the basic criteria for voluntary rural resettlement are satisfied. Specifically these include:

- “The affected people should be fully informed and closely consulted on resettlement and compensation options. Because adversely affected people are particularly vulnerable, resettlement and compensation decisions should be preceded by a social preparation phase to build up the capacity of the vulnerable people to deal with the issue.”
- “Appropriate patterns of social organisation should be promoted, and existing social and cultural institutions of settlers and their hosts should be supported and used to the greatest extent possible. Settlers should be integrated economically and socially into host communities so that adverse impacts on host communities are minimised. One of the effective ways of achieving this integration may be by extending development benefits to host communities.”
- “The full costs of resettlement and compensation, including the costs of social preparation and livelihood programmes as well as the incremental benefits

See the section in Policy Dialogue Issues above on the rationale for voluntary rural resettlement.
See Chapter 5 for details
ADB, 1995, ibid
over the “without project” situation, should be included in the presentation of Project costs and benefits.”

- “To better assure timely availability of required resources and to ensure compliance with …. resettlement procedures during implementation, eligible costs of resettlement and compensation may be considered for inclusion in Bank loans financing for the project, if requested.”

419 In addition to these ADB Guidelines (on involuntary settlement), the international experiences of voluntary settlement reviewed in the report indicate that the following principles are also important for the success of a voluntary settlement project:

- settlers should be fully informed of the resource potentials and risks of the settlement area.
- settler selection process should be free of political favouritism;
- host population should be adequately compensated for the loss to new settlers; and
- spontaneous settlement and private sector involvement in project implementation should be encouraged.

420 Avoidance of reputational damage and satisfaction of the guidelines are the primary considerations for ADB. Each individual settlement scheme will need to be considered on its own merits. If any scheme is found eligible, support can be provided both within the context of a resettlement project or as a SIF or CDF 17 where a resettlement component is included.

421 There is no doubt that the international and PRC experience show shortcomings in previous voluntary rural mobility projects. However, if the above guidelines are followed and there is good governance in implementation there is no reason why such projects should not be implemented successfully. In PRC the facts are that without free labour mobility and a free land market spontaneous resettlement from remote mountainous areas is not going to take place. The government is committed to the strategy. ADB’s choice is one of engagement to improve the strategy or not.

Settler Microfinance

422 Within the context of direct lending for resettlement, ADB could include components for microfinance for settler farmers. The microfinance policies and procedures applied would need to be consistent with the criteria adopted for all ADB supported microfinance projects in PRC 18.
Parallel Lending Opportunities

The parallel lending opportunities essentially embrace all of the above direct lending opportunities if they feature as components that will be financed by a provincial government that has freed-up resources for poverty reduction activities through the parallel lending mechanism.

Mechanisms for Implementation

Resettlement Projects including Resettlement Components of SIFs and CDFs

Implementation would be on a project by project basis. Each investment would be appraised using ADB's normal project processing cycle, the evaluation being submitted to the ADB Board either as a stand alone investment or as an investment within a wider project (including within a SIF or a CDF).

Figure 4.1 illustrates simply how these ideas could work in practice. ADB would lend for resettlement infrastructure development to a provincial government that would in turn finance or on-lend to the agency responsible for resettlement. Cofinancing from the borrower or from private sources may also contribute. ADB would carry out its own oversight of the project. FCPMC would have a role in the identification and appraisal of the infrastructure investments and an essential role in monitoring best practice compliance and poverty impact as part of the on-going research to establish the case for OCR funding more generally.

Settler Microfinance

There are three mechanisms that can be considered by ADB and the PRC government for the provision of settler microfinance in support of resettlement projects. These are essentially the same as the provision of producer microfinance of which settler microfinance is a special case. Funding could be provided for production and resettlement expenses.

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19 See Chapter 3 for details of microfinance mechanisms.
426 The first alternative is to rely on the generalised provision of microfinance to producers of different products within a settlement area, where the decision to lend for any specific product is independently taken by the microfinance provider. In this case the settlement authority must accept that certain farmers will not be funded because the intermediary by its own criteria does not consider them to be good credit risks.

427 The second is the loan of an amount for settler microfinance as working capital for a particular processing enterprise. In this scenario, the enterprise would arrange to provide settlers with the means of production, mainly in kind through the provision of seeds or planting material, fertiliser, agrochemicals. A contract with settlers receiving the support would provide for repayment with raw materials supplied to the processing enterprise. This type of financing would be enterprise and product specific. This is straightforward to organise on an enterprise by enterprise basis and the absence of intermediaries allows the enterprise autonomy in deciding which farmers to support and makes it fully accountable for recovery of advance to farmers through purchase of their production.

428 The third would involve the provision of microfinance for settlers through an intermediary such as the settlement authority. This is not considered a good alternative because the authority is neither banker nor processing enterprise and will lack the requisite skills to effectively operate a microfinance programme.

429 The first alternative is preferred because it allows market forced to determine the allocation of resources. The second alternative provides a good means of overcoming market failure if the generalised provision of microfinance is not available. The third mechanism is not recommended.

Summary of Opportunities for the Use of OCR and TA Funds

OCR Funding

430 Accepting that certain types of infrastructure and microfinance provision can withstand OCR rates and that special intervention is required because of scarcity of capital (particularly long-term capital) it is recommended (subject to satisfactory policy dialogue outcomes) that OCR funding is applied in the following order of priority because of ease of implementation:

- major infrastructure developments within resettlement projects including roads, irrigation and utilities where there are full cost recovery opportunities;

- microfinance for settlers, testing the Microfinance Organisation (MFO) modality (and later the Microfinance Fund modality)\(^2\).

TA Funding

431 TA funding contributions will be required from ADB for the design of any of the proposed interventions with OCR funds into components of projects (including SIFs and CDFs) and microfinance. The contributions would be applied under ADB’s

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\(^{2}\) See Chapter 3 for details of these modalities.
normal procedures for project preparation technical assistance (PPTA). Implementation will require advisory and operational technical assistance (AOTA) for the implementation of microfinance\textsuperscript{21} and possibly to assist settlement authorities with international best practice guideline implementation.

\textsuperscript{21} See Chapter 3 for details of TA that would apply.
Findings for Agroindustry and Rural Enterprise

International Experience 1

432 Worldwide the last three decades have seen major shifts in rural economies. Subsistence peasant farming systems have been replaced with small farm businesses and have been increasingly integrated into the wider economy. Both domestic and international markets have opened and the opportunities for value added production and processing in rural areas have increased with increasing urban consumer living standards and demand for a wider variety of products.

433 The main issues in relation to agroindustry and its impact on poverty reduction are: how to ensure enterprise viability because without this any initiative is unsustainable; how to develop effective linkages between agroindustry and poor farmers in the context of the need for industry viability; the circumstances under which it is appropriate to focus on the development of non-farm employment, particularly in the light of the dominant role of small and medium scale enterprises (SMEs) in economic growth (including in PRC where TVEs and more recently the private sector account for increasing and significant shares of employment and output); and what support mechanisms are appropriate in the context of a market economy. It must be recognised at the outset that agroindustry and rural enterprise development (other than at a micro level) can be pro-poor growth strategies that will benefit by creating jobs and input supply opportunities. This can generally benefit the near poor and the working poor but will benefit the absolute and vulnerable poor only when these groups can also be included in the labour force or as suppliers of raw materials. The latter will only be true where viable agroindustry or rural enterprise can locate in or close to areas of absolute poverty.

434 Factors in enterprise viability that are of particular importance for rural poverty reduction relate to the arrangements of the individual enterprise for procurement, processing, marketing and environmental management. From the poor farmer’s perspective, the main concern is to be able to produce raw materials profitably on a sustained basis without being held hostage to a monopoly processor. There is a mutual concern by both farmer and processor for the quality of raw materials because higher quality will generally mean higher income for farmers and the processor. From the processor’s perspective, there is a need to ensure quality by investing in extension and other support services for the farmer where these are not available (or not available at a sufficient standard) from the public sector. From the processors’ viewpoint issues of the necessary scale of technology influence plant location because of the need for adequate raw material production within a cost

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1 The reader is referred to appendix A11, "International Agroindustry and Rural Enterprise Approaches and Experience" for the detailed arguments that justify the findings and a wide range of supporting illustrative case study experience.
effective distance from the plant. The need for good infrastructure also affects plant location. Therefore, geographic and agronomic factors are important determinants of enterprise viability and enterprises are not (and should not be) drawn to remote rural areas unless these conditions are satisfied. As a consequence the proximity of poor areas to infrastructure affects the ability of agroindustry to impact on poverty.

435 All aspects of marketing: planning, research, promotion and distribution have the same importance for agroindustrial enterprise as they do for any other business. Marketing considerations should take precedence over technology and production potential in investment appraisal, but they often have not. Market linkages, as with “dragonhead” enterprises in PRC, are important because they contribute to enterprise viability and sustainability and therefore indirectly to poverty reduction where poor farmers are the primary producers. Environmental considerations are also important determinants of sustainability for any rural enterprise, and corporate environmental conduct is increasingly scrutinised and penalised if it is detrimental to the environment.

436 Many of PRC’s remaining pockets of absolute poverty are in remote mountain areas. Research into enterprise development (agricultural and otherwise) in mountain areas shows that there are generally location specific opportunities that can be exploited, but that the single most important factor that has resulted in the development of comparative advantage has been accessibility. The research also shows that the absence market research into product potential and hence information on opportunity has constrained development of many mountain specific products.

437 Agroindustrial enterprises have choices between having production under their direct control; relying on the market for raw material supply with varying degrees of intervention with farmers to help assure supply; and joint venturing with farmers on a contractual basis (which may or may not involve distribution of a share of enterprise earnings). Enterprise driven linkages have evolved over the last three decades. In general there has been a move away from plantation production with hired labour towards greater reliance on small-scale farmers for raw materials. However, many enterprises still use the nucleus estate in combination with supply from outgrowers to assure a minimum quantity of raw material supply, but avoid the higher investment costs of total own-production. This is rational behaviour for commercial enterprise because it does not particularly empower farmers other than in relation to obtaining ordinary market prices for a part of the raw material supply, and this combination can be adjusted to have similar overall costs and risks to joint venturing with farmers. For some crops (for example seed potatoes and certain types of fruit and berries) where an agronomic need for high altitude and often geographically fragmented production areas make enterprise management of production difficult, farmer production systems predominate. However, farmer ownership of processing plants in joint venture with enterprises is not common except where farmers themselves are organised into co-operative or co-operative type organisations that give them a strong basis for such arrangements.

438 Farmer driven linkages are also been important in poverty reduction. There are many examples of the success of co-operatives or co-operative type organisations (not including collectives). The UN estimated in 1994 that the livelihoods of nearly half of the world’s population (about 3 billion people) had been
made secure by co-operative enterprise of some type. Agricultural farmer’s organisations are important worldwide in production, marketing and lobbying with government on agricultural policy. Depending on business purpose these may be groups, associations, pre-co-operatives, unions, co-operatives, federations, syndicates, partnerships or farmer-controlled companies. The research demonstrates that there are many advantages to these organisations: they mobilise capital and pool resources in underserved rural areas; foster entrepreneurship and democracy; and allow farmers to achieve economies of scale, vertical integration and access to capital investment. The research also shows that there are certain conditions critical to the success of farmer organisations. Specifically there should be: visible benefits to group action; no government involvement in management or its appointment; treatment of organisations as private and professional and not as an extension of state authority (or as “against government”); a high degree of farmer equity; accountability to members and by members; and a common purpose supported by a diversity of skills. These conditions are not met in PRC because government involvement is ubiquitous and farmer organisations are used as an instrument of government policy. The recently closed Rural Credit Foundations in PRC were probably to organisations that have been closest to satisfying these criteria in PRC. Where these conditions are not met, external assistance can focus on developing them as a precursor to capacity building for farmer organisations themselves.

439 Other non-farm rural enterprises are important generators of employment and economic growth, internationally and in PRC. SMEs are particularly important in accounting for a high share of employment and output. However, despite their phenomenal growth SMEs have common systemic constraints to their development. These affect agricultural SMEs as well as other rural enterprises. SMEs face a range of constraints which governments and donors can help to address by facilitating efficient and unbiased financial markets; a suitable business environment; education, training, and competitive capacity; and access to information, networks and the global market place. In many cases market failure in financing has led donors to develop special credit and other financial facilities for SMEs.

440 There are many actions that government and donors can support to facilitate the business environment ranging from infrastructure provision to ensuring an equitable tax base and adequate company, accounting and contract law. Research shows that technical innovation can be sponsored, most effectively by creating competition for the resources that fund the development and dissemination of new technologies. Broad-based non-financial business development services that work in response to demand in a competitive environment have proved more sustainable than government sponsored services because they have been market driven rather than prescriptive. This includes not only training and advisory services, but also market information services. Export promotion has also proven to be more effective where there is competition for resources for specific initiatives rather than bureaucratic trade promotion.

441 From the detailed analysis in appendix A11 and In the context of PRC’s rural industrialisation and the experience with TVE development (both successful and
otherwise)\textsuperscript{2}, international approaches and experience can offer some useful guidelines for making agroindustry and rural enterprise more effective for poverty reduction. The specific guidelines can be summarised as follows.

- Enterprise viability is the primary consideration. This is enterprise and location specific and generalisations should not be made other than that relevant procurement, processing, marketing and environmental aspects need to be examined in each case.

-Enterprise should be encouraged to locate in poor areas or to obtain raw materials from poor areas only if the criteria of viability can be satisfied. This should not be brought about by direct subsidy to enterprise operations, but government can assist though infrastructure provision and by sponsoring market or product development research for specific uses of raw materials from poor areas, particularly if these are unique to those areas due to agroclimatic or other factors.

-Enterprises should be free to choose the type of linkage that they form with poor farmers based on their own judgement of the risks and rewards of different types of linkage. Government should not attempt to force enterprises to joint venture with farmers because it restricts enterprise autonomy, but can actively encourage the development of farmers organisations that are able to negotiate effectively with enterprise and/or joint venture with it.

-SME non-farm rural employment creation, although it does not directly benefit poor farmers, has been the engine of economic growth in many economies including PRC, and has created work for migrant labour from poor areas. The constraints to SME development generally are shared by agroindustries and other rural enterprises, and so synergies can be exploited in developing support services by targeting these at SMEs generally rather than agroindustrial SMEs specifically.

-By definition, "viable enterprise" can withstand commercial funding and it is inappropriate to develop enterprise that cannot. As a consequence the use of OCR or other commercial resources for funding agroindustry is not a contention. However, where there is financial market failure donors and governments can address this through the creation of specific financial facilities (loans, equity and guarantees) that assist SMEs or more specifically private agroindustry. There is often a particular need for long-term capital because of the lead-time to full production for agricultural SMEs. The provision of long-term capital should not be subsidised for this reason, rather the terms and conditions of the financing should relate to realistic schedules for the enterprise to repay.

-Support services of various kinds (for example market research and technology development, business development, and information services) have all proven useful in assisting development of rural enterprise including agroindustry. The research generally shows that self-sustaining market

\textsuperscript{2} See appendix A12, "PRC Agroindustry and Rural Enterprise Development"
oriented services that compete for resources and customers can be more effective than government operated services. Government can sponsor the start-up of such services as a means of overcoming specific market failure and can assure their direction towards SMEs or agroindustry or poverty reduction though the eligibility criteria that are used to allocate resources.

**PRC Experience**

442 PRC’s economic development has been characterised by a shift from an agrarian to an industrial economy. Non-farm employment has become an essential component of rural incomes, and the structure of employment is changing rapidly. The proportion of the population employed in the state sector is declining, employment in TVE’s, formerly the engine of economic growth, is static (and has been for more than a decade in the agroindustrial sector), while engagement in private sector activities, particularly in small business, is expanding very rapidly.

443 Reform of PRC’s 400,000 state-owned enterprises (SOEs) progresses slowly. Outstanding loans to SOEs are estimated to be 70 percent of GDP and bad loans 20 percent of GDP. This restricts the available credit to other productive enterprise including TVEs and the private sector and will result in a significant fiscal burden for government that reduces the potential level of future public spending, including potential public spending on poverty reduction projects. SOEs continue to face increasing competition from TVEs and the private sector, and while their "corporatisation" is urgent, reform is slow because of the impediments to social asset transfer. However, progressing the restructuring of SOEs (agroindustrial or otherwise) has important implications for poverty reduction because viable, "corporatised" SOEs will: help to stem the increases in urban unemployment; provide a continuing market for TVEs as subcontract suppliers (which is important in some areas and sectors); increase credit availability for other enterprises; and can free-up public spending for poverty reduction.

444 Rural industrial enterprises (TVEs and the private sector) have been the main engine of PRC’s economic growth and now account for more than half of national industrial output. These enterprises are generally SMEs. TVEs account for about three-quarters of the output from this sector, but the private sector share is increasing rapidly. Historically, TVEs have been more successful than private enterprise because their "community" ownership structure, which includes local government, has given them preferential access to finance, greater protection of property rights, and access to resources controlled by the state sector. In an economy where product markets have developed ahead of asset markets, the development of such community enterprises has been an effective way of turning community assets, particularly land, into cashflow while at the same time generating tax revenue and bolstering employment. However, research demonstrates that TVEs are losing their comparative advantage over the private sector with economic

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3 The reader is referred to appendix A12, "PRC Agroindustry and Rural Enterprise Approaches and Experience" for the detailed arguments that justify the findings and a wide range of supporting illustrative case study experience.

4 As is demonstrated elsewhere in the overall strategy for poverty reduction, the freeing-up of resources generally can make a significant contribution if those resources can then be used directly, indirectly or through parallel funding mechanisms for poverty reduction.
liberalisation and urbanisation, and that the traditional, opaque ownership structures with their ambiguities between ownership and management will turn from advantage to disadvantage as reform progresses. Support for the full commercialisation of TVEs, their restructuring, and addressing the systemic management constraints is important to maintain viable enterprise and thus employment, growth and the availability of credit and budgetary funds for poverty reduction and other purposes. This applies to all TVEs not just the agroindustrial ones.

445 Agroindustry is not the main rural industry even though TVEs are located in the countryside. In fact, by 1996, TVEs that used agricultural products as raw materials accounted for only 2.6 percent of employment and 2 percent of the output of all TVEs. Within this relatively small sector, the eastern and central regions of PRC are dominant although there are signs that there has been a small degree of "catch-up" over the last decade or so with the relative share of employment and output of the central and western regions growing. This is an expected phenomenon, and the research bears out the hypothesis that TVE growth would initially be greatest in the most reformist provinces (in this case in eastern PRC), but that as reforms spread other provinces would begin to "catch-up".

446 TVEs are of different types. Models include those developed using local surplus resources, private capital, foreign capital, and SOE sponsorship. However, TVEs without exception enjoy local government sponsorship either through participation in the ownership or because of their importance in revenue remittances at the local level. Although TVE managers have more day-to-day autonomy than SOEs, they are still subject to some control from local government, and in western PRC in particular the traditional SOE management styles suited to a planned economy have often been applied to TVEs. Separating management and ownership and introducing modern business management and marketing practices is as important for TVEs as it is for SOEs if TVEs (or their successor enterprises) are to retain a pre-eminent position in the economy.

447 The "dragonhead" approach in which a larger, well-established enterprise assists with the establishment of a new enterprise in a different region has been advocated as a mechanism for poverty reduction. "Dragonheads" do not necessarily operate in poor areas, and depending on their structure, have varying poverty reduction impact. Those that establish their own self-managed production bases have little impact. Those that rely on farmers for raw material supplies have moderate impact, while those that are joint ventures with farmers and share profits can have greater impact still. Case study research under the TA indicates that there are location specific opportunities for successful "dragonheads" in poor areas: processing plants need to be located where there is adequate infrastructure which will not usually be in the poor area itself; government support, particularly through access to finance has been important; advanced technology, experienced management and market oriented buying and selling behaviour are characteristics of successful TVEs and are often injected by the "dragonhead" enterprise; and technological support for producers and provision of working capital are essential.

448 The key characteristic of "dragonheads" is their vertical integration. Imperfect information, lack of access to markets and low levels of farmer education and farm technology contribute to making the alternative of farmer based organisations such as co-operatives, or production for the open market, less effective means for poverty
reduction at present in PRC. More importantly, government's preoccupation with making enterprise types (SOEs, TVEs and co-operatives) instruments of policy rather than market based institutions greatly inhibits the development of sustainable farmer organisations. The recent closure of RCFs and the current insistence on the use of RCCs as the only vehicle for microfinance are illustrative of this.

449 From the PRC experience it is concluded that agroindustry can make an effective contribution to poverty reduction. In western PRC, if the TVE growth trends for agroindustry of 1987 to 1997 continue, then tentatively there is potential for the creation of more than 400,000 direct jobs. Further scientific research is needed into the potential for indirect employment creation. As an example, if for each direct job there are between 35 and 50 indirect farmer beneficiaries, then the potential is to benefit between about 15 and 20 million farm families. It is also concluded that poor areas have both comparative advantages and disadvantages, generalisation is inappropriate, and investment needs to be treated on a case-by-case basis. This can be accommodated within a traditional credit line approach using eligibility criteria to assist the focus on poverty reduction, drawing on experience in PRC and internationally and through new mechanisms being pioneered by the International Finance Corporation (IFC) and others.

450 With regard to future development accelerating the restructuring of SOEs (including those with strong linkages to agroindustry in poor areas), rationalising TVE governance for a competitive market economy, removing barriers to private sector market entry, and fostering the continuing growth of both private sector and TVE-type SMEs should be the policy agenda priorities. Addressing the systemic management constraints in all types of enterprises should be a priority for action, and the establishment of "business development centres" (BDCs) that would provide information, advice, training and facilitate all types of business linkages is consistent with the government's regional development strategy and worthy of consideration. Access to credit to facilitate SOE restructuring, and for SMEs and rural entrepreneurs generally, continues to require special interventions in the absence of a fully reformed banking system and a high level of non-performing loans in the state bank sector. Measures that foster effective linkages for poverty reduction can be built in to the design of the technical and financial support mechanisms.

Policy Dialogue Issues

451 In the dialogue between ADB and the PRC government over the funding of agroindustry with poverty reduction linkages there are three important areas that are supplementary to the credit line and investment facilities that are recommended. These are:

- ADB participation in developing the east-west linkage;
- improving the enabling environment for SMEs and co-operative organisations;
- development of support services for SMEs; and

It is stressed that this is an illustrative example and not an estimate.
• SOE reform.

452 As the supporting papers demonstrate\(^6\) these four areas of cooperation, SME policy development, support services and reform of the state sector are complementary to and agroindustry and rural enterprise development in PRC and at the least measures to improve the operating environment for SMEs and to develop support services should be on the agenda of conditionality for loan support.

**ADB Participation Developing the East-West Linkage**

453 East-west linkages are already well established in PRC with many of the eastern, richer coastal provinces and industries supporting poorer western provinces through investment. For example, in 2000 so far, Shanghai Municipal Committee has made development plans with leaders in Henan, Shaanxi, Ningxia, Inner Mongolia, Xinjiang, Gansu and Qinghai for more than 500 cooperation projects valued at about 3.6 billion US dollars for infrastructure, ecological protection, resource exploration, tourism, science and education. There is an opportunity for ADB to participate in this, either by funding the investments or by helping to free-up funds for such investments through the parallel funding mechanism.

**Improving the Enabling Environment for SMEs**

454 Historically, the policy environment has favoured SOEs over TVEs, and TVEs over the private sector. Changes in taxation in 1994 helped to create more even competition, but directed credit and subsidies continue to assist SOEs, and to a lesser extent TVEs. The removal of mechanisms that create uneven competition in favour of SOEs and TVEs is essential for future healthy economic growth.

455 An improved enabling environment for more formal operation of the private sector has begun to emerge through new legislation and the rural private sector itself is growing rapidly. Many of the traditional advantages of TVEs will be eroded in the near future. Specifically: PRC’s WTO accession will result in better access to capital for the private sector and intensify competition; as property rights and market institutions strengthen and the state sector declines further, TVEs close connections to local government will be less and less of an advantage and may turn to disadvantage where there is heavy dependence on them for revenue and ownership is not distinct from management; and SOE "corporatisation" will result in increasingly "commercial" relationships with TVEs and increased competition with the private sector for subcontracting.

456 In this new environment, policies that do not discriminate against either TVEs or private sector enterprise are desirable, and in particular: clarity about the relationships between ownership and management is required, barriers to market entry for private sector firms need to be removed, and the general enabling environment for small and medium-scale enterprises (TVEs and the private sector) progressively improved. The policy dialogue can centre on the best international practices identified for broad-based support to SMEs (developed further in the next

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\(^6\) See appendices A11 and A12 for the discourse.
subsection) 7. Where appropriate ADB can offer technical assistance to develop specific aspects of policy or legislation.

457 In addition, a special dialogue could be initiated on the development of farmer organisations. This dialogue would focus on how to put in place the conditionality that is critical for the success and self-reliance of farmer organisations 8. It is judged this dialogue will be extended because the principles of success involve the absence of government involvement in any aspect of operations, the treatment of such organisations as private and professional and not "against government", and abstinence from the use of such organisations as instruments of state policy.

Development of Support Services for SMEs

458 Facilitating access to efficient and unbiased financial markets for SMEs should be the medium-term goal. Short-term achievement in the existing market place is unlikely because the existing biases within state-owned banks and the high level of non-performing loans in SOEs cannot be removed immediately, and in one sense SOE reform is a precursor to better financial markets. However, measures can be taken now to provide SMEs with better access to finance. By definition, viable enterprise can withstand "commercial" funding and so the use of OCR or other commercially priced funds for SMEs (in both the agroindustrial and other sectors) is not a policy issue 9. It can be argued that in the absence of equitable access to financial resources, positive discrimination in favour of SMEs through access to the long-term resources of funding agencies such as World Bank, ADB and IFC is justified to help accelerate their development. There is often a particular need for long-term capital because of the long lead-times to full production for agricultural SMEs (for example, tree crop based enterprises may take some years to establish). Although returns may mature only in the medium term, this is not a valid argument for subsidised lending. Rather the terms and conditions of the financing should relate to realistic schedules for repayment.

459 PRC has had both successes and failures in agroindustrial development. Success has come primarily from a complex of factors, in the TVE sector particularly the linkages to local government through ownership. Failure has been mainly due to systemic constraints in most aspects of management because management has not been equipped to operate in a market environment 10. To address these constraints consideration can be given to the establishment of sustainable BDCs. Internationally, these have evolved as multifaceted agencies providing a wide range of information and advice, management training, facilitating access to credit, and "signposting" linkages of all kinds between enterprises, financiers, investors and other stakeholders. The specialisation of such agencies in agroindustry would be possible, but it is probably more desirable for such agencies to adapt themselves to the overall

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7 See paras 44 - 84 in appendix A11, "International Agroindustry and Rural Enterprise Development Approaches and Experience" for full details.

8 See paras 33 - 39 of appendix A11, "International Agroindustry and Rural Enterprise Development Approaches and Experience"

9 There are already two ADB agroindustrial credit lines operating through the Agricultural Bank of China using OCR resources.

10 See paras 37 - 46 of appendix A12, "PRC Agroindustry and Rural Enterprise Development Approaches and Experience"
economic growth potential of the regions in which they operate, with emphasis on agroindustry where it is a major component of the local economy. The focus might be oriented towards the "pillar industries" that it is planned will be core of future regional development in PRC.

A more specific agroindustrial slant could be given through the use of a "competitive agricultural technology fund" (CATF) that would sponsor applied research. Special emphasis could be given to product and market development for agricultural raw materials from poor areas. Fostering competitive private sector market information services, enterprise networks and export promotion schemes are also options that can have a specific focus on agriculture and products from poor areas if required.

SOE Reform

SOE reform has been hampered by ineffective ownership structures and management relationships, excessive governmental interference in enterprise operations, high debt burdens and poor financial management, fragmented manufacturing operations and supply chains, an absence of planning and forecasting and a general lack of management sophistication. PRC's current policy continues to focus on maintaining state ownership of key large-scale enterprises while divesting smaller units of production. According to the PRC State Economic and Trade Commission, at the end of 1998 of the 7,680 SOEs targeted under the government's reform programme, 2,300 were operating in the red, debt climbed by more than 35 percent to USD 9.5 billion during the year in response to the Asian economic crisis and resulting overproduction and declining exports, the number of laid-off workers increased from 11.5 to 16 million, and two-thirds of enterprises had not completed restructuring tasks required of them.

While SOE reform can have no direct impact on rural poverty reduction, it is important in the context of poverty overall in PRC. SOE reform can help to: stem the tide of urban unemployment (both by retaining jobs in restructured SOEs that would otherwise be bankrupt and by creating jobs through the growth of newly restructured firms); provide a more stable and commercial market for SMEs that are their suppliers; and most importantly it can free-up credit and budgetary resources which could, at least in part, be allocated to poverty reduction. The dialogue should centre on innovative ways in which ADB can support SOE reform such as extending BDC services to SOEs and the provision of loan guarantees for reforming SOEs.

OCR Lending Opportunities

The overarching goal of any future agroindustrial and rural enterprise lending and technical assistance in PRC will need to be poverty reduction in order to comply with ADB's new orientation. This will represent a departure from the two previous agroindustrial credit lines to ABC of which the first was targeted at economic growth and the second at economic growth with poverty reduction as a secondary objective. The purpose of lending will be to create employment and income opportunities for

See paras 60 - 61 of appendix A11, "International Agroindustry and Rural Enterprise Development Approaches and Experience"
the poor, though this will not be at the expense of enterprise viability. As a consequence, direct creation of employment (ie the use of labour intensive technology) should not be a criterion for enterprise selection, but indirect employment creation for poor farmers or other suppliers of raw materials to rural enterprises should be.

Direct Project Lending Opportunities

Components of Projects including SIFs and CDFs

464 There are direct lending opportunities for OCR resources for individual components of projects. These would involve direct lending to privately owned agroindustrial companies ("dragonheads" or otherwise) that were making investments in poor areas and were going to rely on poor farmers for raw material supply. Such projects would need to satisfy the basic criteria developed from the research and TA case study experience\(^{12}\) for support to agroindustry for poverty reduction which are:

- viability of the enterprise, meaning that the enterprise business plan clearly demonstrates its access to markets, the responsiveness of its products to market demand, adequate overall market size and its ability to obtain market share, the competence of management, a satisfactory useful life for the technology chosen, and adequate financing;

- independence of the enterprise, meaning that even if government participates in the ownership, the relationship between ownership and management is that which would normally be found in a commercial enterprise where the shareholders appoint the managers, the managers are free to manage and are judged on their performance, and returns to shareholders are balanced by the need for retained earnings to support corporate growth;

- equitable arrangements with farmers, meaning that farmers receive at least market prices for their produce, are not exploited or put in a position where they could be exploited by monopoly power of single buyer, receive an adequate return on their investment, and where that investment is long-term have a reasonable expectation of a sustained market over the life of the investment;

- adequate technical extension arrangements, meaning that the enterprise provides or can cause to be provided technical information, support and training to farmers sufficient for them to be able to realise expectations in terms of yield and quality of produce and hence income;

- clarity of contractual arrangements, meaning that any rights and obligations of the enterprise and the farmers in connection with production, purchasing, prices, quality, loans or any other matter is clearly explained to farmers in

\(^{12}\) See paras 55 and 70 of appendix A12, "PRC Agroindustry and Rural Enterprise Development Approaches and Experience"
advance and that farmers understanding of the arrangements is independently verified;

- no negative environmental impact, meaning that the natural resources used for production are used on a sustainable basis and that the enterprise itself is compliant with prevailing environmental regulations.

Enterprise viability is the primary consideration. This is enterprise and location specific and generalisation cannot be made. Each individual project investment will need to be considered on its merits. Such support could be provided both within the context of a conventional project where agricultural or rural infrastructure is being developed and the resulting infrastructure allows new enterprise to be established, or within the context of a SIF or CDF\textsuperscript{13} where the development of a specific enterprise is justified.

**Producer Microfinance**

Within the context of direct lending or other financial support to agroindustry, ADB could include components for microfinance for poor farmers producing for the specific enterprise being financed. The microfinance policies and procedures applied would need to be consistent with the criteria adopted for all ADB supported microfinance projects in PRC\textsuperscript{14}.

**Indirect Project Lending Opportunities**

**Commercial Bank Lending to Enterprises**

To support agroindustrial development generally rather than specific enterprises on a case-by-case basis, ADB has provided two credit lines through the commercial banking system for agroindustry. The first was directed towards economic growth in coastal provinces and had little poverty reduction impact. The second had both economic growth and poverty reduction objectives and is being executed in seven inland provinces (Hebei, Hubei, Henan, Hunan, Shanxi, Sichuan and Xinjiang). To satisfy ADB’s over-arching poverty reduction goal, future credit lines will need to be more poverty reduction oriented.

To achieve this the criteria that the government and ADB should adopt are:

- investment of loan proceeds from future credit lines could be directed only or in substantial part at poor provinces in central and western PRC;

See Chapter 2 for details of SIFs and CDFs.
See Chapter 3 for details of the criteria for microfinance projects.
• borrowers should be limited to "dragonhead" enterprises that would use outgrowers in poor areas (or in resettlement areas\(^\text{15}\)) for a significant proportion of production; and

• the general criteria for viability and independence of the enterprise, equitable arrangements with farmers, adequate technical extension arrangements, clarity of contractual arrangements, and no negative environmental impact, would also apply\(^\text{16}\).

469 ADB might need to accept that its overall loan size would be smaller than previous agroindustry credit lines because of limited opportunity. The potential participating banks will argue that there are many other opportunities that have indirect poverty impact through direct employment creation in eastern PRC. However, if the priority is poverty reduction for poor farmers, then the above criteria should apply a priori. Such credit lines should focus on "dragonhead" type opportunities as these have good ability to satisfy the basic criteria for financing. Within the overall loan, subloans would be relatively large.

### SME Credit Lines and Microfinance

470 Although "dragonhead" type industries offer one of the best chances for sustainable poverty reduction through agroindustrial financing, "dragonheads" have not been the engine of economic growth and employment creation in PRC's rural industrialisation. Rather, locally based TVEs and the emerging private sector, generally needing smaller amounts of finance, account for this. These enterprises can be targeted through SME credit lines of the type widely developed in transitional economies by the European Bank for Reconstruction and Development (EBRD) and the World Bank. Lending would be against the same criteria as for larger loans and could be extended to include non-agroindustrial SMEs that account for about 97.4 percent of employment in rural light industry in PRC. The basic criteria for subloans should not be extended to require such SMEs to be labour intensive because technology selection affects enterprise viability. Rather, and as with "dragonhead" enterprises, the focus should be on the assessment of the indirect employment and income generation.

471 Microfinance for small individual entrepreneurs developing value added processing for agricultural products at the local level can foster the growth of non-farm employment. Again, the microfinance policies and procedures applied would need to be consistent with the criteria adopted for all ADB supported microfinance projects in PRC\(^\text{17}\).

\(^{15}\) The case might arise where a "dragonhead" industry wished to establish itself in an areas where poor people from remoter mountainous regions had been resettled. In this case the industry development could be treated as part of the overall poverty reduction initiative and might qualify for financing.

\(^{16}\) See paras 55 and 70 appendix A12 for the derivation of these criteria from international research and case studies.

\(^{17}\) See Chapter 3 for details of the criteria for microfinance projects.
Credit Guarantees for Reforming SOEs

472 ADB could contribute to credit guarantee funding for reforming SOEs or individual businesses that are divested as SMEs in the restructuring process. There are no firm precedents for credit guarantee funds in PRC and so detailed design would be a necessary precursor.

473 Criteria for fund operations should include:

- local participation in the fund;
- availability of guarantee funding only against short-falls in the normal security required by lenders;
- clear procedures that protect the interests of borrowers, lenders and the guarantee funds, and that do not precipitate calling of guarantees without first recourse to best practice in recovery or restructuring or realisation of security; and
- the parallel implementation of Institutional Building Programmes (IBPs) in lenders to improve credit risk management.

474 To qualify for credit guarantee support, SOEs would need to be in the process of significant carefully planned restructuring. Specifically, core, viable businesses will need to have been identified, diagnostic analysis completed, strategies documented, change activities planned and the resources and performance indicators for transformation identified. Strategies will need to be both short-term (covering debt restructuring, cost cutting, product change and divestment) and medium-term covering subsequent performance improvement.

Parallel Lending Opportunities

475 The parallel lending opportunities essentially embrace all of the above direct and indirect lending opportunities if they feature as components that will be financed by a provincial government that has freed-up resources for poverty reduction activities through the parallel lending mechanism.

Mechanisms for Implementation

Components of Projects Including SIFs and CDFs

476 This could be done on an individual project-by-project basis or through a facility designed for the purpose. On a project-by-project basis, each investment would be appraised using ADB’s normal project processing cycle, the evaluation being submitted to the ADB Board either as a stand-alone investment or as an investment within a wider project (including within a SIF or a CDF).

477 Alternatively, ADB could establish a facility similar in concept to the IFC "Reach Initiative". This facility would involve the proactive involvement on the part of ADB staff (or consultants) based in PRC to develop a deeper understanding of agroindustries needs in poor areas, build working relationships with local entrepreneurs, local government and financial institutions, and working with clients to
develop viable agroindustry projects with poverty reduction potential. The facility could be flexible providing loan finance, equity, quasi-equity and loan guarantees, and based on the IFC experience it would provide up to 40 percent of project costs. The facility could operate independently or within the framework of a challenge or replicator fund.18

**Illustrative Structure and Funds Flow**

478 Figures 5.1 and 5.2 illustrate simply how these ideas could work in practice. On a project-by-project basis ADB would lend to client agro or rural industry. Where the project is a component of a SIF or CDF type project, the SIF or CDF intermediary would have an oversight role together with ADB. FCPMC would have functional roles liaison with ADB, in the identification of investments and in monitoring poverty impact. ADB would have functional links at all levels through design consultation and implementation monitoring. In a “Reach” type initiative, the essential difference will be that the drawdown of funds will be on a facility and “Reach” agents will promote and monitor its use.

**Figure 5.1 Illustrative Management Structure and Funds Flow for Direct Lending**

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ADB

ADB or ABD and SIF / CDF Agency

Client Agroindustry or Rural Enterprise

FCPMC

Suppliers (Poor farmers or rural entrepreneurs)
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**Figure 5.2 Illustrative Management Structure and Funds Flow for “Reach” Type Initiative**

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ADB

“Reach” Type Facility

“Reach” Agents

Client Agroindustry or Rural Enterprise

FCPMC

Suppliers (Poor farmers or rural entrepreneurs)
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18 See Chapter 2 for details of challenge and replicator funds.
Producers Microfinance

There are three particular mechanisms that can be considered by ADB and the PRC government for the provision of producer microfinance in support of specific agroindustrial investments on a case-by-case basis.

The first alternative is to rely on the generalised provision of microfinance to producers of different products within an area, where the decision to lend for any specific product is an independently taken by the microfinance provider. In this case the enterprise must accept that certain farmers will not be funded because the intermediary by its own criteria does not consider them or the production of the raw materials that it needs to be good credit risks.

The second is the loan of an amount for producer microfinance as working capital for a particular enterprise. In this scenario, the enterprise would arrange to provide producers with the means of production, mainly in kind through the provision of seeds or planting material, fertiliser, agrochemicals. A contract with farmers receiving the support would provide for repayment with raw materials supplied to the processing enterprise. This type of financing would be enterprise and product specific. This is straightforward to organise on an enterprise-by-enterprise basis and the absence of intermediaries allows the enterprise autonomy in deciding which farmers to support and makes it fully accountable for recovery of advance to farmers through purchase of their production.

The third would involve the provision of microfinance for producers through an intermediary other than the agroindustrial enterprise where the intermediary acts as agent for the enterprise. The chosen intermediary would depend on any strategy agreed between ADB and the PRC government for microfinance development. Here the enterprise would decide which farmers will benefit and would take the full credit risk. The enterprise must accept that there will not be strong incentives for the intermediary to assist in recovery in the event of default.

The first alternative is preferred because it allows market forces to determine the allocation of resources. The second alternative provides a good means of overcoming market failure if the generalised provision of microfinance in not available. The third mechanism is not recommended because even if the enterprise takes the credit risk it makes itself reliant on a third party the provision of credit management services where that party is not accountable for the quality of the services. This leads to conflict of interest and potential breakdown in the relationship.

Commercial Bank Lending to Enterprises

ADB’s relationship to date has been through two credit lines to ABC that has been the natural choice of partner because of its nation-wide outreach, agricultural orientation and the willingness of the PRC government to accept the borrowing as sovereign debt. ABC remains the partner of choice for these reasons. Although in

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19 See Chapter 3 for illustrative management structure and funds flow for microfinance.
20 It is, of course, a condition that the market distortions produced by the present subsidised loan schemes are first removed and that interest rates are liberalised. See chapter 3 on rural and microfinance development for details.
due course, with the opening up of the banking system to greater domestic and foreign competition, there will be more opportunities for other commercial banks to lend to agroindustry, it is unlikely the PRC government would guarantee private sector debt to ADB in the way that would be necessary for an apex credit line which operated through several private commercial banks. Therefore, this option should only be explored further if a sovereign guarantee can be put in place.

485 Implementation through ABC will not be without difficulty. ABC's increasingly commercial leaning means there is an inherent reservation about lending for poverty reduction. The government's use of ABC as a policy instrument for delivering the subsidised loan programme has served to increase ABC's resistance to such lending. In the second credit line from ADB, the criteria that require lending to be based in poor areas have been a source of concern to ABC, and ABC has argued (as it turns out rightly) that there are poor in non-government designated poor areas and that opportunity is missed in these areas if poverty counties are the physical basis for the distribution of lending. This may be overcome by relaxing the poor county criteria, and instead focusing on the poverty status of the households that will benefit from being outgrowers and the impact on income that will result from the new agroindustry. A regional focus in western and central PRC would also be possible. Implementation mechanisms would be similar to those already in place for the first and second credit lines and would follow ADB's standard procedures.

486 The alternative of lending through budget bureaux is not considered viable because it would not be market driven and, budget bureaux are not banks, potentially have conflicting objectives in the lending with perceived tax revenue considerations taking precedence over other criteria, and have poor recovery rates and credit discipline under the existing subsidised loan programme.

487 In discussions with FCPMC during the TA fieldwork a proposal for a pilot project for financing "dragonhead" industries was considered. In practice, piloting is not considered necessary given ADB’s previous extensive experience with ABC and the fact that such a credit line would adhere to the normal procedures already established, the principal differences being only in the criteria for enterprise selection and the linkage to support services.

**Illustrative Management Structure and Funds Flow**

488 Figure 5.3 illustrates simply how these ideas could work in practice. ADB would establish a credit line with ABC for on-lending under similar terms and conditions to the client agro or rural industry. ADB would carry out its own oversight of the project. FCPMC would have a role in the identification of investments and in monitoring poverty impact.

**Figure 5.3 Illustrative Management Structure and Funds Flow for Indirect Lending**

See paras 83 to 93 in appendix A6, "PRC Poverty Reduction Approaches and Experience"
SMEs and Microfinance

489 ABC and RCCs have been the principal financiers of SMEs to date and have the necessary outreach at township level. SME lending will be inherently more risky than "dragonhead" type lending because: the enterprises will not be able to rely on "parent companies" for skills, experience and market access; and a significant part of existing lending to SMEs has been politically influenced. Accordingly, the parallel development of SME management skills through BDCs and the execution of IBPs in selected ABC branch and individual RCC operations will be necessary.\(^{22}\)

490 In line with normal SME credit line arrangements, participating ABC branches and RCCs would need to satisfy and maintain prudent financial ratios and resources available under an SME credit line through such outlets would be limited in relation to their individual capital. An element of competition for resources could be introduced by encouraging ABC branches and individual RCCs to associate with local government in the formulation of combined proposals for the establishment of credit line, IBP and BDC facilities. The latter would need to demonstrate the potential for sustainability and increasing private sector participation in service delivery. It may also be possible to link the credit lines to the pilot Credit Guarantee Institutions (CGIs) that are being set-up by the State Economic and Trade Commission to assist in facilitating SME credit access.

491 Any microfinance component would rely on the generalised provision of microfinance, where the lending decisions are independently taken by the microfinance provider.

Illustrative Management Structure and Funds Flow

492 Figure 5.4 illustrates simply how these ideas could work in practice. ADB would establish a credit line with ABC or with RCCs for on-lending under similar terms and conditions to the client SME. ADB would carry out its own oversight of the project. BDCs would have a role in the identification of investments and in support for SMEs. FCPMC (and possibly the TVE Bureau) would have an oversight role together with ADB for the BDCs and would monitor poverty impact.

\(^{22}\) See Chapter 3 for details on technical assistance.
Credit Guarantees for Reforming SOEs

493 Implementation of a credit guarantee fund would be at local (provincial or prefectural) level. The lack of precedent in PRC at the present time means that a national scheme without any local piloting would not be acceptable to government, nor would large-scale operations without pilot testing be prudent.

494 Because of the need for pilot scale operations and linkages to IBPs, credit guarantee funds will be best implemented initially as components of wider SME support projects or under parallel lending initiatives. The management and funds flow structure would be similar to that in Figure 5.4.

Summary of Opportunities for the Use of OCR and TA Funds

OCR Funding

495 Accepting that commercial enterprise can withstand OCR rates and that special intervention is required because of scarcity of capital (particularly long-term capital) it is recommended that OCR funding is applied in the following order of priority because of ease of implementation:

- credit line facilities for "dragonhead" industries with ABC as the partner of choice, effectively extending the existing relationship with ABC under conditions that relate more closely to poverty reduction;

- credit line facilities for SMEs with selected branches of ABC and RCCs as partners in co-operation with local government and the private sector for the development of SME support services;

- individual loans, equity participation and guarantee arrangements directly from ADB to private sector agroindustry in the context of other rural development or poverty reduction projects preferably through a facility designed for the purpose rather than on a case by case basis along the lines of the IFC Reach programme (to service sectoral and multisectoral projects of both ADB and other donors) and including the capacity to provide sufficient
working capital to enterprise to fund outgrowers through credit in kind or microfinance;

• credit guarantees for reforming SOEs or their divested components.

Components of SIF, CDF, and parallel-funded type projects should follow as soon as these mechanisms are developed by the government and ADB using the same design criteria as credit lines. Microfinance interventions (other than working capital components of enterprise loans) should conform to the overall strategy for microfinance development.
TA Funding

497 TA funding contributions will be required from ADB for the design of any of the proposed interventions with OCR funds into components of projects (including SIFs and CDFs), credit lines, guarantee funds and microfinance. The contributions would be applied under ADB’s normal procedures for project preparation technical assistance (PPTA). Implementation will require advisory and operational technical assistance (AOTA) for different aspects of capacity building in lenders and borrowers.

498 ABC has already received substantial TA in relation to project lending and credit risk management for larger scale agroindustrial projects focused on officials undertaking credit line management and on the piloting of reforms in Ningbo Branch. Any further credit line through ABC for "dragonhead" type lending may require further technical assistance to further strengthen ABC’s capabilities with regard to applying the specific criteria necessary for successful “dragonhead” enterprise, although this would be dependent on diagnostics at the design stage. The non-financial aspects of business planning and business plan assessment are the areas in which ABC has received least assistance under previous TAs.

499 For SME credit lines and guarantee funds TA support will be necessary for all aspects of credit management including appraisal, supervision and recovery at the loan level and risk management of SME portfolios. Such TA would concentrate on the special characteristics of SME lending which focus on business and business performance in a market environment, rather than on collateral (although security remains important).

500 For microfinance, TA would be within the context of any overall microfinance operations supported by ADB.

501 The major opportunity for ADB AOTA is in the provision of support for BDCs. Such TA could be linked to an ADB credit line or to the credit lines of other donors or could be a stand-alone TA project. Detailed design is required, but for example such an AOTA could create support services based on partnerships with the local private sector at prefectural or county level. Based on a business plan, a typical BDC would have a mandate that embraces:

- providing access to business information: through a help desk and web site that provides information about where to go for the best business advice, where to get finance, local suppliers and business contacts, quality programmes, employee training, new legislation (particularly tax and accounting), markets, industry sectors, partnerships and meeting special requirements on a fee paying basis;

- promoting business advisory services: by the introduction of accredited service providers to businesses and initial financial support for service provision to eligible businesses to assist in the establishment of longer-term commercial relationships between advisors and businesses;

See Chapter 3 for details
fostering a vibrant local rural business advisory capacity: through accreditation, initial performance related financial support, training in advisory business management and development of rounded business advisory counselling skills;

facilitating finance: through advice on credit, equity and guarantee availability, links with funds providers and support at the interface between the financier and the enterprise;

encouraging new market linkages and mechanisms: through a core of specialist advisers in marketing, market information, and co-operative enterprise development;

offering innovation and technology counselling: through a core of specialist advisors in areas such as production technology, agro-processing equipment and IT applications;

supporting business in the community: by creating awareness of opportunity and through stimulating public-private partnerships and self-help initiatives; and

creating local support networks: by bringing together business leaders, business associations and local authorities, encouraging advocacy to lobby at local government level for laws, policy and regulations that provide a better environment for SMEs.

The emphasis would be on catalysing private sector participation rather than the creation of semi-autonomous project-supported units. This would be a novel approach for ADB, but is important for reasons of sustainability. It has the advantages that it creates private sector stakeholders from the outset; allows advisory services to be developed without dependence on project staff; and focuses activities on sustainable business advisory services and thus on customer needs. In general, sustainable service will need to work across different sectors (because most of the opportunity is not agroindustrial) and BDCs should be developed for rural enterprise as a whole, not a specific sector.

In the provision of this TA, ADB should consider strategic partnerships with bilaterals that have substantially greater experience in SME development. Partners to approach include: USAID, DFID and GTZ all of whom have relevant experience in transitional economic environments.
Findings for Rural Infrastructure

International Experience

504 The importance of developing infrastructure has long been recognised as central in promoting economic growth. In rural areas it has wide ranging impacts on individuals, households and communities both in terms of income and other quality of life indicators. There are both direct and indirect benefits from infrastructure development and it is important to consider the indirect benefits in decision-making about infrastructure projects. Education, for example, can affect income and health both of that in turn affect quality of life. There are also strong social benefits from infrastructure that need to be taken into account. Economic benefits such as increased income, employment, productivity gain, better income distribution and opportunity for diversification are obvious. Social benefits such as time savings, school enrolment levels, access to health services, environmental improvement, skill development, capacity building, improved information and gender impacts are less transparent, but in the longer term may be as or more effective in poverty reduction because they lead to sustained improvements in quality of life independent of income sources.

505 Four trends are noticeable in the development and implementation of infrastructure projects: the increasing incorporation of incentives to involve the private sector in the provision of infrastructure financing; a greater concentration on institutional and regulatory reform; an increasing focus on smaller scale projects; and increasing stakeholder involvement in design and maintenance of projects.

506 Governments have often performed poorly in the provision and maintenance of infrastructure and interest in private sector involvement is increasing. Governments also do not have the resources and annual private capital investment in infrastructure in developing countries increased from $100 million in 1988 to $20.3 billion in 1996. Private sector investment now accounts for about 15 percent of total investment, focused on power, telecommunications and roads. Development assistance also substantially makes up for government’s own lack of resources with between 25 and 40 percent of funding going to infrastructure projects. Although the private sector faces risks in infrastructure investment, governments should not assume these risks on its behalf because it encourages inefficient investment, and the guarantees that have been provided have often been to compensate for structural problems such as low user fees, macroeconomic mismanagement and inefficient state enterprise. A better approach is to bring about regulatory reform. This at once improves efficiency and makes the environment for private investment more...

\(^1\) The reader is referred to appendix A13, "International Rural Infrastructure Approaches and Experience" for the detailed arguments that justify the findings and a range of supporting illustrative case study experience.
attractive. In Latin America for example, the introduction of formal bidding procedures and tariffs that reflect costs of services have encouraged private investment. Technological advances, for example in the case of small power plants and solar energy, have meant that small scale projects, more suited to less densely populated rural areas can be made profitable. However, in the donor sector, although this apparently receives support, small-scale rural projects are not yet common. This in part stems from the major donor’s need for large overall loan sizes, a lack of mechanisms for implementing a large number of small projects using one large loan, and perceptions about the lack of profitability of such investments. Decentralisation of responsibility for local level infrastructure, past poor performance, global democratisation, and delays arising from public protest are factors contributing to greater participation by beneficiaries in infrastructure design. Creating participation also creates ownership and can contribute to more effective operation and maintenance as a result. However, decentralisation needs balancing by oversight to ensure an equitable distribution of funding and that the benefits are not captured by the non-poor. Participation may also promote new approaches that make small scale infrastructure economically viable where it might not have been before. For example, working with the poor and microfinance organisations to establish schemes for infrastructure access (the relatively large capital payments for electricity connection and water supply installation may be prohibitive if paid at one time) or flexible timing of payments to fit household cash flows (for example prepayment at harvest when there is cash available) may create viability.

507 Electricity seems to be most beneficial in terms of QOL gains (extended working hours, opportunities for evening study, introduction of labour saving appliances) and has differential gender impacts. Businesses can also benefit and new business opportunities (using different tools or opening at different hours) become available. However, electricity on its own does not push ahead development and growth in the absence of other infrastructure (or other assets for the poor) and it is concluded that it should only form part of a package or bundle of infrastructure investment, and then only where there are roads, growth potential in agriculture, population concentrations, generally improving living standards because of other factors, plans for regional development and proximity to the power grid2. The latter condition is modified where solar power can be used. The need for complementarity must be taken into account in the design. Tariff policy is also important because subsidies are unsustainable and result in misallocation of resources. Where there is a need for welfare because of extreme poverty, discounted “lifeline” rates can be charged, but the full costs should be recovered through the tariff structure for other consumers, not from the government budget.

508 Roads have generally been viewed as the most important economic infrastructural development. Benefits for poor rural areas include lower transport costs, lower prices, expanded extension services, and greater free time because of substitution of goods (for example kerosene for firewood resulting in less time spend collecting the latter). However, the research shows that the prior social and economic context of where roads are located matters in their eventual impact on development

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2 This conclusion from elsewhere is being tested under the pilot project for this TA in PRC. See paras 26-32 of appendix A13 for details of the research findings and recommendations on RE projects from other countries.
and the need for complementarity of investment is also demonstrated in this sector. The policy environment is also important. Road development can create landlessness, and can result in larger landowners gaining a greater share of the benefits because of their greater access to other resources such as credit. However, in the right context roads bring better access to markets, higher prices for produce, and better access to health and education facilities. Upkeep has been a persistent problem with rural road development. ILO argues for a labour intensive approach to construction and maintenance, but while voluntary labour can be used for construction it has not proven a good approach to maintenance. Project design must include clearly identified funding for maintenance, which can be contracted to the private sector if appropriate and can have further poverty reduction impact by creating on-going employment.

509 Irrigation projects have also suffered from a lack of operation and maintenance funding and have been biased towards larger farms and high cost solutions. Other common problems with irrigation have related to water management and user fees. Research suggests that participation at all stages in irrigation projects is the best means to ensure on-going maintenance and adequate cost recovery. There are also advantages to involving users directly in management of irrigation projects. Water has many uses, and there are common and potentially conflicting interests among users. Water availability and quality are potential sources of conflict. However, few countries have involved stakeholders in this way, and where they are involved they have mainly been farmers using water for crop irrigation rather than drawn from the wider community of water users. Research also shows that community water management works better where there is a high level of social capital and social and economic homogeneity. The income benefits of irrigation accrue through increased yields for those who have land. Benefits for the land poor also accrue, because water can be used for livestock and domestic purposes, they can gain from employment created through the intensification of agriculture. They can also temporarily gain from employment in construction. Innovative schemes have also found ways to further capitalise on irrigation development for the land poor. In India and Nepal for example, water rights have been allocated on a household basis, and land poor households have been able to sell this asset to those with more land. In Bangladesh, microcredit has provided groups of land poor with the means of drilling wells and pumping to supply water to other users.

510 Safe domestic water supply is central to poverty reduction. It can reduce disease and morbidity, and raise productivity because of time savings in collecting water. However, there has been less successful financing of water supply by private capital than for other types of infrastructure. Reasons advanced are that water services are normally under the control of local government which may be less accountable than national government; the condition of infrastructure is difficult to assess because it is often below ground; and perceptions that water is a right for all encourage its supply even to those who cannot pay. Researchers suggest that independent regulatory bodies and increased competition are the way to encourage the private sector, but this does not address supply to the poorest. Sustaining water supply projects also requires similar stakeholder participation to that of irrigation projects.

511 Telecommunications are an increasingly important contributor to poverty reduction. Information about prices for outputs and raw materials can be made more
accessible to farmers. Radio, TV and Internet can enhance the learning of rural schoolchildren and can make up for deficiencies in teachers. Rural medical and relief workers can get assistance and advice. Communications can be used to reduce the impact of natural disasters and the spread of disease. Competition to bring costs down needs to flourish for successful telecom development and to attract private sector capital. World Bank research suggests various organisational models for private sector participation: revenue sharing concessions, joint ventures, and rural co-operatives. Some concessions in terms of costs: for example tax relief or finer interest rates may be appropriate where there are barriers to market entry or markets will take time to yield satisfactory returns on investment.

In drawing lessons for PRC from the international experience, it is concluded that: institutions matter and good governance at all levels effects the poverty reduction outcome of infrastructure projects; sustainability depends critically on planning for maintenance and repairs and setting tariffs sufficiently high; viability can be greatly increased through user participation and management of projects, most effectively where there is a high degree of social capital and homogeneity among stakeholders; oversight is necessary to prevent the poor being excluded from the gains; and access to other types of soft infrastructure such as extension and credit can enhance the impact. In general, measurement of the impact of infrastructure has focused on the more obvious economic factors: increased income, employment creation, productivity gains, income distribution and diversification. Less focus has been given to monitoring and measuring the “value” of the social gains such as those in time saving, education, improved health, improved environment and increased information but the evidence that there is suggests that these may even exceed economic effects in the longer term.

**PRC Experience**

Government authorities in PRC have attached priority to economic infrastructure development. Irrigation and drainage works, small-scale hydropower facilities, potable water supplies for people and animals, roads, electricity and telecommunications have all received substantial investment.

Irrigation has been developed extensively since 1949. The area covered has increased from 238 million mu in 1949 to 784 million mu at the end of 1997. Only about 20 percent of this area is in western PRC. Hydropower resources have been developed extensively over this period. In the 1950s, the installed capacity was small and mainly used for lighting. There are now more than 800 local power grids that supply more than 20 million kW to customers. However, there are still 11 counties and 70 million people in PRC without electricity supply. In the 50s and 60s drinking water shortages were not severe. Population growth and drought prompted more investment in the 1970s and 80s, but rapid economic development through the 90s has still left about 69 million people and about 51 million livestock without adequate water supply and about 22.5 million people with contaminated water supply. More than 20 percent of the population in western PRC do not have access to potable water. Road development has progressed from about 80,700 kms in 1949 to 847,900

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The reader is referred to appendix A14, "PRC Rural Infrastructure Approaches and Experience" for the detailed arguments that justify the findings.
km at the end of 1996. The food for work programme (FFW) has been instrumental in much of this since the mid 1980s. However, at the end of 1998 there were still 591 towns and 92,000 villages not connected to the road network of which 457 towns and 28,210 villages were in western PRC. In general, infrastructure development in poor areas has lagged behind that in other areas, in some ways reinforcing their poverty.

515 During the 1990s the government has made efforts to improve the effectiveness and efficiency of infrastructure development. These policies have centred on trying to combine irrigation and hydropower developments effectively, progressively introducing market rates for electricity and water to make depreciation and operation and maintenance self-funding, raise funds from different sources including commercial funds to accelerate infrastructure development, and use the food for work programme as a means of developing infrastructure and having an impact on poverty reduction at the same time.

516 The FFW programme has been the most important small-scale rural infrastructure programme from a poverty reduction perspective because it is focused on poor areas. By the end of 1998 the programme had created or renovated 300,000 km of rural roads, provided drinking water for 63 million people and 54 million livestock, developed 53 million mu of new agricultural land, newly irrigated or rehabilitated 73 million mu of irrigated land, planted 46 million mu of fruit trees and forest and contributed to hydropower and telecommunications development in rural areas.

517 Local Government is responsible for the management of infrastructure projects in poor rural areas. Engineering design is mostly but not always subcontracted to line agencies or institutes, and unified standards are not necessarily followed. Construction may be by force account (ie by the government department concerned) or use local labour, and private sector competitive tendering is not common. There has been limited attention to operation and maintenance funding at the design stage and it is widely recognised that there has been more emphasis on construction than maintenance.

518 Funds for investment in infrastructure come from a wide variety of sources: from the community (particularly in the form of labour), from local fiscal revenues, from government budgetary subsidies, from the FFW programme, from donations, from domestic bank loans and from international funding agencies. In general, the investment decisions for infrastructure development where there is no loan involved are not fully appraised from a financial standpoint because recovery of investment costs is treated as less significant. For investments that involve borrowing, there is more thorough analysis and recovery issues are covered.

519 Funds for operation and maintenance generally have to come from charging, but effective charging structures are not always in place. Capital costs may or may not be recovered by inclusion of a depreciation element in the fees. Electricity and water are relatively easy to charge for. Roads need to be paid for from the public

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See paras 101-108 in appendix A6 for a detailed analysis of the effectiveness of the Food for Work Programme and para 66 of appendix A5 for comparative analysis with other countries.
purse, though local labour can be mobilised on a voluntary basis to carry out some repairs.

520 The provision of infrastructure in rural areas has been a component of poverty reduction programmes in PRC but has typically not been viewed as the major factor in bringing about the dramatic reduction in poverty. Little work has been done on the impact of infrastructure development on poverty and its construction is widely perceived as a “relief” activity in poor areas rather than an economic one. Cost recovery has therefore received little attention, reinforcing the perception. Where there is cost recovery, it has often been at subsidised rates. This in turn has resulted in a preference for the development of other kinds of infrastructure by local government where revenues can be easily generated.

521 It is concluded that decisions about infrastructure in poor areas need to be better co-ordinated with poverty reduction efforts. This means first a better understanding of how infrastructure impacts on poverty. The pilot project under the TA and other research can contribute to this and monitoring and evaluation of both economic and social benefits in needed to help to demonstrate the benefits and to dispel the traditional views that rural infrastructure should only be funded with soft money or grants. Mechanisms that encourage investment in infrastructure that will reduce poverty also need to be developed. The present incentive system does not encourage such investments because of the pressures on local officials to make revenue-generating investments. Investments in hard infrastructure alone will have limited benefits and the development of soft infrastructure such as microfinance and technology and enterprise development are also important. More beneficiary consultation would be useful in enhancing the effectiveness of infrastructure development. If cost recovery programmes are to be effective, the development of infrastructure needs to be in response to demand (willingness and ability to pay). Participation is the only means through which local officials will be able to determine this. At the same time it will build greater ownership. Although FFW has been a very important component of infrastructure development, and its focus on agricultural land development has led to productive increases, its large-scale use of free-labour from the poorest households is inappropriate and has a negative effect on poverty reduction as well as making a potential source of discontent. Outmigration will continue to be an important means for poor households to supplement income. In establishing the priorities for infrastructure development consideration needs to be given to how infrastructure can facilitate this (for example better roads or better telecommunications).

Policy Dialogue Issues

522 In dialogue between ADB and the PRC government over the funding of infrastructure for poverty reduction, there are several issues that merit attention and should be the basis for establishing the conditionality of funding. The topics to be considered draw on both the international and PRC experience and the discussion will help to incorporate international and PRC best practice into future projects. The subject areas are:

Note that crowding in and parallel funding mechanism discussed in the overall strategy effect this.
the relative roles of the public and private sector in infrastructure financing;

institutional and regulatory reform aimed at efficiency improvement and price liberalisation;

reduction in project scale;

greater stakeholder participation;

greater equity in benefit distribution; and

improved poverty impact research.

Public and Private Sector Roles

While a dominant trend is to shift away from the public provision and financing of infrastructure, this does not automatically imply that there is not role for the public. In particular, the 'public good' nature of much infrastructure is an argument for public provision. Public goods are those which have positive externalities (benefits accrue to more than just the user, e.g. vaccinations benefit the patient but the public good is in preventing the spread of disease) and the benefits are not excludable (i.e. cleaning up the water supply or reducing air pollution means that all get the benefits, regardless of whether they pay for the cleanup). Because of these features of public goods, they are likely to be under-provided by the market at a level that is sub-optimal from society's point of view. In addition, the costs of under-provision are likely to be borne by the government. For example, an outbreak of preventable disease carries large public health costs. This is a traditional argument for the role of the state in supplying public good.

Another argument for state involvement is derived from current thinking about the goals of development. As an indicator and goal of development, quality of life (QOL) is increasingly replacing an earlier focus on income. Social indicators such as health or education do not always go hand in hand with per capita GDP. China and Sri Lanka, for example, have better social outcomes than some countries with higher incomes. This suggests that development is a much broader concept than simply income growth and measures such as the UNDP's Human Development Index attempt to capture this complexity.

From a policy point of view, it is not simply that a broader set of indicators for assessing development is warranted but rather that there may be important interlinkages among different factors. In particular, there may indirect benefits and links associated with investments in the different factors that policy makers need to take into account. While standard cost-benefit analyses look at the direct effects of policies, viewing the determinants of QOL as an interlinked system means that there may be social multiplier effects associated with investments. In the case of

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7 Bloom D E, P H Craig and P N Malaney, Forthcoming, “The Quality of Life in Rural Asia: Peril and Promise"
infrastructure, there may be direct improvements to quality of life or income but there may be indirect ones as well.

526 For example, there are direct economic effects. Poverty reduction is an especially important aspect of rural infrastructure. Labour intensive construction of infrastructure projects may also have a poverty reducing impact, provided the poor are paid for their labour. Rural roads allow farmers better access to agricultural inputs like fertiliser and allow them to better market their surpluses. Irrigation can permit farmers to cultivate their land more intensively and sometimes increase the number of annual yields, which may allow them to move out of subsistence production and into cash production.

527 In addition, infrastructure such as roads may offer indirect benefits on rural quality of life by allowing people greater access to social services such as health clinics or schools. Health benefits in terms of reducing mortality and morbidity are outcomes associated with the provision of safe drinking water and sanitation. This is an example of a social multiplier, because better health is not simply a good in and of itself but is also linked to higher incomes because, as many authors have shown, healthier individuals have higher productivity and are more likely to be in the labour force. Similarly, if infrastructure investments allow children better access to schooling, improve their attendance or allow them to study more, this may lead to indirect, long-run benefits in terms of higher productivity or income.

528 The social multiplier effect that is possible with infrastructure investments is another argument for a role for public investment. However, the fact remains that such investments still must consider issues of cost recovery, sound market principals and work with the private sector.

529 Public infrastructure investments are closely linked to national output and in many countries to growth rates. At the macro level, the stock of infrastructure is linked to a country’s competitive position and thus to jobs, investment and export earnings. Infrastructure is also viewed as enhancing the quality of life both through its effect on raising incomes as well as through providing access to goods, social services and information.

10 World Bank, 1994, ibid
Since the 1994 World Development Report, the issue of infrastructure has been a priority of the international policy community. Without investments in infrastructure, they fear that poor countries are likely to fall further behind their developed counterparts. At the same time, however, changes in thinking about the appropriate provision and financing of infrastructure investments are evident at the end of the century.

First, the role of the state as the sole or even main source of funds and delivery is highly questionable. Not only have many state-run infrastructure projects in many parts of the world failed to live up to expectations due to poor management, inefficiency and corruption, but the current infrastructure needs of developing countries are such that governments simply do not have the funds to meet them.

The role for the private sector, both for profit and non profit, is one of the most important topics facing infrastructure specialists today. This does not imply that there is no role for the state but rather, there is an on-going process of figuring out the appropriate tasks for each of these sectors, which are likely to vary according to local context. In general, however, there are some widespread trends that should be noted.

The following diagram shows the options open to national policy makers in terms of the delivery and financing of infrastructure. The traditional model in many countries is represented by the upper left box -- public provision and financing of infrastructure. The shifts away from this traditional model that are commonly advocated are represented by the solid arrows. The first is a shift entirely to the private sector, which is a market solution and is the move from the upper left cell to the bottom right. This is essentially where private providers offer services to private consumers. An example of this would be private phone carriers who serve urban phone customers. A second trend is represented by the shift from the upper left to the lower left cell. This is seen in contracting out of services by the state. This attempts to take advantage of the greater efficiency that presumably exists within the private sector so that the state gains by having lower costs for providing services. Here, examples might be interstate highway systems that are paid for by the state, but constructed by private contractors who win the contract in a competitive bidding process or NGO provision of small water systems. The third move away from state financing is represented by the move from the upper left to the upper right cell and is exemplified by the introduction of cost-recovery mechanisms such as user fees for state services that better reflect the true cost of those services. Finally, there are attempts to make the traditional model work better. The global trends towards devolution or decentralisation of state administration as well as greater demands for stakeholder participation in projects can be viewed as attempts to introduce more accountability to state activities. In essence, these use elements of the private sector such as consumer satisfaction and choice to enhance the performance of the traditional public sector. This is represented by the dotted arrow.
The participation of the private sector has risen enormously in the past decade, with foreign investments in financing infrastructure projects in developing nations growing from only $100 million in 1988 to $20.3 billion in 1996 and the expectation that private sector investment will account for about 15% of infrastructure spending in developing countries by the year 2000. Power is the most important sector to attract private finance, followed by telecommunication and transportation. Additionally, infrastructure has been a major focus of development assistance and loans.

Despite the rapid increase of private investment in infrastructure, the overall rise has been lower than the increase of private capital flows to developing regions in general. This is the result of political pressures to keep prices of infrastructure goods such as electricity or water below the cost of producing them and because the typical time horizon of infrastructure investments is long (ten to thirty years) and during that time, investors are exposed to huge risks. These risks include currency fluctuations and the ability of governments to sustain the original conditions of contracts.

Generally, the riskier the perceived conditions in a country, the greater the guarantees the government will be expected to assume by private investors. While governmental assumption of risk is a way to attract investment, most economists believe that it creates higher costs and negative incentives for sound management. Often, the guarantees extended by governments regarding cost overruns, future demand for the particular service or even currency fluctuations are a way of dealing with unresolved, fundamental structural problems of low user fees, macroeconomic mismanagement and inefficient state enterprises.

A better strategy than relying on a host of government guarantees is to undertake institutional and regulatory reform. There are steps governments can take to encourage private investment in infrastructure projects. These include:

- having formal, competitive bidding processes for projects;
- creating a stable macroeconomic environment;

16 Anayiotos A, N.D. "Infrastructure Investment Funds" in Public Policy for the Private sector series, Private Sector Development Department, World Bank
18 Dailami and Klein, 1997, ibid
19 Dailami and Klein, 1997, ibid
allowing tariff increases that reflect costs of services;

- better project management, including considering privatising the management of projects;

- dialogue with project developers throughout the project to reduce risks; and

- improving information flows about projects.

Each of these measures potentially reduces costs or increases revenues in turn opening up new avenues of financing including the use of commercially priced funds.

Project Scale

At the same time that better management and regulation is advocated to reduce costs of projects, there is a trend, at least at the rhetorical level, to focus on smaller projects. This may be facilitated by technological advances, as in the case of electricity, where small power plants of 50 megawatts can be profitable\(^{21}\). Yet, it is also the case that large, complex infrastructure projects may raise costs because they drive up legal and financial expenses involved in protecting against risk. While there has been a public commitment on the part of agencies such as the World Bank to finance more small and medium sized projects, some critics point out that there has been little increase in lending for smaller infrastructure projects to date\(^{22}\).

Stakeholder Participation

Another extremely important trend in infrastructure development and provision is finding ways to involve the public, or stakeholders in projects. Doing so can cut down on costs associated with projects. Delays that may result from the protests of those affected by projects have resulted in increased costs and embarrassment to funders. Also, beneficiary consultation and involvement in projects may improve performance of projects in the long-run. Programmes where the community is involved and co-ordinated by local officials or NGOs are generally more successful than where such participation is lacking\(^{23}\). In addition, cost-recovery may be easier when consumers feel that services are meeting their needs or that they have some recourse in case of dissatisfaction. There is also some evidence that labour relations in projects with public consultation may be better. For all of these reasons, many donor and lending agencies as well as some private corporations now insist on the prior and continuous consultation with project beneficiaries.

Public participation also may lead to better results in terms of providing access to infrastructure for the poor and thereby aid in the reduction of poverty. One of the drawbacks to private provision of infrastructure often cited is that the poor are not a profitable market and so they are likely to be under-served in terms of infrastructure. However, a number of arguments work against this position. First,

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\(^{21}\) A Malhotra, 1997, ibid


\(^{23}\) Jimenez E, 1988, "Urban Services and Rural Infrastructure", Finance and Development, September:6-8
competition in some areas may actually bring the costs of services down, making them more accessible to the poor. Even where that is not the case, public dialogue and information exchange can be beneficial for the poor's access to infrastructure. By representing the interests of stakeholders, a better mix of the infrastructure provided may be achieved. For example, because men and women often have different priorities in terms of their infrastructure needs, the fact that women's interests are frequently not represented means that the services most crucial to them are given short shrift.

Empowering the poor may also mean that more appropriate, affordable infrastructure is provided. Ways in which dialoguing and working with the poor may allow them to become consumers of private infrastructure services include:

- information exchange: providing information about low cost alternative services may allow for the development of market niches serving the poor
- working with the poor and private groups such as NGOs to develop micro-credit arrangements that allow the poor to finance their connection to infrastructure or the purchase of infrastructure inputs;
- creating innovative payment systems. Household ability of the poor to pay for services may differ drastically from a standard schedule of monthly billing. Daily or weekly payments may suit their needs better or pre-payments at harvest time may be a solution. By adjusting payment schedules to household needs, poor consumers can be brought on line.

Distributing the Benefits

In the PRC context the ubiquitous use of free rather than wage labour in the food for work programme lessens the poverty impact of the programme significantly. Apart from the opportunity to provide some income for the poor, being a wage labourer under FFW can also create other opportunities that would otherwise not be available. Both migrant workers and voluntary resettlers have used this mechanism to accumulate sufficient resources to make the move. There is also a degree of inequity in using labour tax. Those that participate in FFW programmes are generally the poorest and least gainfully employed. However, all rural residents benefit from the outcome. As a consequence while the poorest may work for free, the richer stand to gain, often disproportionately from this effort. Consideration needs to be given to ensuring that FFW programmes are wage programmes. The Indian model that guarantees payment for work and also guarantees a minimum wage that is sufficient to bring about some sustainable poverty reduction is a useful model for PRC to consider.

Farah H H, 1998, "Improving Access to Services by Low-income Households through Private Sector Participation in the Provision of Infrastructure"
Poverty Impact Research

544 The pilot project under the TA will pioneer research in PRC on the impact of infrastructure on poverty, an area in which the quantified international and domestic research is limited. It is important that FCPMC sustain the research effort beyond the life of the TA and that the results are disseminated because evaluation of the quality of life benefits and the indirect benefits will help to demonstrate that infrastructure is a major contributor to poverty reduction in the context of poverty’s broader definition. However, this alone may not be sufficient to convince SDPC that OCR funding can be used for small-scale rural infrastructure because of the cost recovery issue. Although the introduction of greater efficiency in construction and management can reduce costs and price liberalisation can increase returns to help justify use of commercial funding, where possible FCPMC should introduce novel mechanisms, such as microfinance for communities and individuals and flexible payment terms to try to demonstrate that these mechanisms can make seemingly unviable and unsustainable investments worthwhile. Monitoring and evaluation of such methods will also add to the case for using commercial funding.

OCR Lending Opportunities

Direct Project Lending Opportunities

Components of Projects including SIFs and CDFs

545 There are direct lending opportunities for OCR resources for individual small scale rural infrastructure components of poverty projects in PRC. Initially, the specific opportunities would involve the development of productive infrastructure that is able to withstand OCR rates and where the sources of loan repayment and operation and maintenance costs are clear. These are most likely to include irrigation works and water and electricity supply. OCR funding for rural roads is significantly more problematic because cost recovery opportunities are difficult. It is more likely that these will be funded through parallel funding mechanisms in due course. Because SIFs, CDFs and parallel funding mechanisms are likely to take some time to establish in PRC, it is recommended that the initial priority is to incorporate elements of rural infrastructure funding for poverty reduction into other ADB projects along the lines of the Shanxi Road Project on a case by case basis. This will allow the funding of smaller projects from the outset without the need for separate loans, hence overall larger loan size can be maintained.

546 In this context the development and financing by ADB of smaller-scale infrastructure projects in PRC will need greater attention to cost-recovery and efforts to enhance market mechanisms. There will need to be a move away from subsidy of rural infrastructure and progress towards charging rural consumers prices that are not below cost. This will avoid the outcome of subsidised projects that predictably has been that services are often intermittent, customer satisfaction is low, payment is sporadic and in some cases, citizens have come to expect services to be free or virtually free as a right. For the poorest who are unable to afford basic services,
‘lifeline’ tariffs can be applied, but in the context of overall viability so that the “subsidy” for lifeline rates is paid by other consumers and not be government.

547 Care will also need to be taken to ensure that projects work in concert with markets and do not supplant them. For example, nascent local markets will not develop if goods (such as stoves or the equipment necessary to use some types of infrastructure) are given away. Where some subsidies are essential to ensure use of facilities, it is far preferable to give an initial donation rather than subsidise regular service or payments. This may also be avoidable through microfinance provision 27.

548 In the design of such small-scale infrastructure, there will also be a need to consider the differences that such projects have with larger projects and not simply look at them as smaller versions of normal practise. Labour-intensive construction methods are often more appropriate to small projects, particularly because they are associated with poverty reduction that results from employment and income generation. Using local labour or firms may necessitate developing new contracting and payment schemes however, since small local firms may need a more regular cash flow. Payments from consumers for water, electricity or telecommunications may need to better reflect household income flows so that new methods of fee collection need to be devised. Providing services may also be better left to local organisations who understand the particular dynamics of a given locale better than firms that are located far away. Thus, both private firms involved and the PRC Government may seek collaborate more with NGOs in these projects.

Community and Individual Microfinance

549 Within the context of direct lending for projects in poverty areas, ADB could include components for microfinance for the communities to construct small-scale infrastructure and for individuals to gain access to infrastructure. The microfinance policies and procedures applied would need to be consistent with the criteria adopted for all ADB supported microfinance projects in PRC 28.

550 Micro-credit may be an alternative to subsidising high initial costs of infrastructure such as connection fees or machinery. Because willingness to pay for services is often higher than imagined, in many cases it should be possible to develop micro-credit mechanisms for the costs associated with initial access to infrastructure.

551 In some cases, there is not necessarily an existing market or overt demand. In such situations, the government or lenders may play the role of stimulating demand including the provision of microfinance. The example of solar energy shows that a market may emerge when the government introduces a programme to show consumers the merits and possibilities of a new technology. This example also highlights the importance of considering cost-effective alternatives to traditional forms of infrastructure that may not make sense to provide to the poorest, most remote rural areas.

27 See below.
28 See appendix A7 for details of the criteria for microfinance projects.
Parallel Lending Opportunities

552 The parallel lending opportunities essentially embrace all of the above direct lending opportunities if they feature as components that will be financed by a provincial government that has freed-up resources for poverty reduction activities through the parallel lending mechanism. Parallel funding probably has its greatest applicability in rural infrastructure in PRC at the present time because it is the best means to crowd-in resources to the sector and at the same time effectively reward local governments for doing so.

Mechanisms for Implementation

Components of Projects Including SIFs and CDFs

553 ADB investments in rural infrastructure can be made on an individual project by project basis or through a facility designed for the purpose.

554 On a project by project basis, each investment would be appraised using ADB’s normal project processing cycle, the evaluation being submitted to the ADB Board as an investment within a wider project. Although this will entail negotiation on a project by project basis and will thus be time consuming, it is the most practical way to begin small-scale rural infrastructure funding for poverty reduction because it can build on the existing lending programme and can begin to introduce and promote better practice ahead of the other mechanisms recommended in this report.

555 A special facility could be set up to fund small-scale rural infrastructure. Such a facility would support rural infrastructure poverty reduction components of ADB projects and once approved by the ADB Board could be used on all eligible projects. This mechanism has complications because the timing of expenditure would be uncertain and it would not fit well with ADB’s existing programming and loan processing procedures. A better alternative will be to use CIF and CDF type mechanisms in due course and eventually the proposed challenge and replicator funds. Although there is also uncertainty in these mechanisms over the timing of expenditure, overall expenditure is more widely spread and so the risk of non-disbursement is less. Eventually, these should be the preferred mechanisms because they allow the flexible integration of rural infrastructure components with other complementary poverty reduction initiatives.

Illustrative Management Structure and Funds Flow

556 Figure 6.1 illustrates simply how these ideas could work in practice. ADB would include a rural infrastructure component in its overall loan to a national or provincial government agency under the same terms and conditions as the loan for the larger project. Cofinancing from the borrower or from private sources may also contribute (as in the case of the Shanxi Roads Project). ADB would carry out its own oversight of the project. FCPMC would have a role in the identification and appraisal of the infrastructure investments and an essential role in monitoring poverty impact as part of the on-going research to establish the case for OCR funding more generally.
Community and Individual Microfinance

There are two particular mechanisms that can be considered by ADB and the PRC government for the provision of community microfinance in support of specific rural infrastructure investments on a case by case basis.

The first alternative is to rely on the generalised provision of microfinance to communities, where the decision to lend for any specific product is independently taken by the microfinance provider. In this the government must accept that certain communities will not be funded because the intermediary by its own criteria does not consider them or the infrastructure to be good credit risks.

The second would involve the provision of microfinance for communities producers through an intermediary where the intermediary acts as agent for local government. The chosen intermediary would depend on any strategy agreed between ADB and the PRC government for microfinance development. Here the local government would decide which communities will benefit and would take the full credit risk. The government would need to accept that there will not be strong incentives for the intermediary to assist in recovery in the event of default.

The first alternative is preferred because it allows market forces to determine the allocation of resources. The second alternative provides a good means of overcoming market failure and although it would not be justified for production activities or those that benefit individuals it may be (at least initially while this form of lending is established in PRC) be the only viable mechanism for community lending.

Summary of Opportunities for the Use of OCR and TA Funds

OCR Funding

Accepting that certain types of infrastructure and microfinance provision can withstand OCR rates and that special intervention is required because of scarcity of capital (particularly long-term capital) it is recommended OCR funding is applied in the following order of priority because of ease of implementation:

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See Chapter 3 for illustrative management structure and funds flow for microfinance.
• major infrastructure developments as components of projects that include small-scale rural infrastructure (irrigation and utilities where there are full cost recovery opportunities);

• microfinance for small-scale community infrastructure as components in projects, testing the Microfinance Organisation (MFO) modality (and later the Microfinance Fund modality)\(^{30}\).

**TA Funding**

562 TA funding contributions will be required from ADB for the design of any of the proposed interventions with OCR funds into components of projects (including SIFs and CDFs) and microfinance. The contributions would be applied under ADB’s normal procedures for project preparation technical assistance (PPTA). Implementation will require advisory and operational technical assistance (AOTA) for the implementation of microfinance\(^ {31}\) and possibly to assist local authorities with aspects of participatory methods, project appraisal, improving cost recovery and the measurement of infrastructure impact on poverty.

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\(^{30}\) See Chapter 3 for details of these modalities.

\(^{31}\) See Chapter 3 for details of TA that would apply.
## Design Summary

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| Reduce poverty in PRC by implementing sustainable poverty reduction activities and narrowing regional disparities. Disseminate knowledge gained to poverty experts throughout PRC. | Number of ordinary capital resource (OCR) loans used to finance poverty reduction projects. Poverty officials from most provinces, municipalities, and autonomous regions receive training. | Annual country assistance plans. Reactions regarding acceptability of the recommendations. State Council Leading Group for Poverty Alleviation and Development (LGOP) reports and statistical analysis. | The national and provincial governments accept the concept of financing poverty reduction projects with OCR loans. | #

## Purpose

- Assess the possibility of using OCR loans for poverty reduction activities.

## Outputs

| Fund management system for poverty loans. Microfinance system suited to rural poor. Voluntary rural mobility framework. Guidelines for funding agroindustrial activities in poor areas. Pilot infrastructure project undertaken in poor area. | Operational by year 2000 Rural poor use of OCR loans increases and repayment exceeds 80 percent. Retraining of poverty officials to adopt guidelines accomplished by 2000. Analysis of correlation between provision of infrastructure and increased incomes and improved quality of life in the pilot project area. | Project implementation progress reports. Project implementation progress reports. National workshop. Socio-economic surveys. | Foreign exchange risks can be managed. The rural poor are willing to use and pay back interest-bearing loans. People will voluntarily move in search of better economic opportunities. Financial institutions will find it profitable to fund projects in rural areas. Investments in small infrastructure projects in poor rural areas will lead to poverty reduction. | #

## Inputs

| Consultants Applied Research Equipment Training Local Costs | Project implementation progress reports. Project accounts | Consultants are competent and perform well. Counterpart budget is available on a timely basis. Counterpart staff are available. | # |
A2

Terms of Reference

A. Rural Poverty Policy Experts (four person months of international services and five person months of domestic services)

(i) explain the strengths and weaknesses of systems of poverty reduction in place in Asian countries and Latin America;

(ii) explain the strengths and weaknesses of non-government organisation (NGO) and private sector systems for poverty reduction in place in other Asian countries and Latin America;

(iii) analyse the effectiveness of these international systems in reducing poverty;

(iv) develop criteria to compare international government, NGO and private sector systems for poverty reduction with the PRC systems;

(v) compare the effectiveness of these international systems in reducing rural poverty with the PRC systems;

(vi) analyse the effectiveness of using ordinary capital resources (OCR) loan to fund poverty reduction activities in other Asian countries and Latin America and delineate the conditions under which use of such funds is appropriate, citing specific examples (such as World Bank loans), and examine the best way to handle foreign exchange risk when using such funds;

(vii) analyse the positive and negative aspects of international government and NGO methods for targeting poverty funds (strategies, policies and plans);

(viii) analyse the positive and negative aspects of PRC methods for targeting poverty funds (strategies, policies and plans) in poverty counties and targeting other funds for poverty relief at the township and village level in non-poverty counties;

(ix) develop a typology of poverty in PRC based on economic activities;

(x) based on the above analysis, recommend (a) priorities for poverty reduction activities in PRC; (b) criteria for determining types of projects best suited to OCR-loan funding and a list of past projects that satisfy the criteria; (c) how to fund agroindustrial and other enterprise driven, microfinance, voluntary resettlement, and rural infrastructure activities with OCR loans; and (d) the most appropriate poverty reduction strategy for each type of economy within the poverty typology, including the feasibility of using OCR funds for each type of economy, and a plan for administering the funds;

(xi) recommend and provide training for an appropriate institutional system for OCR loan financing of poverty reduction activities, including the requisite policies and mechanisms for fund management (ie fund utilisation procedures, and a management system), and a repayment mechanism: this should include fund management rules; mechanisms for reducing loan risks; procedures for loan delivery, use and repayment; and a management model.
B. Rural Finance and Microfinance Experts (two months international, three months domestic)

(i) analyse the rural finance systems and major issues in providing rural credit to the poor in Asian countries and Latin America, examining both successful and unsuccessful experiences;

(ii) identify the strengths and weaknesses of the design and implementation of international microfinance schemes in Asian countries (such as Bangladesh, Indonesia, Malaysia and the Philippines) as well as Latin America;

(iii) analyse the similarities and differences of the international rural finance systems including the pros and cons;

(iv) analyse the similarities and differences of the international microfinance schemes, including the pros and cons;

(v) explain the factors that led to successes and failures that other countries have had in addressing their microfinance problems for the rural poor, including local economic conditions, structure of product markets, and the characteristics of the target group, the poor (in terms of income levels, education levels, demographics and institutional factors);

(vi) review the experience of the rural financial system in PRC (including the Agricultural Bank of China (ABC), rural credit co-operatives (RCC's), and rural credit foundations and analyse the effectiveness of the system - the review will focus on the strengths and weaknesses of the various elements of the financial system relative to microfinance, the degree to which microfinance would be consistent with business strategies, and the conditions under which financial institutions would be involved in microfinance; in this regard, past Bank loan assistance to ABC should be reviewed as well as the on-going TA for RCC's;

(vii) review the experience of microfinance schemes in the PRC, ie Grameen Bank loans, Grameen style loans, and other microcredit endeavours (including those of the Human resources Development Centre for Western PRC of FCPMC) and analyse the effectiveness of the schemes; the review will include (a) consultations with beneficiaries, microfinance schemes providing non-subsidised credit in poor areas, such as those developed by Canadian International Development Agency (CIDA) and Australian Agency for International Development (AusAID); and (b) evaluation of the legal and regulatory frameworks for microfinance in PRC;

(viii) compare the design and implementation of PRC microfinance schemes (including schemes financed by the Government, World Bank and bilateral agencies) with those of other countries;

(ix) based on the above analysis, make specific recommendations on (a) actions needed to solve PRC's microfinance problems for the poor, including poor women and ethnic minorities; (b) a microfinance system or systems and legal/regulatory frameworks best suited to the rural poor in PRC and/or different poor regions within PRC; (c) how to integrate the recommended microfinance system with the traditional rural finance system within PRC;
and (d) a checklist of socio-economic conditions necessary for microfinance to be effective; and

(x) review the types of funds available in other countries and in PRC for microfinance activities and analyse the feasibility of using OCR loan funds for such activities; include analysis of interest rate policies, use of subsidised versus commercial interest rates, and blending hard loans with soft funds and grants from bilateral sources; and discuss in detail and provide training for the necessary conditions for use of OCR loan funds, citing specific examples of such successful use internationally and within PRC (especially under World Bank projects).

C. Voluntary Rural Mobility Experts (two months international, four months domestic)

(i) assess the strengths and weaknesses of international experience in voluntary rural mobility of poor households and workers with particular attention to Brazil, Colombia, Egypt, Indonesia, Malaysia, Nepal and Sri Lanka;

(ii) develop criteria to analyse the experience in voluntary rural mobility of the poor in PRC, consulting with beneficiaries in the analysis;

(iii) compare the effectiveness of voluntary rural mobility of the poor with other countries, with attention to the pros and cons;

(iv) review how voluntary rural mobility activities have been funded internationally (particularly by the World Bank) and within PRC;

(v) provide an assessment of the successes and failures to guide further discussion on the prospects or lack or prospects for using OCR loans to fund voluntary rural mobility, citing specific successful and unsuccessful examples of such funding in other countries and within PRC;

(vi) evaluate the legal, policy and regulatory frameworks and recommend changes;

(vii) review Bank policies and guidelines on involuntary resettlement and identify criteria that would need to be satisfied before ADB could consider financing voluntary rural mobility of households and workers; and

(viii) based on the above analysis, assess experience and practice related to state-sponsored migration and develop a checklist of key social factors that must be addresses if state-sponsored migration in PRC is to be successful, with particular attention to ethnic minorities and women and provide related training.

D. Agroindustry and Rural Enterprise Experts (two months international, three months domestic)

(i) identify the strengths and weaknesses of agroindustrial and other enterprise driven linkages in other countries in Asia and Latin America used to help poor farmers;

(ii) identify the strengths and weaknesses of the agroindustrial and other enterprise-driven linkages (such as "dragonhead industries") that PRC uses to help poor farmers;
(iii) compare the international and PRC linkages and analyse the effectiveness of such linkages in lifting farmers out of poverty;

(iv) identify issues and problems with the current PRC system, including use of financial intermediaries in agroprocessing and other enterprise driven projects, and recommend solutions based on successful international examples;

(v) determine the feasibility of promoting further primary processing factories at the county level to help the poor in PRC;

(vi) identify key marketing and training issues to be addressed when establishing "dragonhead" and other industries to help poor farmers;

(vii) prepare two case studies of successful "dragonhead" and other enterprise driven industries in poverty counties in PRC that can be used as models for other poor areas, including any recommended improvements (beneficiary consultations should be part of the case studies);

(viii) prepare a case study of a successful "dragonhead" and other enterprise driven industry in a non-poverty county that can be adapted to poor areas; and

(ix) in consultation with the Service Centre of Poverty Alleviation and Development of the LGOP and other relevant agencies designated by FCPMC, determine the feasibility of use OCR loans to fund agroindustrial activities; and create a set of guidelines and provide training on the necessary conditions for use of hard loan funds, citing specific examples of such successful use, internationally and within PRC, especially under World Bank and Bank projects (the issue of producers locked into selling to a single buyer should be carefully examined).

E. Rural Infrastructure Experts (two months international, three months domestic)

(i) develop criteria to analyse how other countries in Asia and Latin America fund rural infrastructure in poor areas (especially village access roads and small electricity plants), drawing on both positive and negative experiences;

(ii) compare such international experience to that of the PRC in providing similar infrastructure;

(iii) analyse the effectiveness of providing such infrastructure in poor areas in PRC, noting the correlation of providing such infrastructure with poverty reduction and compare with international experience;

(iv) analyse the poverty reduction impact of selected Bank-funded projects and World Bank funded infrastructure projects with specific attention to participatory research, socio-economic sampling and survey work, gender analysis, and social analysis as applied to poverty reduction, resettlement, women, indigenous peoples and human resource development;

(v) prepare a checklist and guidelines to follow when providing infrastructure in poor areas in order to maximise effectiveness in reducing poverty;

(vi) test the guidelines by conducting applied research (that included extensive beneficiary consultation) through a small pilot project in a poor village
selected for provision of a small village infrastructure project (eg access road, electricity plant, or other activities to be decided on by FCPMC and the consultant with the concurrence of ADB) - this could include rural access roads or rural power plants funded under an on-going Bank-funded project -- and design and implement mechanisms for measuring the effects of such infrastructure on reducing poverty, including the use of a carefully selected control village; and

(vii) strengthen the capacity of local agencies tasked with monitoring and evaluation and help them set-up a pilot participatory rural appraisal impact measuring exercise, supplementary to the monitoring and evaluation built into projects (a specific road or power plant could be selected in a poverty township and a database on which to design future infrastructure projects could be developed).
A3

**Commerically Funded Microfinance**

1. The following are eight examples of microfinance institutions developed in different continents using different models, all of which have become self sustaining while maintaining good client outreach, small loan sizes and good recovery. They have been selected to illustrate not only the viability of microfinance using commercially priced funds once a critical mass has been achieved, but also to show that there are many different models for doing this, some of which were initiated almost two decades ago.

*The Albanian Foundation for Enterprise Finance and Development (FEFAD)*  

2. FEFAD was established in 1996 as an independent microfinance foundation. Its source of capital is loans from KfW. It has a Board of Trustees on which the Ministry of Finance, the Bank of Albania, KfW and the private sector are represented. Technical assistance to management is provided by GTZ. Staff are paid at market rates, with performance related components in salary. FEFAD provides loans to small and medium scale enterprises. At the end of 1997, the outstanding portfolio was about USD 1.5 million at interest rates of 26 percent for production loans, 30 percent for service loans and 32 percent for trade loans in an environment where inflation was about 17 percent. Self sustainability was achieved within two years.

*The Egyptian Alexandra Business Association (ABA)*  

3. The ABA was established in 1989 with assistance from USAID. It achieved full self-sufficiency in 1995 with a portfolio of about US$ 6 million and an average loan size of about US$ 730. ABA uses commercial bank borrowing to supplement its equity and onlends to borrowers at rates that are effectively 15 to 20 percent above the commercial bank cost of borrowed funds to ABA.

*The Guatemalan Unión Popular (UP)*  

4. Guatemala has 35 credit unions affiliated to a national federation owned by more than 150,000 poor who have accumulated US$ 20.5 million in share capital, and US$ 43 million in savings. One example of a self-sustaining credit union is Unión Popular. This union finances itself from shares on which it pay 8 percent per annum and deposits for which it pays 15 percent, and onlends at 19 to 24 percent. Fully market oriented, UP has developed financial services rather than just credit, with savers outnumbering borrowers in the ratio 2:1.

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3. Almeyda G and B Branch, 1999, "The Case of Unión Popular and Unión Progressista Amatitlaneca (UPA) Credit Unions"
Bank Rakyat Indonesia (BRI)  

Bank Rakyat Indonesia was established in 1984 to transform 3,600 state-owned rural branches acting as disbursement centres for subsidised agricultural credit into financially self-sustaining microfinance intermediaries. It has been one of the most successful microfinance institutions. BRI obtained independence from subsidies in 1987 within three years of its establishment and has remained profitable and financially independent since. During the 1990s BRI has maintained a spread on its lending of around 22 percent, using a strong deposit base to fund its operations and generating high return on equity. BRI is a large institution. At the end of 1996 it had $3 billion in deposits and $1.7 billion in loans through more than 3,500 outlets.

The Kenya Rural Enterprise Programme (K-REP)  

K-REP was established in 1984 an intermediary for onlending to NGOs for their microfinance operations with funding from USAID. Its early operations were pioneering for a microfinance institution, and inevitably many lessons about sustainability were learned from experience. However, by 1995, with a clear separation of K-REPs financial services from other support services and real interest rates of 28 percent K-REP became a sustainable institution. By the end of 1996 it had US$ 12 million in loan funds extended to more than 330,000 borrowers. K-REP reduced it dependence on donors from US $ 1.7 million per year in the early 1990s to practically nil by 1996.

The Niger Caisses Populaires D'Epargne et de Crédit (CPEC)  

CPEC is a network of credit unions in Niger. It was founded in 1990 and despite political instability and the withdrawal of initial funding partner USAID after the coup d' état in 1996, it has made substantial progress. Based on operating principles established by the World Council of Credit Unions (WOCCU) CPECs are member-owned, member-operated non-profit organisations. CPECs are funded primarily by deposits and member subscriptions. In the first six years of operation the portfolio grew to about US$ 250,000. CPECs charge interest at 2 percent per month and by the end of 1996 were operationally and financially self-sufficient.

The Peruvian Cajas Municipales de Ahorro y Crédito (CMAC)  

CMACs are Peruvian microfinance banks with collective national outreach. They are a formally recognised part of the financial system and subject to regulation by the Banking Superintendency and the Central Reserve Bank of Peru. The first CMAC was established in 1982 with GTZ assistance. In 1998, there were 13 CMACs. Since 1987 they have been federated and represented at an apex level by the Federación Peruana de Cajas Municipales de Ahorro y Crédito (FEPCMAC) which also provides technical support and audit and control functions. CMACs draw

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5 Charitonenko S, C Friman and G Pederson, 1998, "Kenya Rural Enterprise Program Case Study in Microfinance"
7 Cuevas J B C and J Paxton, 1999, "Peru: Cajas Municipales de Ahorro y Crédito"
their funding from equity, savings deposits and loans and at the end of 1998 had a loan portfolio of more than US$ 98 million. CMACs pay commercial rates on deposits and borrowings, and in 1998 had an average loan size of about US$ 440. Rates of interest are market rates and varied between 4.5 and 5 percent per month in 1998.

**The South African Get Ahead Foundation (GAF)**

GAF was founded in 1984 by prominent community leaders in South Africa. It has evolved from a broad-based community development organisation into a specialised microfinance institution. GAF provides small loans with an average size of around US$ 600 and borrows from the Standard Chartered commercial bank to fund its loan portfolio. It lends on a flat rate basis at interest rates of between 12 and 26 percent. Self-sustainability was not achieved quickly, but from the mid 1990s with recognition by management of the need to introduce prudent banking practices and the introduction of major reforms, real profits are expected by 2000.

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8 Churchill C, 1998, "South Africa Get Ahead Foundation"
Examples of OCR Funding

1. The following are examples of where OCR funding (or its equivalent) and TA funding have been used by multilateral development assistance agencies to fund poverty reduction projects or components of them using direct and indirect funding mechanisms such as those described in the paper on “Strategies for Supporting Poverty Reduction Projects”.

**Multisectoral**

**Argentina – Sector Programme in Support of Fiscal Adjustment and Social Reform**

IADB, US$ 450 million OCR, to ensure adequate levels of spending on basic social services for low-income groups; reform the social services, health and education sectors focused on food assistance, job creation, health programmes, teacher training, sanitation and finance for small-scale agricultural producers (1995).

**Brazil – Social Sector and Social Protection Programme**

IADB, US$ 2.2 billion OCR and World Bank US$ 252 million IBRD, for a programme to support reforms and maintain social spending on health, education and poverty reduction programmes during economic downturn (1998).

**Brazil – Administrative and Fiscal Management of Municipalities**

IADB, US$ 1.1 billion OCR to assist the government development of an efficient and transparent public policy for managing municipal income and spending (1999).

**Brazil – Rio Grande do Norte Rural Poverty Project**

World Bank, US$ 24 million OCR, for community subprojects and institutional development such as water supply, electrification and rural roads, agroprocessing and community shared equipment and improvement of poverty targeting of interventions through strengthening municipal governance (1996).

**Colombia – Social Solidarity Network**

IADB, US$ 250 million OCR, to support quality of life improvements for the poorest and the most vulnerable segments of society particularly small-scale infrastructure, improve access to social services and enhance government's ability to respond to social problems through improved decentralised governance, greater community and NGO participation and better monitoring and measurement of poverty impact (1995).

**Colombia – Pacific Coast Sustainable Development Programme**

IADB, US$ 50 million OCR, to support a regional development programme in an areas of extreme poverty through strengthening local governance, provision of basic
rural infrastructure and services including health, education, electrification and telecommunications, and promotion of sustainable productive activities (1994).

**India – Parallel Funding of Power Sector and Economic Restructuring**

World Bank, US$ 210 million IBRD for power sector restructuring linked to parallel funding of nutrition, primary health care, and irrigation and rural road maintenance expenditure by the government from savings from fiscal reforms (subsidy reduction) aimed at bringing about a permanent shift in public expenditure (1998).

**Malaysia – Poverty Alleviation**

World Bank, US$ 60 million IBRD, to provide social services and basic health care to poor and vulnerable groups and to strengthen the government’s capacity to monitor and measure poverty (1999).

**Mexico – Programme of Essential Social Services**


**Philippines – Local Governance**

World Bank, US$ 100 million IBRD, to assist local government’s in upgrading basic infrastructure and strengthen their capacities in governance, investment planning, revenue generation and project development and implementation (1999)

**Microfinance**

**Bosnia and Herzegovina – Microenterprise Bank**

EBRD, DM 0.5 million in equity, to develop a microenterprise bank to fund MSEs and develop sound microlending techniques in the country (1999)

**Columbia – Global Microenterprise Programme**

IADB, US$ 50 million OCR, to eliminate credit restriction in government subsidised loan programmes, liberalise the interest rate structure and develop a market based approach to financing microbusinesses using on-lending through intermediaries (1993)

**Russia – Microfinance Bank**

EBRD, US$ 6 million in equity, into a specialised institutions devoted to lending to micro and small enterprises that would otherwise have little or no access to credit to be established as a best practice institutional model (1999).
Examples of OCR Funding

**Ukraine – Micro and SME Finance Facility**

EBRD, Euro 120 million OCR, for a credit line to Ukrainian banks to improve their ability to lend to micro and SMEs and develop best practice in these banks (1998).

**Agroindustry and Rural Enterprise**

**Argentina – Multisector Credit Programme**

IADB, US$ 300 million OCR, market rate funding for financial intermediaries to onlend to viable enterprises and enhance private bank participation in the financial sector and generate economic growth (1998).

**Bosnia and Herzegovina – SME Framework**

EBRD, Euro 10.2 million OCR, for lending to private banks to on-lend to SMEs for investment, privatisation, trade finance and working capital (1999).

**Brazil – Global Credit Programme for SMEs**

IADB, US$ 1.2 billion OCR, to finance the development of the country’s SME sector through commercial bank loans through intermediary financial institutions for investment and working capital purposes (1999).

**Chile – SME Financing**

IADB, US$ 240 million OCR, to provide long-term credit to SMEs for capital and working capital through various financial intermediaries including leasing companies based on fixed spread lending (not specifically poverty targeted) (1998).

**Colombia – Support for the Economic Participation of Women**

IADB, US$ 6.5 million OCR, for improving information on women in the labour market, providing vocational counselling and job placement services and assisting small businesses to modernise (1994).

**Eastern Europe – Regional SME Finance Facility**

EBRD, Euro 50 million for onlending and Euro 25 million in equity to support the growth of SMEs by creating access to terms loans and equity and establish sound business financing processes in intermediary institutions (1999).

**Ghana – Agroindustry Development**

African Development Bank (AfDB), 0.7 million Units of Account (UA) for an agroindustrial study to identify agro-processing projects for subsequent credit line support with a focus on projects that will create direct an indirect employment and indirectly reduce poverty (1998).
Examples of OCR Funding

**Mexico – Agribusiness Venture Capital Fund**

IADB, US$ 3 million in equity, to a venture capital fund to invest in small-scale agroindustry to create jobs, generate income and indirectly impact on rural living standards (1998).

**Paraguay – Large and Small Company Linkages**

IADB, US$ 1.2 million in TA to help build business links between large and small companies and promote the use of clean technologies (1999).

**Russian Federation – Agro Credit Line**

EBRD, US$ 50 million OCR for an agricultural bank (SBS Agro) to onlend to agroindustry and improve operating practices (1998).

**Seychelles – SME Credit Line**

AfDB, 7.5 million UA for an SME credit line to the Development Bank of the Seychelles for onlending to finance small and medium scale enterprises in the industrial, agro-industrial, tourism, fisheries and service subsectors (1999).

**Rural Infrastructure**

**Argentina – Community Development**

World Bank, US$ 90 million IBRD, to reinforce the capacity of poor communities to develop small projects by mobilising resources on a participatory basis and improving social programmes (1999).

**Argentina – Provincial Agricultural Services Programme**

IADB, US$ 125 million and World Bank US$ 125 million, for provincial, regional and national projects with a focus on irrigation and drainage works and land reclamation and research and training (1995).

**Chile – Low-cost Housing and Village Improvements**

IADB, US$ 50 million OCR, to reduce the housing deficit and improve sanitation for 40,000 families through low cost housing development and the installation of clean water supply and sanitation in existing housing (1993).

**Mexico – Improvement and Modernisation of Feeder Highways and Rural Roads**

IADB, US$ 180 million OCR, to improve communications and road maintenance and decentralise management for about 1,460 kms of feeder roads and 1,950 kms of rural roads (1993).
**Mozambique – Small-scale Irrigation**

AfDB, 12.4 million UA, for the development of food security through improved and the development of small-scale irrigation, improved extension and training and strengthening of governance for the delivery of agricultural support services (1998).

**Panama – Rural Poverty and Natural Resources Project**

World Bank, US$ 16 million IBRD, for sustainable rural development including community organisation and action plan development, productive infrastructure such as irrigation, processing facilities, access roads, water supply and community facilities and protected areas management by NGOs (1997).

**PRC – Rural Electrification**

World Bank, US$ 100 million IBRD, for the provision of solar and wind powered electricity for schools, households and small businesses in the poorest parts of north west PRC (1999).

**Peru – Rural Roads Rehabilitation and Maintenance**

IADB, US$ 90 million OCR and World Bank, US$ 90 OCR, for rehabilitation of 7,500 kms of rural roads, 2,200 kms of secondary roads, to improve transport conditions in rural areas, generate employment, promote small and medium scale private sector contractors and establish microenterprise systems for road maintenance (1995).

**Zimbabwe – Small-scale Irrigation**

AfDB, 10.8 million UA, for development of basic small-scale rural infrastructure and minor irrigation works in communal lands to improve output and rural livelihoods (1999).
# International Poverty Reduction Approaches and Experience

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Summary

In its introductory section this paper reviews the evolving conception of poverty over three decades, the current goals in poverty reduction and the outlook for their achievement. It goes on to review the evolution of donor approaches to poverty reduction and summarises the trends and important aspects of current thinking about the successful design of poverty reduction interventions and the potential lessons for the People’s Republic of China (PRC). In the subsequent section on a case study basis it examines the approaches of various governments in Asia and Latin America to poverty reduction and highlights aspects of other government’s programmes that may be of interest to PRC policy makers. The evolution of non-government organisations (NGO) and private sector approaches is then considered with emphasis on the complimentary of their approaches with those of government and donors and a focus on partnership. Selected examples of aid effectiveness research are reviewed leading to generalised conclusions about success factors in poverty reduction based on academic and official development agency research. A final section summarises the lessons from an international perspective to serve as principles for consideration in future poverty reduction programme design in PRC.

From the mid 1990’s the complexity of poverty has been restated, and poverty programmes and projects have begun to move away from the exclusive use of income (US$ 1 per day) and poverty lines for poverty definition. The poverty reduction goals for official development assistance (ODA) have been expanded to include social and environmental measures as well as those of economic well being. However, the outlook, even for income poverty reduction is mixed with the real possibility that more than 1.5 billion people will be living below the US$ 1 per day poverty line by the end of 2000.

Multilateral and bilateral ODAs are united in their overall goal to reduce and eventually eradicate poverty. There is great consistency of focus and a recognition that past approaches, particularly to structural adjustment, have not always benefited the poor. The changing conception of poverty and its adoption as an overarching goal have led to many new ideas about the design of poverty reduction projects and how to learn from them to make projects more effective in the future. A summary of the findings indicates that: poverty must be recognised as complex and associated with natural, physical, financial, human and social capital access and development, is individually variable and is affected by externalities; the goals need to address policy, economic growth, income redistribution, gender equality, livelihood quality, facilitating access and the environment; ODA, government and NGOs approaches are all legitimate ingredients provided they are client based; sustainability, capacity building, environment, gender and subsidy reduction must all be main design concerns; individual projects should build on people’s strengths; target households, communities, implementing agencies and wider policy; a multisectoral approach should be accommodated; design should be participatory, iterative and flexible in implementation; the long term nature of capacity building and social capital development should be recognised in design; successful project interventions are made at the local level and may be small or involve many small components; local and national governance issues should be addressed; partnerships of all types should be encouraged (particularly between the public and private sector and with NGOs where appropriate); project management should be within the implementing
organisations and not discrete; and monitoring and evaluation should be linked to learning now, not later. This provides a lengthy agenda of new thinking for the PRC government to consider as few of these principles are reflected in its existing programmes.

The past three decades have also seen changes in the approaches to poverty reduction by governments. In the countries where governments are heavily dependent on aid, the approaches have mirrored those of the donors because donor dependence results in the domination of donor ideas in project design. In the countries where governments have had their own programmes, the approaches of government have also mirrored the approaches of donors where aid finance is involved, but have lagged behind the most current thinking in their own programmes which have tended to be adaptations of earlier donor approaches. In the run-up to the completion of the 8/7 programme, there are many models that the PRC government may wish to consider for future approaches. Some examples are: the Thailand social investment fund approach; the development of autonomous microfinance agencies or funds such as in Albania; the food for education programme in Bangladesh; the holistic comprehensive development framework (CDF) approach being pioneered in Bolivia, Dominican Republic and Vietnam; the design characteristics of India’s workfare programmes that try to underwrite participation of the poor and use NGOs for service delivery; Pakistan’s approach to poverty alleviation funding in its efforts to improve governance, and Vietnam’s attempts to restructure state-owned enterprises and free up budgetary resources.

NGO’s relative freedom and the small-scale nature of operations have facilitated many new approaches. However, scaling up has been difficult for reasons of inadequate funding and lack of the wider programme management skills needed for rollout. NGO’s development of microfinance and participatory development methods have contributed important lessons to the new thinking and their approaches are worthy of consideration for inclusion in future government strategies in PRC. The private sector can also have a role in poverty reduction. Partnerships like dragonheads have been pioneered in PRC, but there are also many examples of other roles for private sector participation in poverty project implementation and for the provision of complementary funding. Lessons from the World Bank’s evolving CDF projects will be of particular interest to PRC.

The conclusions from a review of aid effectiveness research are as follows. Economic growth is essential for social development and particularly to ensure the provision of basic social services, but one does not follow automatically from the other and: strong and sustained political commitment to distribution of income factors; investment in human resources; and encouragement of labour intensive growth are also required if there is to be an impact on poverty. Promoting productive employment through education and training, particularly for those in informal sectors, needs to focus on raising worker efficiency and should be regularly revised to take account of labour markets and national development needs, with particular attention being given to the non-farm sector in rural areas. Provision of basic social services (primary education, primary health care, nutrition, family planning, clean water and sanitation) are effective in reducing poverty because they give people the skills and improved health they need to work effectively, but programmes must be targeted to ensure benefits reach the poor and self-help should be fostered. Greater assurance of finance for basic social services is needed from Government, from mobilisation of
community resources in kind, through debt relief or debt swaps, additional aid and borrowing, and the use of tax and cost recovery mechanisms. The complexity of poverty needs to be recognised and interventions need to take account of local circumstances, including the possibility that some groups and institutions can stand to gain from the poverty of others and how this should be addressed. Building partnerships with the poor and encouraging self-reliance are not short-term activities and participation and empowerment of the poor and building on existing strengths are important entry points for sustainability. Design must include institutional analysis for all partners including NGOs and other civil society organisations.

Few of these principles are embodied in PRC’s current government poverty alleviation programmes, but they are all reflected in the Poverty Reduction Strategies of the Asian Development Bank (ADB) and other ODAs. With the conclusion of the 8/7 programme, there is a window of opportunity to use this accumulated international experience in the design of PRC’s future poverty reduction programmes. ADB and others can play a major role in policy dialogue, funding and technical assistance and training in the context of their own projects and those of the government.
Introduction

Conceptions of Poverty

1 Conceptions of poverty have changed over time. The holistic nature of poverty and its many possible dimensions have long been recognised. This perception underpinned many of the donor assistance programmes of the late 1970s and 80s, particularly Integrated Rural Development Projects (IRDPs) that sought mainly to achieve productivity gains through technology interventions to improve the natural resource base combined with infrastructure development and credit. Although it was recognised that education and health were important contributors to economic well being, the dominant theme, at least amongst the major delvers of development assistance, was productivity gain for improved income. Despite the recognition of poverty’s many dimensions, there was often an underlying assumption that at the level of the individual poverty was in some way uniform. Assistance was “packaged”, for farmers, for the landless, for a particular crop, and to a large extent this was necessary to satisfy the procedural and methodological requirements of donors.

2 To some extent this theme was reinforced in the later 1980s and early 1990s by an increasing focus on income definitions of poverty. In 1985, the adoption by the World Bank and others of a “poverty line” of $1 per day per capita in income provided a target and a means of comparison that was easily measurable. This fostered the adoption of national poverty lines and surveys of rural and urban poverty in some 60 countries between 1987 and 1995 to establish baseline percentages of poor. Although other indicators (such as consumption, malnutrition, mortality, illiteracy, income distribution, educational levels, access to clean water and sanitation) have been used on aggregate, the nature of much development assistance, requiring detailed financial and economic analysis to justify it, was focused on income generation and effectively used income as a surrogate measure of poverty.

3 From the mid 1990’s there are some distinct changes in the conception of poverty in development assistance. The complexity of poverty has been restated, and it is now recognised that it is relative, specific to individuals, and has dimensions.

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related to a wide range of assets (natural, physical, financial, human, and social), the organisations that facilitate access to these assets for the poor, and about the policies that make that facilitation possible or not.

Conceptions of the 90s

“Poverty is hunger. Poverty is lack of shelter. Poverty is being sick and not being able to see a doctor. Poverty is not being able to go to school, not knowing how to read, not being able to speak properly. Poverty is not having a job, is fear of the future, living one day at a time. Poverty is losing a child to illness brought about by unclean water. Poverty is powerlessness, lack of representation and freedom”

Poverty is a lack of money, but also “Poverty Is the deprivation of material requirement for minimally acceptable fulfilment of human needs, including food” and poverty “represents the absence of some basic capabilities to function” - UNDP definitions of the 90s.

The Goals

In May 1996, the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD) published a document called "Shaping the 21st Century". This called for global partnership between donors, governments, NGOs and others to pursue strategies aimed at the following goals:

- economic well-being
  - a reduction in the proportion of people living in extreme poverty (below the $1 per day poverty line) by one half by 2015.

- social development
  - universal primary education in all countries by 2015;
  - demonstrated progress toward gender equality and the empowerment of women by the elimination of gender disparity in primary and secondary education by 2005;
  - a reduction in the mortality rates for infants and children under age 5 by two-thirds, and a reduction in maternal mortality by three quarters by 2015;
  - access through the primary health-care system to reproductive health services for all individuals of appropriate ages no later that the year 2015.

- environmental sustainability and regeneration
  - the implementation of national strategies for sustainable development in all countries by 2005, to ensure that current trends in the loss of

World Bank, 1999, “Understanding and Responding to Poverty”, World Bank
environmental resources are effectively reversed at both global and national levels by 2015.

5 These inter-related goals have been subscribed to by the UN System, the multilateral development agencies and many of the individual bilateral agencies that provide development assistance. They reflect the increasing recognition over the last two-and-half decades that economic well being—cannot be achieved by productivity gains alone and that social development and environmental sustainability will not only contribute to gains in the quality of life for the poor, but are essential for the sustainability of economic well-being.

The Outlook for Income

6 These are ambitious goals. The most recent global aggregate estimates of numbers of people living in poverty are for 1993. These are still in terms of income although the use of other simplified benchmarks is increasing.

<table>
<thead>
<tr>
<th>Some Indicators in the 90s</th>
</tr>
</thead>
</table>
| "The number of absolute poor, the truly destitute, was estimated by the World Bank at 1.3 billion in 1993, and is probably still growing. One fifth of the world lives in countries, mainly in Africa and Latin America, where living standards actually fell in the 1980s. Several indicators of aggregate poverty – 1.5 billion lack access to safe water and 2 billion lack safe sanitation; more than 1 billion are illiterate, including half of the rural women – are no less chilling than a quarter-century ago. The conditions of this 20 percent of humanity -- and millions of other close to this perilous state -- should be a matter of overriding priority."

7 The estimates are that 1.3 billion people were living with income of under $1 per day and some 3 billion people were living under $2 per day. The numbers of poor living under $1 per day in 1993 had increased from previous estimates for 1987 of 1.2 billion. Of the 1.3 billion, more than 950 million people were in the Asian Pacific region. The World Bank warns that there could be 1.5 billion living below $1 a day by 2000.

8 The present situation is not entirely clear pending new estimates, but some individual trends are available: Recently, in East Asia, the financial crisis has resulted in 20 million additional people in Indonesia falling below the $1 per day benchmark and an overall fall in living standards of about 24 percent. In Thailand, living standards fell by about 14 percent in 1998 and in Korea by nearly 22 percent. In PRC, in contrast and according to official statistics, some 75 million rural people were lifted above the national benchmark between 1995 and 1997. In South Asia, Eurostep, 1997, “Partnership 2000, Eurostep’s Proposals on Social Development”


In this estimate by the World Bank, the $1 per day is $1 in mid 1980s prices.


It should be noted that the national benchmark in PRC is about US$ 0.67 per capita per day, or about two-thirds of the international US$ 1 per day. It is estimated that there are still 160 million people below the international benchmark in PRC.
estimates for India suggest that there are now 340 million living in poverty, up from 300 million in the late 1980s.

**A New Urgency?**

"The financial turmoil of the last two years has dealt a blow to the expectations we had for reducing poverty. Just a short time ago, we had the confidence that the international development goal of halving poverty would be met in the next 20 years in most areas of the world. Today, countries that until recently believed they were turning the tide in the fight against poverty are witnessing its re-emergence along with hunger and the human suffering it brings. We must now draw on the lessons of recent experience to help us reshape our strategies for the future."..."the overarching lesson for policy makers arising from the East Asia crisis, and its subsequent spread to Russia, Brazil and other emerging markets, is the need to avoid irreversible welfare losses for the poor. These can occur, when, for example, children are taken out of school to help their families and never resume their education, higher infant malnutrition slows children's mental development, or crisis-related unrest becomes a permanent fixture.\(^8\)

In Africa, lower commodity prices resulting from the financial crisis, conflict and natural disaster have combined to slow aggregate growth. Growth in 1998 was below projected population increase implying a decline in per capita income. In Latin America, although there is positive growth, the financial crisis in Brazil, natural disasters and rising inequality all mitigate against any significant reduction in the number of poor. Elsewhere, sharp declines in growth in Russia, Ukraine, and Romania, zero growth in the Eastern European and Former Soviet Union region as a whole and decline in GDP per capita in the Middle East and North Africa in 1998 will contribute to increasing the number of poor.

**Present Difficulties and Challenges Facing Poverty Reduction**

"Although China has made remarkable achievements in reducing poverty, the difficulty in attacking the hard core poverty increases... Firstly, the remaining poor that are still faced with inadequate food and clothing are mainly concentrated in the remote mountainous areas, deserts, high-altitude mountains, Loess Plateau, border areas, [and] areas with high incidence of endemic disease in south-west and north-west China. These areas are crippled by inconvenient transportation, isolation, resource-deficiency, eco-environment degradation, poor education services, stagnant economic development, low productivity and poor quality of farmers... Secondly, amongst the remaining poor, 50 percent are in a state of extreme impoverishment lacking basic living and production conditions. In addition, there are over 20 million rural population whose annual per capital income is on the verge of the poverty line. They are so vulnerable that any natural disaster or human calamity would cause them to slip from the state of being adequately fed and clothed to the state of starvation and coldness..."\(^9\)

Overall, with the major exception of PRC, the picture is one of stalled progress and the recent financial crises in Asia, Latin America and the Former Soviet Union have increased concerns about sustainability, the ability of the poor to withstand economic shocks and how to consolidate gains in poverty reduction. This is also true for PRC because its success so far may mean that the most difficult problems remain, as it addresses hardcore poverty in the remotest regions for the most marginalised societies.

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11 The table below shows the World Bank's most recent projections in relation to income poverty and the economic well-being objective of the "Shaping the 21st Century" agenda. With the exceptions of East and South Asia, the prospects are not good and they show the situation as one of increasing poverty in all other regions in the last three years of the 20th century.

<table>
<thead>
<tr>
<th>Region</th>
<th>Per capita growth rate required to reduce poverty by half (%)</th>
<th>Real consumption per capita growth rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>East Asia</td>
<td>1.2</td>
<td>1.9</td>
</tr>
<tr>
<td>Europe and Central Asia</td>
<td>0.8</td>
<td>1.2</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>1.8</td>
<td>2.7</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>0.3</td>
<td>1.2</td>
</tr>
<tr>
<td>South Asia</td>
<td>1.3</td>
<td>4.5</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>1.9</td>
<td>3.3</td>
</tr>
</tbody>
</table>

12 The last two decades and present trends show that the 2015 economic well-being goal is not going to be easy to achieve, but evolving approaches by donors and governments are testing new directions and research into aid effectiveness is increasingly available to assist in this process.

The Evolution of Donor Approaches

Multilateral Donors

World Bank

13 The World Bank's mission is to reduce poverty and improve living standards through sustainable growth and investment in people. The World Bank has subscribed to the DAC OECD 21st Century agenda. In its response to its mission the World Bank argues that accelerating economic growth is the best means to achieve higher living standards, provided that it is accompanied by more equitable distribution of income and wealth. In parallel it supports the development of education (particularly for females) and health (particularly safe water and sanitation, child immunisation and safety nets to protect the most vulnerable). The World Bank’s current approach divides social sectors into two clusters: health care, education and food security; and poverty alleviation, employment creation and income maintenance. There is an increasing focus on regulatory reform and on supporting civil society with the stated intention to design and implement measures "in a participatory, transparent and, where appropriate, decentralised manner" \(^{10}\) with community participation and the involvement of NGOs.

African Development Bank (AfDB)

14 The AfDB mandate is to contribute to the economic development and social progress of its regional members. ADB interprets this mandate in its mission statement which says simply that it is "to assist Regional Member Countries to break
the vicious cycle of poverty”\(^{11}\) To address this, AfDB aims to promote accelerated, sustained economic growth with equity and poverty reduction as its goals and to give the greatest attention to agriculture and rural development, human resource development, good governance, economic integration and co-operation, and environment and gender. ADB subscribes to the development goals in the Strategy for the 21st Century, the requirement for a strong commitment on the part of all stakeholders, and the need for participatory approaches and effective collaboration among these.

**Asian Development Bank**

ADB's mandate is to contribute to the sustainable development of the region's counties. Its mission is to promote economic growth, reduce poverty, support human development, improve the status of women and protect the environment. Poverty reduction is one of the main missions of ADB and its most difficult development challenge. It has been an implicit objective since ADB's foundation. ADB's approach to poverty reduction has been characterised by the promotion of broad-based economic growth and support for targeted interventions, based on the assumption that sustained rates of economic growth in turn provide opportunities for the poor to participate and benefit from this. This strategy has dominated operations, with only two projects of more than 70 approved in 1997 having poverty reduction as the primary objective while ten had economic growth as the primary objective and poverty reduction as the secondary one. In parallel ADB has supported policy reforms that can improve the opportunities for the poor and projects for the development of human resources though education and health services. Gender equality, environmental conservation and more recently good governance also feature strongly in ADB's projects and these aspects have been increasingly mainstreamed in project design. In 1998 ADB adopted a new policy for co-operation with NGOs recognising the importance of NGOs in development activities\(^{12}\). Recently, ADB has decided that poverty reduction will be its overarching objective and is in the process of refining its poverty strategy\(^{13}\) and establishing a special Poverty Unit to support implementation of this refocused agenda.

**Some Other Examples**

The United Nations Development Programme (UNDP) identifies poverty eradication as one of its top priorities. It views poverty eradication as being closely linked with human development, income generation, employment creation and better access to health and education services for the poor. The World Food Programme (WFP) uses food to alleviate hunger and poverty mainly through food-for-work type projects that aim to generate more lasting benefits though infrastructure construction and skill training. The International Fund for Agricultural Development (IFAD) is mandated to promote sustainable and replicable rural development at a grass roots level and devotes most resources to projects for small-holders and the landless. Its vision is to be “the leader in showing the way and galvanising energies to eradicate

\(^{11}\) [www.afdb.org](http://www.afdb.org), July 1999
rural poverty and hunger, and to unleash, through their own participation, the capacities of its clients: poor rural people.\textsuperscript{14}

17 The International Monetary Fund (IMF) believes economic growth in a stable and favourable macroeconomic environment is a prerequisite for poverty reduction. IMF now recognises that in the short-run certain macro-economic measures may have adverse effects on the poor, and that social considerations are also important.

**Structural Adjustment Has Disadvantaged the Poor**

In its analysis of structural adjustment programmes and their effects on the poor, the UN concludes the following about the structural adjustment programmes of the 1980s and early 1990s:

- Structural adjustment programmes (SAPs) may in the future benefit the poor, but in the short and medium term may have imposed significant costs on the poor;
- The fiscal changes brought about by SAPs, in Africa, Latin America and elsewhere, resulted in rapid increases in the prices of basic goods consumed by the poor such as food and kerosene, and in transport fares, in fees and charges for education and health care, and in indirect taxation;
- in Latin America and Africa, changes in government expenditures resulted in a surging of interest payments on foreign debt and while most areas remained constant, a reduction in spending on social services;
- hardest hit were expenditure on primary education and health care that fell on average by between 10 and 15 percent per capita in these two continents over a decade.\textsuperscript{15}

18 Consideration to poverty reduction factors is now given in all IMF adjustment lending.

**Bilateral Donors**

*The UK Department for International Development*

19 DFID, the UK development agency, is committed to promoting sustainable livelihoods and to protecting and improving the management of the natural and physical resource environment. These operational objectives are expected to contribute to the DFID’s overall goal of poverty eradication. To operationalise its objectives, DFID interventions are designed to provide: more secure access to and better management of natural resources; a more supportive and cohesive social environment; more secure access to financial resources; improved access to high quality education, information technologies and training; better nutrition and health; better access to facilitating infrastructure; and a policy and institutional environment that supports multiple livelihood strategies and promotes equitable access to competitive markets for all.

\textsuperscript{14} IFAD, May 1995, “IFAD’s Vision”, IFAD
CIDA

20 "The purpose of Canada's Official Development Assistance is to support sustainable development in developing countries in order to reduce poverty and to contribute to a more secure, equitable and prosperous world."16 CIDA's efforts are concentrated on basic human needs; women in development; infrastructure; human rights, democracy and good governance; private sector development and the environment. In its approach to poverty reduction, CIDA aims to address root causes and structural factors by focusing on: "recognising and developing the potential of poor people, increasing their productive capacity, and reducing barriers that limit their participation in society."17 CIDA believes that strategies are needed at community, local, regional, national and international level to address both systemic causes and promote effective programming of assistance, and that the key element in sustained poverty reduction is enabling the poor to secure sustainable livelihoods.

CIDA Strategy

"A poverty reduction strategy requires an understanding of the specific characteristics of poverty in a country or locality, the requirements for poverty reduction, and assessments of where CIDA, given its resources, can have the greatest impact. CIDA will select activities that work to diminish constraints or improve opportunities for the largest possible number of people. The identification of constraints and opportunities common to a large number of the poor in a group or country, as well as the selection of activities to reduce poverty, must be done with the full participation of people, their organisations and their governments."18

The German Federal Ministry for Economic Co-operation and Development (BMZ)19

21 Poverty reduction has been a priority goal of German official development assistance since the early 1980s. From the outset, German assistance has given emphasis to participation, self-help and self-help organisations as key components of its poverty reduction programme, drawing initially on the earlier experience of German NGOs in these areas. Over time, the programme has evolved and now distinguishes three approaches to poverty reduction: structural reform for the creation of an enabling economic, political and social climate; “direct poverty reduction” by promotion of projects that target the poor (have more than 50 percent of the poor as the target group); and “indirect poverty reduction” through contributing to macroeconomic or sector policies that enlarge the scope of activities for the poor and bring about redistribution in their favour.

Swedish International Development Assistance

22 Since the inception of Swedish aid in the 1960s the overall goal has been to “raise the level of living of poor people”. In its most recent mission statements, the main objectives are stated as “fighting poverty and improving living conditions, not
least for women and children, but also contributing to a sustainable utilisation of natural resources and reduction of pollution".

Overall Approaches

23 With the changing conceptions of poverty have come changing goals for ODA. For two decades to the mid 1990s, economic growth objectives dominated ODA projects. While the research shows the common finding that economic growth in good policy environments can benefit the poor, it also shows that issues of income distribution, the terms of trade faced by the poor and wider budgetary and governance issues are important considerations. World Bank and other research, for example has shown financial aid in a good policy environment leads to faster economic growth and poverty reduction and improvements in social indicators. With sound economic management $10 billion in development assistance can lift 25 million people permanently out of poverty, with poor economic management only 7 million people would be so affected. This, together with the broader conception of poverty has led donors and governments alike to begin to set project goals that are more complex addressing policy, economic growth, income redistribution, gender disparity, livelihood quality, the environment, and facilitating the access of the poor to assets.

24 These changes have come about as a result of aid effectiveness research that has examined and compared projects and tried to assess their impact in terms of poverty reduction. In turn, the research findings have affected design, project frameworks and the learning process, and have led to new conclusions about the success factors in poverty reduction.

Design Concerns

25 The changing conceptual framework has been paralleled by changes in project design. There are many themes, but four of the most important factors and their trends have been:

- sustainability: with a transition from not being explicitly considered in the 1970s other than for levels of (though not necessarily guaranteed funding for)

20 Dethier J J, 1999, "Governance and Economic Performance", Centre for Economic Research, Bonn University
23 van der Walle D, 1998, “Public Spending and the Poor”, Policy Research Department, World Bank
28 Carney D, 1998 in "Sustainable Rural Livelihoods, What Contribution Can We Make?", Ed. Carney, D, DFID.
operation and maintenance costs to a major design determinant both at project and policy levels;

- capacity building: from being a minor concern with heavy reliance on external (foreign) project management to being a major design determinant at project and policy levels;

- environment and gender: from being add-ons and “cross-cutting” issues to being mainstreamed in design;

- subsidies: from being acceptable, common and non-transparent to being generally not acceptable.

26 While these factors influence the framework of individual projects, they have much further reaching implications for the policy environment and good governance.

The Project Framework

27 The changes in conceptual framework and the new emphases in design have resulted in significant changes in project frameworks. Again there many trends, particularly in ODA, important amongst which are the transitions in:

- entry points: from structures and areas in the 1970s, to resources and needs in the 80s and early 90s to people’s strengths in the late 90s;

- targeting: from area based strategies to a complex based on households, communities, implementing agencies and the policy environment;

- design processes: from on-off top-down processes to participative, iterative approaches that allow flexibility in implementation;

- technologies: from foreign to local with an increasing emphasis on labour intensive technology;

- focus of operations: from local and area based to policy and field level;

- project size: from large to small or comprised of many small components;

- partners and implementation managers: from national and local government to national and local government, NGOs, other civil organisations and the private sector; and

- project operations management: from dedicated project management units to management within the structures of partner organisations.

Learning

28 There is limited aid effectiveness research, and much of the literature reports frustration with lack of information. This is partly because neither governments nor donors have been willing to commit substantial resources to such research. This was most true between the mid 1980s and the mid 1990s when project progress reporting focused entirely on disbursements and physical progress. The lack of detailed impact
analysis has slowed the evolution and adoption of new ideas, and is more acute in the NGO sector than elsewhere because of NGO concerns about minimising overhead. Yet, while NGOs are credited with much innovation, particularly with regard to participatory techniques, evidence of NGOs impact on poverty reduction is not abundant and few NGO projects are innovative in the true sense, most being replicators of earlier approaches.

29 The learning issues have yet to be properly addressed, but if iterative design is going to become a common feature, greater investment will be needed. The private sector may have a significant contribution here, because adaptations of business management concepts and tools may prove to be an effective route for measuring poverty impact.

A Summary of Trends

30 These trends in different aspects of the approaches to poverty reduction projects are summarised in Figure 1. They provide a framework for examination of the existing approaches in PRC and a basis for considering future directions.

29 Modified, after Carney D, 1998 in "Sustainable Rural Livelihoods, What Contribution Can We Make?"
<table>
<thead>
<tr>
<th>Trend Factor</th>
<th>Late 70s and Early 80s</th>
<th>Late 80s and Early 90s</th>
<th>Late 90s and Emerging</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conceptions of Poverty</td>
<td>Holistic but designs assumed uniformity amongst beneficiaries and beneficiary enterprises</td>
<td>Income oriented and simply measurable (1$ a day)</td>
<td>Complex and associated with natural, physical, financial, human and social capital, individual variability and the enabling environment</td>
</tr>
<tr>
<td>Goals</td>
<td>Economic growth and income oriented based on production increases with some recognition of quality of life factors</td>
<td>Economic growth and income oriented with cross cutting issues</td>
<td>Complex addressing policy, economic growth, income redistribution, gender equality, livelihood quality, facilitating access, and the environment</td>
</tr>
<tr>
<td>Overall Approaches</td>
<td>Multilateral focus on infrastructure and technology. Bilateral focus on trade. NGO focus on relief. Paternalistic and prescriptive.</td>
<td>Transitional with increasing focus on poverty reduction. Beneficiary based.</td>
<td>Common focus on poverty reduction with adoption of some NGO approaches by donors and governments and adoption of some donor concepts by NGOs. Client based.</td>
</tr>
<tr>
<td>Sustainability</td>
<td>Not explicitly considered except from an operating and maintenance cost view point</td>
<td>An increasing concern</td>
<td>A major design determinant at project and policy levels</td>
</tr>
<tr>
<td>Capacity Building</td>
<td>A minor concern with heavy reliance on external project management</td>
<td>An increasing concern</td>
<td>A major design determinant at project and policy levels</td>
</tr>
<tr>
<td>Environment and Gender</td>
<td>Treated as add-ons if at all</td>
<td>Treated as add-ons but called &quot;cross-cutting&quot;</td>
<td>Increasingly mainstreamed in design</td>
</tr>
<tr>
<td>Subsidies</td>
<td>Acceptable, common and not transparent</td>
<td>Sometimes acceptable if transparent</td>
<td>Generally not acceptable</td>
</tr>
<tr>
<td>Entry Points</td>
<td>Structures and areas</td>
<td>Resources and needs</td>
<td>People’s strengths</td>
</tr>
<tr>
<td>Targeting</td>
<td>Area based</td>
<td>Income based with percentage of poor as beneficiaries</td>
<td>Household, community, implementing agency and policy based</td>
</tr>
<tr>
<td>Design Process</td>
<td>Sectoral and multi-sectoral, top-down, conclusive with a 5 to 10 year planning horizon</td>
<td>One-off process centred on logical frameworks with some participation and 3 to 5 year planning horizon and sector focused</td>
<td>Multisectoral, significantly greater participation evolving towards iterative design processes in implement-ation and longer-term commitment envisaged</td>
</tr>
<tr>
<td>Technologies</td>
<td>Foreign</td>
<td>Adaptive</td>
<td>Local</td>
</tr>
<tr>
<td>Focus of Operations</td>
<td>Local and area based</td>
<td>Policy level or field level</td>
<td>Policy level and field level</td>
</tr>
<tr>
<td>Project size</td>
<td>Large</td>
<td>Medium</td>
<td>Small or many small components</td>
</tr>
<tr>
<td>Partners and Implementation Managers</td>
<td>National and local government</td>
<td>National and local government and some NGOs</td>
<td>National and local government, NGOs, other civil organisations and the private sector</td>
</tr>
<tr>
<td>Project Operations Management</td>
<td>Dedicated Project Management Unit</td>
<td>Project management structure within recipient organisation</td>
<td>Project management structure within partner organisations</td>
</tr>
<tr>
<td>Monitoring and Evaluation</td>
<td>Survey based oriented to measurement of income changes, or cost recovery, or not considered</td>
<td>Disbursement and project progress based with some assessment of policy environment</td>
<td>Still mainly disbursement and progress based but with increasing return to survey based approach with income and quality of life indicators, and institutional and policy review</td>
</tr>
<tr>
<td>Feedback</td>
<td>To future projects</td>
<td>To future projects</td>
<td>To current and future projects</td>
</tr>
</tbody>
</table>
The Evolution of Government Approaches

The past three decades have also seen changes in the approaches to poverty reduction by governments. In the countries where governments are heavily dependent on aid, the approaches have mirrored those of the donors because donor dependence results in the domination of donor ideas in project design. In the countries where governments have had their own programmes, the approaches of government have also mirrored the approaches of donors where aid finance is involved, but have lagged behind the most current thinking in their own programmes which have tended to be adaptations of earlier donor approaches.

Government’s own approaches to poverty reduction are quite diverse. Many have institutionalised poverty reduction activities and objectives in successive national plans, each plan attempting to learn from the previous. In some cases, there are discrete government-run poverty reduction programmes that are central to the plan in addition to sectoral development plans for both social and productive sectors. Bangladesh, India, Viet Nam are examples. Some have taken an integrated approach working within an overall framework to balance economic growth, equity and governance. Bolivia and the Dominican Republic are examples and the World Bank has initiated a similar approach in Viet Nam though it has yet to take shape. Almost all governments have combined ODA projects into their approach, sometimes as discrete initiatives and sometimes as budgetary support. Others, particularly the poorest or those in the earliest stages of transition have taken an almost entirely project based approach because of the weakness of the revenue base, the dependence on external assistance, and poor governance structures. Albania is one example. Approaches also vary depending on the role and importance of civil society and NGOs. In Bangladesh, for example, NGOs and donors dominate the enterprise development and employment creation interventions (sometimes in partnership with government), while the Government manages social safety net, education and health programmes. The sections below provide some selected illustrations of different aspects of Government approaches and possible lessons for PRC to draw on.

Thailand – An Evolving Planning Framework and a Commitment to Innovation

An example of how one government’s approach has changed over two-and-half decades of rapid economic development is illustrated in by the changing objectives of successive national plans for Thailand. The trends that stand out are a decreased emphasis on economic growth; and increased emphasis on the development of human and social capital; and an increased emphasis on the environment. There is good evidence that Thailand’s economic growth has impacted significantly on poverty. However, the research shows that the distributional benefits have not been even and the poor benefited relatively less the better off. This is typical of “trickle down” in rapidly growing economies where the growth is sufficient to impact on all. Thailand’s latest plan recognises that the high growth rates of the recent past may not be sustainable, that greater targeting efforts will be required, and that the non-income aspects of poverty need to be addressed, reflecting international experience and the general tend in poverty reduction.

ILO, 1998, ibid
### Summary Objectives of the National Economic and Social Development Plans of the Government of Thailand for Selected Plan Periods 1961 to 2001

<table>
<thead>
<tr>
<th>Plan 1</th>
<th>Plan 4</th>
<th>Plan 6</th>
<th>Plan 8</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic growth</td>
<td>Economic rehabilitation for higher growth</td>
<td>Economic growth and expansion</td>
<td>Promotion of potentials of individuals both physically and intellectually with good health, knowledge and skills for gainful occupation, and ability to adjust and adapt to changing economic, social and administrative conditions</td>
</tr>
<tr>
<td>and expansion</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Promotion of industrial production</td>
<td>Reduction of economic and social gaps among people</td>
<td>Employment generation</td>
<td>Development of a stable social environment, promotion of the strength of family and community leading to the support of human potentials and quality of life, including the possibility of greater community participation in national development</td>
</tr>
<tr>
<td>Promotion of investment and competition in the private sector</td>
<td>Reduction of population growth rate and improvement of quality of population and domestic employment</td>
<td>Economic, financial and fiscal stabilisation</td>
<td>Economic development of the country which is stable, secure and balanced, promoting the opportunity to develop human potentials to participate in development and to benefit fairly from development</td>
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<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Conservation and improvement of national environment and resources</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Improvement of human quality to develop progressive, peaceful and just society</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Utilisation and preservation of natural resources and the environment in support of the development of the economy, society, and sustainable quality of life</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Maintenance of national security</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Preservation of national identity, culture, and good values</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Adjustments of administrative and management systems to allow greater participation of private organisations, the private sector, communities and the general public in the development process of the country</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Raising the standard of living and quality of life of people in rural and urban areas</td>
</tr>
</tbody>
</table>

34 Thailand's development record over the past three decades through these successive plans has been impressive. There has been positive growth in real per capita income every year, averaging almost 4 percent over the period. The rapid economic growth has benefited the poor, with absolute poverty reduced to about 20%

percent in 1997 from 57 percent in the late 60s. The major challenges now are to maintain development; tackle hard core poverty; and mitigate the effects of the 1997 financial crisis which resulted in the loss of more than 1 million jobs, a reduction in hours worked, increased food and essential commodity prices, reverse migration from urban to rural areas, and increasing school dropouts and use of child labour.

35 Thailand has worked with the World Bank on the “Social Investment Project” (SIP) approach. This is one of the first projects in Asia to try to address health, education, food security, employment, income and strengthening civil society in a single project framework. It draws on the Social Investment Fund (SIF) approach developed in Latin America. The project involves:

- $30.4 million for short-term interventions to support existing government programmes that are well-targeted, easily expandable and labour intensive and includes components for health, job training and skill development;
- $34.3 million in the medium term for improving the access of the poor and unemployed to basic social and economic infrastructure, services and employment opportunities;
- $254 million for various employment and income generating components including construction of small weirs, village roads, irrigation and other small scale urban infrastructure, vocational training, and rural industrial development;
- $133 million for a social investment fund for financing projects proposed by community groups, local governments and NGOs based on pre-determined eligibility criteria.

"The SIP incorporates lessons from similar World Bank post-crisis projects. The major lessons are: (i) focusing on selected large government programs facilitates implementation and supervision (SIP is limited to seven sectoral programs and cofinanciers will supervise three of them on a parallel basis); (ii) agreeing upfront on the procurement and financial accounting practices to be followed in government programs prevents implementation delays; (iii) not seeking far-reaching sector-wide reforms while giving priority to efficiencies in, and better targeting of, existing government programs; (iv) allowing for flexibility in project design and ability to reflect emerging implementation experience based on a continued monitoring both of the evolving impact of the crisis and the performance of crisis related interventions; (v) tapping institutional capacity of all existing agencies including community groups based on comparative advantage for the efficient, speedy, and sustainable delivery of services; and, (vi) the prime importance of high standards of transparency and accountability and the need for strong supervision to insure good governance as well as to address bottlenecks quickly so as to enable rapid disbursement and near term impact." 33

36 Although the SIP is partly designed to mitigate the effects of the financial crisis, its design reflects much of the new thinking about effective poverty reduction approaches and is an example of an innovative approach by the Royal Thai Government in pursuit of the innovative goals of its national plan. The project is characterised by working through existing government programmes at the outset, moving to more participatory assistance in its later stages, with the latter being an

33 World Bank, 1999, “Thailand Social Investment Project”, Public Information Department, World Bank
evolving part of the government's own approach. It works with nine implementing agencies. It uses LIBOR based funding from the World Bank (US$ 239 million) blended with assistance from Japan's OECF (US$ 142 million), a government contribution (US$ 253 million) and TA grants. This approach of selective funding of a package of measures with OCR resources combined with softer OECF funds and grant finance from UNDP and AusAID for non-lending activities has potential application in PRC.

Albania – The Early Stages of Transition

Albania is Europe's poorest country. When the centrally planned economy collapsed in 1992, the per capita GDP was about USD 400. Albania is predominately an agricultural country and some 60 percent of its population lives in rural areas. Rapid privatisation, beginning in 1991, resulted in over 400,000 small family farms averaging 1.4 ha being created from former agricultural co-operatives and state farms. This gave rise to a new class of private landowners with very small holdings. Poverty became most acute in the mountainous areas where rural infrastructure had been damaged in the revolution and rural organisations responsible for its construction and maintenance disbanded. In many rural areas, there was an extreme scarcity of land and no marketable agriculture surplus. Poor infrastructure, lack of resources and access to credit, and lack of training and appropriate technology are inhibiting the development of a rural market economy.

The Government's Rural Poverty Alleviation Programme was formulated to complement the policy changes being introduced under the World Bank's Agriculture Sector Adjustment Credit. It aimed at building a free market rural economy from the bottom up. The strategy had six main components: actively alleviating rural poverty; restoring food security; promoting the small-scale private sector; repairing basic rural infrastructure; strengthening local governments; and rooting rural development policies in local tradition and culture.

The Government initiated a Rural Poverty Alleviation Pilot Project implemented through an autonomous agency: the Rural Development Fund (RDF). The autonomous route was chosen because the existing administration did not have the capability or mindset to pursue a participative approach, nor the outreach, and no suitable indigenous NGOs were present. RDF is governed by a Board of Trustees drawn from various line ministries with interests in poverty reduction and rural development, but run on independent lines by a management board. Its main activities are small-scale rural infrastructure development, providing finance for on-lending to village credit funds, microenterprise support that provides farmers with information on technology and markets, and monitoring and evaluation to generate continuous design improvements.

Using a participatory, pilot approach, informal relationships were developed with village heads and councils to set up village credit funds with joint and several liability for the village as whole, managed by village credit committees. RDF used the local Rural Commercial Bank as an agent for disbursing loans. This microfinance...
scheme had good recovery rates and in 1995 diversified into savings schemes. Initial funding of US$ 2.4 million was by the World Bank, but the Government used the RDF to leverage-in concessional external funds from the Italian Government, the European Union and IFAD.

41 The pilot approach proved successful. Review by the World Bank\textsuperscript{35} in 1994 concluded that: “learning by doing” was effective and demand driven and fostered sustainability; rural works using unemployed village labour were of reasonable quality; and beneficiary participation in credit scheme design had added to ownership and sustainability. Overall, the pilot demonstrated that working independently of central government had been successful in the pilot stage, and this led to World Bank funding of a further US$ 22 million for the Albania Rural Development Project in 1995. This project worked toward the roll-out and institutionalisation of the infrastructure and microfinance components. Successful implementation led in 1998 to further national level funding for ADF to continue infrastructure works under the Albania Community Works Project (US$ 18 million) and the establishment of a formalised national level apex microfinance organisation and the conversion of village credit funds into self sustaining savings and loan associations under the Albania Microcredit Project (US$ 18 million).

42 Although Albania has received IDA (soft) funding from the World Bank for these poverty alleviation initiatives, the sequence of projects is a good illustration of how pilot initiatives that draw on the new thinking can evolve into national level programmes founded on learning by doing. This may be particularly appropriate for microfinance in PRC where targeting difficulties have hampered effective disbursement of poverty funding through the Agricultural Bank of China and credit discipline is weak.

**Bangladesh – Persistent Poverty and Issues of Public Expenditure**

43 In 1995/96, 47.5 percent of the Bangladesh population lived below the poverty line (2,122 calories per day per capita). Urban poverty in Bangladesh rose by over one-third between 1988 and 1996 while rural poverty levels remained stagnant.

44 Poverty reduction is central to development strategy of the Government of Bangladesh. The Government has long included poverty reduction measures in its Annual Development Programme (ADP) and has special poverty reduction components within this. These measures focus particularly on social sectors and food grain distribution, and are complementary to the wide variety of enterprise development and microfinance initiatives supported by NGOs and ODA. In the last decade, these measures have included substantial increases in funding for social sectors (education and health) and special funding for three main poverty reduction programmes: Food for Work (FFW), Vulnerable Group Development (VGD) and Food for Education (FFE). In 1989-90 social sector spending was about 10 percent of the ADP. By 2001 under the Fifth Five Year Plan, it is expected to rise to 30 percent.

\textsuperscript{35} World Bank, 1994, “Albania Rural Development Project”, Public Information Department, World Bank
45 A 1994-95 Demographic Survey indicates that annual per capital health treatment costs were higher than the monthly poverty line income in urban and rural areas. Access to affordable health care for the poor is a priority and the Government has formulated a Health and Population Sector Strategy to address this and quality of care issues. The strategy focuses on reproductive health, maternal and child health, communicable diseases, simple curative care, and social communication to promote behavioural change. The Government intends to reach the objectives of the programme in partnership with NGOs and local communities.

46 The Bangladesh Government recognises the role of education in promoting growth and reducing poverty. Although school enrolment doubled in the 1980s and 80 percent of primary school aged children enrol, drop out rates are still high with only 60 percent completing primary education. Girls account for about 45 percent of enrolled primary students. The quality of education is also a problem with one-third of primary school leavers not achieving basic literacy and a high proportion of students achieving standards later than planned thus increasing public spending. In the mid 1990's the poorest decile received less than 7 percent of public expenditure on education. The strategy being considered by the Government to make education more pro-poor for future implementation is to adjust the share of public spending on primary and secondary education upwards while letting the private sector meet the costs of higher education.

47 The Government's main safety net programmes (FFW, VGD, and FFE) serve both human capital development and transfer payment objectives. FFW provides wheat in exchange for work in rural infrastructure projects; VGD provides food grain and training to disadvantaged women; and FFE provides wheat and rice to children in return for regular primary school attendance. A smaller programme, "Test Relief", provides food in exchange for minor infrastructure maintenance work. These programmes together account for more than one million tonnes of grain distribution. Analysis of the costs of transfer of 1 Taka to the poor for the different programmes are Taka 2.06 for FFW; Taka 1.59 for FFE, Taka 1.56 for VGD and Taka 1.32 for Test relief. It is estimated that costs could be reduced by about 16 percent through monetisation.

48 FFE is a major part of the ADP, and has grown rapidly from its launch in 1993 to account for 43 percent of the primary education budget in 1998. Its objectives are to increase enrolment rates and reduce dropouts. Poor children are targeted by household land ownership (landless or near landless), parent's occupation (day labourers or poorly paid artisans), and family structure (female headed households). FFE has been successful in raising enrolment rates and analysis shows that distribution of 226 kgs of food results on average in one additional child attending primary school for a year. The programme has suffered from leakage, with one third of the beneficiary households having per capita consumption above the upper

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36 Centre for Integrated Rural Development for Asia and Pacific, 1997, Dhaka
37 Subbarao, 1997
38 Dorosh and Haggblade, 1995
39 These costs are consistent with econometric modelling findings: Ravallion M, 1998, “Appraising Workfare Programmes”, Development Research Group, World Bank
40 Household Economic Survey Data, 1995-96
poverty line and half above the lower poverty line. Even allowing for leakage, the break even rate of return on this investment, before externalities such as public savings in health costs, family planning and nutrition, is estimated at 5.8 percent, making programme impact cost effective. If the programme were monetised and food grain handling costs removed, the estimated rate of return rises to 11.5 percent before external benefits. This analysis indicates a high degree of feasibility for this intervention and is worthy of examination in the formulation of future PRC programmes. It is in effect a specialised version of the more general child benefit programmes common in developed economies.

49 Despite these programmes, about 50 percent of the population continue to live in poverty. Critics\(^\text{41}\) of the Government point out that food programmes alleviate the symptoms of poverty but do not address the causes or enable the poor to gain control over productive assets, and that budgetary expenditure overall is not pro-poor with higher percentages benefiting the highest income deciles more than the lowest and issues of governance dominate the debate. Others such as the World Bank point to the “poverty” of the institutions responsible for public service delivery and poverty alleviation programmes as a major cause of persistent poverty\(^\text{42}\) citing poor governance, wavering political commitment, and pervasive corruption as the factors impeding effective progress. This contrasts strongly with the organised poverty reduction efforts in PRC where strong governance and political commitment have contributed substantially to poverty reduction.

**Bolivia – Applying the Lessons of the Research**

50 Bolivia has a GDP per capita of about US$ 1,000. It is one of the poorer countries in Latin America with about 67% of the population being poor, low levels of education with average schooling of less than seven years, high infant mortality at 69 per thousand live births and 10 percent of children under 5 malnourished. It is landlocked with poorly developed communications and although the economy has been progressively stabilised since the hyperinflationary days of the mid 1980s, it has yet to address its poverty issues because underlying social issues were not addressed reflected in low investment, poor quality education and an inadequate road network\(^\text{43}\).

51 Bolivia is one of first countries to partner with the World Bank in a new long term holistic approach to fighting poverty, termed the "Comprehensive Development Framework" (CDF)\(^\text{44, 45}\) which aims to balance social and institutional reforms with sound macroeconomic policies and involves partnership between the government, civil society and the private sector. Following wide consultation with civil society in


\(^{42}\) World Bank, 1998, "The World Bank’s Assistance to Bangladesh, Partnership in Development", World Bank

\(^{43}\) World Bank, 1999, "Bolivia: Implementing the Comprehensive Development Framework"

\(^{44}\) The CDF is being piloted by the World Bank in several countries where governance is considered to be sufficiently or potentially sufficiently good for the approach to be successful. Countries participating or considering participation are: Bolivia, Dominican Republic, Eritrea, Ethiopia, Ghana, Ivory Coast, Kyrgyz Republic, Morocco, Romania, Uganda, Viet Nam and the West Bank and Gaza.

\(^{45}\) World Bank, 1999, Annual Report, World Bank
1997, a consensus emerged on four "pillars" for poverty reduction which were subsequently became the basis of the government's current five year development programme. The pillars are: "opportunity" to generate higher economic growth with better distribution; "equity" to raise the standards of living of the disadvantaged groups in society; "institutionality" to strengthen the institutional framework for better justice and a corruption free administration; and "dignity" to remove Bolivia from the drug circuit by 2002. The World Bank is assisting with the first three pillars.

52 In a novel pilot approach to make the CDF results-oriented, each pillar has an agreed set of indicators and indicator goals relating to the sectors covered. "Opportunity" for example focuses on four sectors: road infrastructure, environment, finance and microenterprise, and norms and regulations. "Equity" covers health, education, rural development and popular participation. "Institutionality" covers public administration modernisation, anti corruption, and judicial system reform. Sector indicators vary, but for example, education has progressive targets for enrolment, dropouts, percentage of public expenditure on primary and secondary education, and pupil achievement. Road infrastructure has targets for paved roads, road maintenance and overall investment.

53 The pilot runs until December 2000 and analysis of the initial results will not be available until 2001. However, it raises interesting possibilities for consideration in PRC because the poverty indicator framework is much wider than income and takes into account the emergent more holistic approach to poverty reduction.

Dominican Republic – Public Participation and Public Sector Reform

54 Although the Dominican Republic is one of the fastest growing economies, averaging 6 percent from 1992 to 1998, the benefits have not been widely distributed. In 1998 the top two income deciles of the population earned 50 percent of total income while the poorest two deciles earned only 7 percent. Poverty incidence is 30 percent in rural areas and 11 percent in urban areas. About 80 percent of the population live in urban areas resulting in 40 percent of the poor being urban dwellers. In 1996, the Government formulated a ten-year poverty reduction strategy. The strategy is integrated and based on economic growth accompanied by improvements in human capital, access to physical assets and improvements in the effectiveness and efficiency of the public spending.

55 The strategy has four components: sustaining economic growth through an improved framework for private sector participation; financial sector reform and deepening; and trade and agricultural liberalisation; modernising the state and improving governance through: transparent and results oriented budget management, anti-corruption measures, decentralisation of service provision and civil service reform; increasing the poor's access to the benefits of growth through: improved educational attainment, quality health services, land and infrastructure improvements and safety nets for the very poor; and implementing environmental policies for sustainable development.

56 Increasing the poor’s access to the benefits of growth will target the coverage of and quality of education. Public expenditure on education will be progressively increased from the 1997 level of 2 percent of GDP. Similar increases in public expenditure from the same present level of about 2 percent of GDP will support
health service reform. Access to land and land titles are among the main causes of poverty. Some 40 percent of the best arable land is state owned and farmed under fragile tenancy arrangements. Some 40 percent of the urban land in Santo Domingo is illegally possessed. Land titling and registry reform are important components of the Government's programme. Clean water and sanitation and rural electrification are the infrastructure priorities. Decentralisation of responsibility to local government and communities will be the foundation for infrastructure development.

57 The strategy is still in its early stages of implementation, and its impact yet to be measured. However, it provides an interesting example of an attempt to apply the lessons on effective poverty reduction that demonstrate growth and good governance are prerequisites. The programme has secured support from the World Bank's CDF pilot programme. This will involve lending commitments of about US$120 million per year for three years from the World Bank's ordinary capital resources for selected investments in up to 12 projects to support the overall government programme.

India – Workfare Programmes and NGO Participation

58 Along with PRC, India has the most comprehensive Government sponsored, non-donor supported poverty alleviation programme, with poverty reduction initiatives forming a major part of successive national development plans, including the current Ninth Five Year Plan (1997-2002). In 1993/94 (the latest year for which figures are available) some 36 percent of the population were below the poverty line. Although the incidence of poverty in India declined over the two decades from about 55 percent in 1973, the absolute number of poor has not changed substantial and is estimated to be around 320 million of which 244 million were rural poor accounting for 37 percent of the rural population46.

59 The Government perceives the origins of poverty to be in lack of productive employment, continuous increases in the price of food (particularly food grains) that make up 70-80 percent of consumption, and inadequate social infrastructure. Government strategy is centred on pro-poor economic growth: in agriculture, rural non-farm employment, and labour intensive export development. Government also recognises the need for quality of life improvements through literacy, education, primary health care, safe drinking water and nutritional supply as also being central to poverty reduction, embracing a wider definition of poverty than income deficiency alone. The Ninth Plan also recognises the need for participation, stating "implementation should be increasingly based on approaches and methods which involve the poor themselves .... possible through a process of social mobilisation, encouraging participatory approaches and institutions and empowerment of the poor"47. The Ninth Plan also recognises the need to create a pro-poor environment and intends to identify laws, policies and procedures that are anti-poor and to modify these. The poverty alleviation programme has self-employment and wage employment components.

47 Government of India, 1997, ibid
The central component of the self-employment poverty alleviation programme is the Integrated Rural Development Programme (IRDP) that aims to provide self-employment to the rural poor through acquisition of productive assets funded partly by start-up grants and partly by bank credit and in parallel to fund rural infrastructure development. This overarching programme has several supporting components. These include: the Training of Rural Youth for self-employment (TRYSEM) which develops basic entrepreneurial skills, the Supply of Improved Toolkits to Rural Artisans (SITRA) programme which provides a 90 percent subsidy on the initial purchase of tools for blacksmithy, pottery, and other artisanal crafts; the Development of Women and Children in Rural Areas (DWCRA) component that aims at empowering women’s groups and encouraging group enterprise with supporting subcomponents for child care and education.

The Government’s main wage employment programmes are: Jawahar Rozgar Yojana (JRY) and the Employment Assistance Scheme (EAS). JRY employs the unemployed or underemployed in rural areas in the construction of economic infrastructure and community and social assets to improve the quality of life of the rural poor. It is an area-targeted programme focused on 120 districts in 12 states. The targeting followed earlier analysis that showed that resources were spread to thinly and the programme operates on the basis of providing about 100 days of work per person at the statutory minimum wage with the prescription that wages comprise 60 percent of expenditure. Over 60 percent of funds have been spent on rural roads. EAS is also an area targeted scheme that aims to provide 100 days of employment to participants in conservation works, minor irrigation works and community building works. The same norm of 60 percent expenditure on wages applies.

Separate but similar programmes for urban areas include the Urban Self-Employment Programme (USEP) which provides assistance to microenterprises with training and start-up, and the Urban Wage Employment Programme (UWEP) for urban public works. The Urban Basic Services Programme (USBP) is a social mobilisation and empowerment programme for poor women that facilitates group action and partnerships with Government and NGOs, similar to the DWCRA. Other centrally funded programmes include the Million Wells Scheme (MWS) which provides poor farmers with open wells or irrigation tanks free of charge; and the National Social Assistance Programme (NSAP) which provides pensions, family benefits and maternity benefits for poor households.

Revisions to earlier approaches in the Ninth Plan’s programmes based on lessons learned are: targeting of the bankable poor (particularly literate unemployed youth) to improve the eventual level of employment generation; measures to increase expenditure on infrastructure from about 7 percent of total IRDP spending to 25 percent in recognition of the fact that results from investment in credit have been hindered by lack of infrastructure (particularly roads and markets); better integration of supporting components such as the TRYSEM programme will endeavour to ensure that more beneficiaries are able to take up employment after training (50 percent of those trained under the Eighth plan were unable to do so because of lack of start-up funding); and modifications to credit procedures to ensure

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49 UNESCO, 1999, "Poverty Alleviation through Community Participation - USBP India", UNESCO
continuous financing of working capital, rather than one time loans will be made to help stabilise small businesses. These new approaches if effectively implemented, will bring about greater efficiency in the Government's poverty alleviation programmes. The Ninth Plan also devolves responsibility for planning and management of poverty alleviation measures to the village level, with consolidation at district level in an attempt to initiate "bottom-up" development.

Recent econometric analysis of India's Poverty Alleviation Programmes in the context of Government spending has yielded interesting findings. An analysis of expenditure type and its impact on poverty from 1970 to 1993 shows spending on agricultural research and development, irrigation, rural infrastructure (including roads and electricity) and targeted welfare investments have all contributed to growth in agricultural productivity as well as poverty reduction. The findings show that Government expenditure on roads had the largest impact on poverty and productivity over the period. Spending on welfare (health and education) for scheduled castes and tribes also had a large impact on poverty but not on productivity. Expenditure on health also significantly reduced poverty. Spending on irrigation, research and agricultural extension improved productivity but did not particularly benefit the rural poor even after allowing for trickle down effects. Expenditure on employment and community development the main poverty alleviation methods of the Ninth Plan did benefit the poor, but impact on poverty per Rs million spent was less than for the same expenditure on roads, welfare and health.

This does not necessarily point to greater Government expenditure on roads, but raises issues about targeting. Many of the IRDP programmes suffer from capture of the benefits by the non-poor in the supply driven components of the programme such as the IRDP credit. Benefits to the poor from the employment programmes are higher because they are demand driven and self-selecting. The Government's response to these targeting weaknesses has been to increasingly involve NGOs in service delivery and more than US$ 1 billion of poverty alleviation funding is now disbursed through NGOs annually. The priority challenges for NGOs are now seen as creating sustainability for the social capital they have developed through self-help groups, and linking creating permanent links with local government for such groups.

Although the Indian programme has suffered from many of the same implementation difficulties as the PRC programmes particularly targeting, the development of urban employment creation programmes, the distinction between start-up grant funding and credit for working capital operations of artisans, the linking of training to entrepreneur development, the monetisation of wage employment programmes and the guarantees of payment for work, and the widespread use of NGOs for service delivery are all ideas that merit consideration in the design of future PRC programmes. Other design features of India's workfare programmes are quite

51 World Bank, 1998, "Reducing Poverty in India"
consistent with the research findings\textsuperscript{53} for effective design: market wage rates, demand driven, specified labour intensity, and beneficiary co-financing are also worthy of consideration.

**Pakistan – Bypassing Public Service**\textsuperscript{54}

67 Poverty incidence estimation in Pakistan is based on a poverty line related to daily calorie intake of 2,550. Rural and urban poverty lines have been in use since 1985 when poverty incidence was estimated to be 46 percent. Pakistan has relied on economic growth for much of its poverty reduction and there have been relatively few programmes targeted directly at poverty. Although poverty incidence declined to 34 percent in 1990, it is thought to have risen again in the 1990s. Nutritional norms are not met for about 30 million people, over two-thirds of the adult population is illiterate, 58 million people do not have access to health facilities, and 28 million are without safe drinking water. Half of children drop out of school before fifth grade.

68 The most important has been an income transfer programme based on the religious taxes of Zakat and Ushr. Zakat taxes are levied on financial assets at 2.5 percent per year. Ushr taxes are levied on landowners that produce in excess of 948 kgs of wheat or the equivalent value of other crops. These taxes finance income transfers to those not able to support themselves: widows, orphans and the disabled. Monthly subsistence allowances of less than RS 225 are provided. One off rehabilitation grants of Rs 3,000 are also given. Implementation has been inefficient and the level of Zakat tax collection low, restricting the numbers of beneficiaries. The Ministry of Social Welfare has also operated poverty reduction schemes. A programme called Bait-ul-mal was established in 1992 and provides individual financial assistance to households with a monthly income of less than Rs 1,500 through a monthly grant of about Rs 300 and a child allowance of Rs 50 per child and food subsidies of Rs 150 per household per month. Funding from the budget has been inadequate to benefit all eligible persons.

69 Another programme, the Social Action Programme (Phase I)\textsuperscript{55}, was launched by the Government in 1993 to improve primary education (particularly for girls), health, nutrition, family planning and rural water supply and sanitation, mainly in economically disadvantaged regions. Public expenditure on this programme accounted for between 2 and 3 percent of GDP in the mid 1990s and it received substantial support from the World Bank, ADB, UNDP and the Dutch and British bilateral programmes resulting in overall investment of about US$ 4 billion. Phase II was launched in 1996 for four years to 2000 with projected investment of US$ 17 billion. The second phase continues to address primary education, basic health care, family planning and rural water supply and sanitation. Implementation is in partnership with NGOs, the private sector and rural communities with emphasis on community management.

\textsuperscript{53} Ravillion M, 1998, ibid

\textsuperscript{54} Banking With the Poor, 1997, "Getting the Framework Right", "Appendix 6: Pakistan"

\textsuperscript{55} Government of Pakistan, 1997, "Social Action Programme Planning and Development Division, Statement for the 35th Session of the UN Commission for Social Development"
Recognising the severity of the poverty problem, the Government has recently established the Pakistan Poverty Alleviation Fund (PPAF) and endowed it with US$ 10 million to be invested in bonds to generate income to fund its operational costs. PPAF’s mandate is to work as an apex institution, financing partner organisations with good track records of working with and mobilising communities to manage microfinance schemes and develop and maintain small scale rural infrastructure. PPAF has been made a legally autonomous organisation to protect it from political influence and patronage.

Partner organisations include NGOs, rural support programmes, commercial banks and the private sector that are involved in income generating activities. These organisations will facilitate PPAF funding by helping communities to prepare their proposals, providing training, assisting with implementation and monitoring. The early operating costs of the PPAF microfinance schemes will be borne through soft funding, but it is intended that it will eventually become self-sustaining. Partner organisations will be prohibited from lending below the commercial bank rate, and interest rates are expected to be between 18 and 28 percent. Beneficiary communities will be expected to contribute to the initial cost of infrastructure projects and to demonstrate the capacity to maintain them, where appropriate borrowing for income generating investments. There are similarities between the PPAF model and, for example, the Albania one, combining microfinance and infrastructure development in a single institution, this combination stemming from a recognition that access to land and infrastructure and enhancing business skills of the poor are necessary adjuncts to credit. PPAF is expected to receive financial assistance from the World Bank and ADB on concessionary terms. These terms however, reflect Pakistan's overall poverty status and will be regularly reviewed. PPAF’s design is that of a self-sustaining institution.

For PRC the fund structure is of interest because it incorporates self-sustaining microfinance initiatives rather than the disbursement of subsidies though a commercial banking structure. Such a role might be considered for the Poverty Office or an independent fund in PRC in the future.

**Viet Nam – Piloting New Approaches but Burdened by SOEs**

The Government of Viet Nam's economic development strategy since 1986 has been doi moi: a reform process to transform the economy from being centrally planned to market based. In 1992/93 51 percent of the population were classified as poor by reference to a low poverty line equivalent to 13 kgs of rice per capita per month. Recent research shows that 20 percent of the population remain very poor, while nearly 50 percent are below the international dollar a day poverty line. The Governments goals for poverty reduction are to lift the remaining very poor above the

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56  World Bank, 1999, "Pakistan Poverty Alleviation Fund Project", World Bank
57  State Planning Commission, 1993, "Viet Nam Living Standards Survey"
The Government has formulated a programme for Hunger Eradication and Poverty Reduction (HEPR) which aims to address the underlying causes of poverty: isolation (geographic, linguistic and social particularly for minority populations in mountainous areas); susceptibility to economic shocks (particularly natural disasters, illness and unplanned births); lack of access to resources (particularly land and credit); lack of sustainability (financial and environmental); and inadequate participation in planning and implementation of Government programmes.

HEPR has six main components: investment in basic infrastructure (roads, rural electrification, schools, clinic and markets) in poor communes and regions; provision of subsidised credit for poor households; redistribution of land to the poor; preferential provision of education and health care for the poor; expansion of vocational training and agricultural extension services in poor areas; resettlement of shifting populations. The design of the programme has many similarities with the programmes of the PRC Government.

To target the HEPR, the Government has introduced a National Target Programme that during 1998-2005 will focus on the 1,715 poorest communes with priority being given to the poorest 1,000. Total estimated costs are US$ 725 million. The majority of the investment will be for rural infrastructure (including schools and clinics) and microfinance. The programme is being implemented through the Ministry of Labour, Invalids and Social Affairs.

The Government has approached donors for support for the programme, but has encountered significant reservations. UNDP, for example, in a wide-ranging study concludes while the framework for HEPR appears sound there are potentially serious problems in implementation. These include the relatively low budget allocation to HEPR (US$ 3 to 6 per person), problems with targeting below the commune level and high potential for leakage, a lack of decentralised mechanisms for effective decision-making and good governance, and broad policy issues such as the inclusion of subsidise credit in the programme, and the targeting of investments in education at the primary level where they will have greatest impact on the poor.

ADB in a recent review also expresses reservations about the real level of participation that will be achieved, inherent top-down management practices, subsidised credit, and anticipates similar targeting problems to those of the PRC 8/7 programme because not all people in poor communes are poor, poor people live in communes that are not poor, and investment decisions will not necessarily reflect the needs of the poorest, particularly where local government needs to increase revenue generation.

These are 15kg of rice per capita per month in rural mountainous areas, 20 kgs in other rural areas and 25kg in urban areas.

Dapice D, ibid
ADB, 1999, "Consultations on Poverty Strategies - Viet Nam", unpublished
In a parallel initiative, the World Bank is working with the Government to pilot the CDF approach, and to develop a programme that includes holistic development, partnership, participation, long-term focus and monitorable indicators and learning processes. Current initiatives include pilot projects in the health, rural development and transport sectors, wider consultation with non-government stakeholders on issues such as environment and governance, and developing greater transparency particularly on public expenditure and budgeting.

Another salient criticism of the present budgetary process is that state-owned enterprises (SOEs) continue to absorb most of the resources of the economy while generating little employment or contribution to poverty reduction. By absorbing these large budgetary allocations, SOEs crowd-out private small and medium scale enterprises (SMEs) seriously restricting the prospects for off-farm employment, and cited by the World Bank as the principal threat to poverty reduction and social cohesion.

In PRC, reducing the budgetary resources directed to SOEs would potentially free-up massive funding for poverty reduction and related SME development. Interesting initiatives are being piloted such as the China SOE Enterprise Restructuring and Enterprise Development Project that involve enterprise reform, SME development and a supporting credit guarantee scheme provide opportunities for OCR funding of the SME development and credit guarantee components, and are important initiatives for poverty avoidance given the large layoffs expected from continuing SOE reform.

The Evolution of NGO and Private Sector Approaches

NGOs

There are thousands of NGOs in Asia, Latin America and Africa. There is a great diversity, each organisation having some uniqueness about its vision, mandate, structure, membership and procedures. These organisations have long been promoters of social and political change and are characterised by working directly with their beneficiaries and “clients”. By definition, NGOs are not based in government, but may or may not have developmental objectives and may or may not be profit-making (in the sense that they serve the interests of their members).

The Asian Development Bank, which is typical of the multilateral organisations, defines developmental NGOs as “private organisations entirely or largely independent of government, not created for financial or material gain, and addressing concerns such as social and humanitarian issues of development, individual and community welfare and well-being, disadvantage, and poverty, as well as environmental and natural resources protection and improvement”. However, there are many other types of non-government organisation that are concerned with

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63 See section on Dominican Republic
65 DFID, 1999, “China SOE Restructuring and Enterprise Development Project Memorandum, DFID”.
development. These include: farmers associations, neighbourhood committees, people’s movements, trade organisations, producer co-operatives, women’s associations, consumer organisations and many more, and ADB recognises that these also have a role as partners and participants in the projects and programmes it supports. Asian Development Bank like other multilaterals has been expanding its co-operation with NGOs. Between 1981 and 1986, the Asian Development Bank approved 17 loans that involved NGOs. The number of loan projects in which NGOs are involved has grown rapidly. In 1990, 5 percent of projects involved NGOs. By 1993 this had grown to 25 percent of projects, and in 1997, 27 of 72 loan projects directly involved NGOs.

Asian Development Bank in its 1999 policy revisions to an earlier 1987 policy paper articulates the reasons. The roles of NGOs were identified in 1987 as being: a source of information, consultants or contractors, executing or co-operating agencies, and cofinanciers. NGOs were perceived as having local knowledge, realistic perceptions of prospects for development and because of their “grassroots” approach a comparative advantage in delivery of some development services. These roles persist, but the co-operation has deepened to involving NGOs in policy dialogue and country programming, facilitating NGO and government co-operation, and new initiatives to build capacity in the NGOs themselves.

NGO’s relative freedom of operation and its small-scale has facilitated many successful examples of poverty reduction. However, scaling-up of many NGO and other civil society initiatives is problematic partly because while governments will tolerate localised initiatives they are more wary of nation-wide operations because of the political concerns, and partly because funding is often unavailable. Because civil society organisations and NGOs are often the champions of political change, critical of government, and because in some cases they have particular cultural agendas, partnerships have been hard to forge both with governments and with multilateral donors (that latter being accountable in turn to the governments of member states, and increasingly to the governments of recipient states as their relative shareholding and voting power has increased within these institutions).

Asian Development Bank, 1999, ibid
An Early Example from CARE

"Since 1982, CARE Canada's Rural Maintenance Program in Bangladesh has provided over 60,000 rural women with full-time jobs on road crews maintaining a network of roads across the country and is now helping them to start their own businesses. Even though they earn only a few dollars a week, the jobs provide steady, reliable income for some of the poorest people in one of the poorest countries on the world.

The project has resulted in significant improvements to the lives of the workers and their families. The women have been able to improve their children’s diets and send them off to school, and on the whole, they themselves are healthier and more active in family and community life.

A new phase of the project is encouraging women to strike out on their own and set up small businesses. They are hired for a four-year period and during the third year of the program they are enrolled in a compulsory savings program and are given training in basic marketing skills and business management.

So far, about 24,000 women have "graduated" from the program and gone into business for themselves. They have confidence in themselves and are respected in their communities."

In the mid 1990s about $6 billion annually in official development assistance was channelled through NGOs in addition to their own resources. This assistance has been growing steadily through the decade, and its increase has been accompanied by new initiatives on the part of the donors providing support. Specifically, donors have:

- become more concerned about measuring the impact, benefits and cost effectiveness of the NGO operations they support, as concerns about fragmentation, replicability and sustainability have grown;
- increasingly focussed on developing the managerial capabilities of the NGOs to design, manage and evaluate projects and tightening the reporting processes and requirements for greater accountability;
- become more concerned about the development of indigenous NGOs, often under the umbrella of international NGOs, but in preparation for international NGO withdrawal (at least on a project by project basis).

NGOs, after some initial resistance to these ideas, and perhaps because of some degree of expediency given the volume of donor funding, have exhibited increasing acceptance of the need to more critically assess impact. Nevertheless, many NGOs are also sceptical about using the traditional methods of donors to assess impact, arguing that:

- beneficiary participation is an important part of impact assessment;
- quantitative and qualitative methods of assessment are needed to take into account the social dimensions and the wider definition of poverty;

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68 Case Study from "Canada's Policy on Poverty Reduction", ibid
cost effectiveness should not be viewed in isolation in small projects if they are replicable on a wider scale; and

benefits do not necessarily accrue in the short-term.

87 The most acute concern is that if funding in the future is allocated on the basis of results achieved, there will be little incentive for NGOs to make a contribution to development that is different from that of Government and donors, and less still for NGOs to be innovative and experiment with new approaches. NGOs are able to point to targeting successes and the pioneering of participatory approaches as evidence of the contribution they have made to evolving donor approaches.

88 These concerns aside, many NGOs both international and local have become increasingly concerned about sustainability as they too have become less relief oriented and more development oriented. This is most evident amongst those who have entered the microfinance arena, where the prospects for replicability are good and traditional sources of finance (donations) can be supplemented by loans if lenders perceive sustainability and financial viability.

89 These changes in conceptions and goals have been reflected in the overall approaches to poverty reduction. From quite different approaches in the 1970s with a multilateral agency focus on infrastructure and technology, a bilateral agency focus on trade, an NGO focus on relief and an all round paternalistic and prescriptive approach, there has been an increasing and unifying focus on poverty reduction, with the poor perceived as beneficiaries and by the more progressive donors and governments as clients. Noticeable trends have been the adoption of elements of NGO approaches by donors, particularly with regard to participation; the adoption of elements of donor approaches by NGOs, particularly with regard to management and sustainability; and an increasing level of partnership between donors, NGOs, governments and in some instances the private sector.

The Private Sector

90 Private sector capital flows dominate flows to developing countries. These take the form of: direct investment by foreign firms; purchase of equities on the domestic stockmarkets by foreign private investors; commercial bank lending; and bond issues by borrowers in developing countries. In 1994, for example, of total resource flows into developing countries of about $184 billion, the multilateral development banks provided about 6 percent (including about $3.9 billion in hard loans and $7.4 billion in soft loans), bilateral assistance about 22 percent (mostly in grants and soft loans and partly through NGOs), while private sector flows contributed about 70 percent. However, private sector investment was focused on about 30 countries, twelve of which (including PRC and India) received about 80 percent of the investment. For others, donor dependence remains.

Overseas Development Institute, 1996, “Rethinking the Role of the Multilateral Development Banks”, ODI
Foreign private sector inflows are not directed at poverty reduction. Investments are made solely on the basis of the anticipated financial rewards to the investors (in the short or long term depending on perspective). Generally, they reflect investors’ belief in economic growth in the country of the investment and growing domestic and export markets for the products or services financed. While it can be argued that the investments of IFC and EBRD, for example, leverage in the private sector, these investment decisions too are based on the anticipated returns to investment, not on any poverty reduction criteria. Foreign private capital can be an engine of economic growth, but it is not, realistically, a direct source of poverty reduction funding.

**An Early Example – Canada and Peru**

*Since 1988, the Peru-Canada Fund has improved the lives of more than a million poor people in Peru and stimulated the economies of hundreds of small towns and villages in the most isolated and impoverished areas of the country.*

The Peru-Canada Fund is a private, non-profit Peruvian Foundation providing support to a wide variety of community self-help projects in Peru’s poorest rural areas and barrios. Using a network of community and non-governmental organisations as “catalysts” and project managers, the project has generated jobs, increased agricultural production, created small businesses and supported the marketing of products. Funding for the community projects is generated through an innovative and highly effective “lines of credit” program administered by CIDA. Peruvian companies buying Canadian-made equipment make their payments directly into the development fund. (CIDA pays the Canadian supplier). Thus, the Peruvian buyers import much-needed Canadian made equipment – which improves the economic infrastructure and provides local currency funding for the Peru-Canada Fund. Since its creation the fund has financed over 170 projects which have directly benefited 1.3 million poor people. The value of their contribution, which is estimated at double the amount of the financing provided by the Fund, is their ideas and their labour. The Peru-Canada Fund has become a model for co-operation programs by other donor countries in the region.”

Much the same is true of private domestic capital flows, but because these too have a wider geographic coverage within countries than foreign capital flows, and because they account for more of the direct investment in enterprise, the impact of domestic private capital on income poverty reduction can be greater through employment creation and stimulating demand for raw materials or products from poor areas.

In some countries, tax relief on charitable donations, for example to NGOs working in poverty reduction, stimulates some flow of private capital more directly to poverty reduction. Additionally, bilateral donors and the European Union, continue to use “counterpart” fund mechanisms to recycle export finance to development projects.

There is also a newly emerging role for the private sector in development. Increasingly, in the same way that is has been recognised that NGO skills and experience have a contribution to make in partnership with donors and governments, so partnerships with the private sector have developed. These are quite diverse, examples including:

- the encouragement of the private sector to use labour intensive contracting methods, particularly for government funded infrastructure development contracts;

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Case Study from “Canada's Policy on Poverty Reduction”, ibid.
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- the use of the private sector to compete for and “manage” components of poverty reduction and other aid interventions such as with the UK Financial Deepening Challenge Fund;
- the outsourcing of skill transfers for areas in which it is recognised that the private sector has superior expertise such as enterprise development; and
- wider consultation with private sector interests in the formulation of aid policy and project design.

Some Examples of Partnerships

"Business Partners for Development" has been launched by the World Bank to bring together the public, private and non-profit sectors in an attempt to demonstrate that such partnerships when structured for mutual benefit can be effective in bringing about poverty reduction. Efforts are currently focused on water, natural resources development, education and youth development.

"The Prince of Wales Business Leader's Forum" in the UK is funded by major UK companies and through a network of affiliates in .. countries aims to stimulate management and entrepreneurship to create new employment opportunities particularly in the micro and small-scale sectors.

"Philippine Business for Social Progress", a leading Filipino NGO is funded by many of the Philippine's largest private corporations and is focused on empowerment of the poor and community based project development in villages throughout the country.

IFC, the "commercial" arm of the World Bank is a partner in the "Peace Technology Fund" with several middle eastern businesses to boost private sector activity in the Palestinian Territories.

The Effectiveness of Approaches in Poverty Reduction

Research into aid effectiveness has increased substantially in the 1990s with the recognition that despite the commonality of the objectives of official development assistance and governments, the impact on poverty reduction has not been as successful as envisaged.

World Bank Findings

In its Staff Appraisal Report for the Southwest Poverty Reduction Project in China71, the World Bank states: "ADB Group's experience with a large number of multisectoral rural-development-cum-poverty-reduction projects has not been entirely successful in terms of impact or sustainability. An extensive OED review of two decades of Bank Group experience ... documents that the complexity of project design and implementation and problems with institutional co-ordination have been the principal causes of mixed results." It goes on to say: " the OED analysis favours the approach of implementing separate project components in different ministries as though they were separate projects but with a co-ordinating unit located in a non-sector ministry such as Planning or the President's Office".

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China Southwest Poverty Reduction Project

This World Bank project has six main components:

- Social service development to increase the access and quality of primary education for the poor;
- Voluntary labour mobility for the upland poor supported by skill training, job placement and monitoring of worker living and working conditions;
- Rural infrastructure development including the labour intensive construction of rural roads, safe drinking water supplies, small-scale irrigation, drainage, biogas digesters and rural electrification;
- Land and farmer development covering livestock, tree crops, land conservation works and research;
- TVE development through credit for labour intensive agroprocessing, mineral, service and handicraft industries with strong backward linkages to the poor; and
- Institution building and poverty monitoring through LGOP.

The conclusions on the key factors for success highlight the importance of:

- strong government commitment and a favourable macroeconomic environment;
- reliance on locally proven technological innovation;
- retaining flexibility in programme design after appraisal;
- the need for a comprehensive monitoring and evaluation process; and
- full community participation.

Recent World Bank research into Aid Effectiveness\(^\text{72}\) has produced some new conclusions. In summary these are:

- financial aid in a good policy environment leads to faster economic growth and poverty reduction and improvements in social indicators: with sound economic management $10 billion in development assistance can lift 25 million people permanently out of poverty, with poor economic management only 7 million people would be so affected.

- and it follows that improvements in economic institutions and policies are the critical contribution needed from recipient governments to make aid effective. Where there is momentum for reform foreign assistance can provide support in ideas, training and finance. In contrast, efforts to "buy" reform have been largely unsuccessful. Estimates suggest that if the reforms of the past decade can be replicated, they would lift another 60 million people out of poverty.

- aid can complement private investment in countries where there is sound economic management and commitment to reform because it supports the reform and the improvement of the enabling environment for the private sector. On aggregate, aid “crowds in” US$ 2 of private capital for every US$ 1 of aid.

• the real value of aid is to strengthen institutions and policies so that services can be effectively delivered. Ideas matter most. It is the overall quality of the public sector that makes aid effective, making the critical function the improvement of service delivery not the increase in funding levels for particular sectors.

• because money is fungible, aid is in fact financing the whole of the public sector. On aggregate, aid has crowded out domestic resources from poverty reduction. For every US$ 1 of aid, the incremental spending on poverty is estimated at only 11 cents.

• active civil society improves public services and participatory approaches have greatly improved project impacts, while conversely a technocratic top-down approach has not worked.

• where reform is not taking place, aid can help through the provision of ideas. Money is of little benefit here.

99 The importance of sound economic management in leveraging the impact of assistance, the benefits and hence the justification of the costs cannot be overstated.

Asian Development Bank Findings

100 During 1998 the Asian Development Bank Project Evaluation Office carried out various evaluations of projects funded by ADB. It examined PPTA projects in Bangladesh; secondary education projects in Bangladesh, Nepal and Pakistan; and assistance to the power sector in the Pacific. The evaluations involved consultations with beneficiaries, executing agencies, consultants and others involved in the design and implementation processes. The conclusions were that many projects had only been partially successful for institutional rather than technical reasons although they cite the design process as following preconceived project concepts rather than being truly investigative in their analysis. Poor management in implementing agencies is also cited as a major cause of poor project performance.

101 The recommendations from the analysis are:

• “PPTAs should undertake rigorous institutional capacity studies, develop executing agencies, be participatory, identify and analyse project risks and incorporate project performance indicators.

• Advisory technical assistance should focus on improving operation and maintenance, standards of safety and environmental protection, efficiency and lower costs, management capacity for both administration and planning, reporting and increased transparency of operations, and measurement of performance.”

102 Previous evaluations of other Bank projects from 1968 to 1993 for countries using OCR funds show some trends, specifically:

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• infrastructure projects are generally judged to be successful,
• success levels in social sector projects declined during the period,
• success levels in agricultural projects improved during the period, but there will still some projects that were judged unsuccessful.

A study of social sector and agricultural projects was also undertaken in 1998 to identify the variables that contributed to success and failure. The major findings were that:

• "monitoring only the project implementation schedule and disbursement levels were insufficient to improve projects in these sectors;
• both project specific and external factors that impact significantly on project performance should be given equal attention;
• a policy environment favourable to project operation, government commitment to a project, and provision of counterpart funds can improve project performance significantly; and
• project success in the sectors depends on the executing agency’s capability to supervise project implementation and to use facilities properly and on its commitment to maintenance and repair."

A Sectoral Example

In a review of livestock projects effectiveness at impacting on the poor, the generally poor performance of more than 800 projects funded before 1990 by the World Bank, Asian Development Bank, the European Union DG1, USAID, FMO, Swiss Development Co-operation and Danida is analysed from these organisations own reviews or independent reviews of their projects. The conclusions about causes of failure were that:

• delivery organisations did not have pro-poor policies;
• state policy and legislation discriminated against the poor, for example through land tenure legislation;
• delivery organisation staff had inadequate skills and poor motivation;
• insufficient funds were allocated from public resources leading to curtailed activities;
• excessive state presence inhibited the development of alternative delivery organisations;

• delivery and research organisations were staffed by people who lacked the skills or the inclination to consult with the poor and understand their poverty and their needs;

• delivery and research organisations used top-down planning procedures that precluded the development of client oriented programmes; and

• research organisations had weak links with delivery organisations so that many technologies were not demand led.
DAC represent represents the consensus of views of development ministers, heads of aid agencies and other senior officials responsible for development co-operation. In a recent synopsis it states:

"The record of the last 50 years, from Marshall plan aid to the network of development partnerships now evolving, shows that the efforts of countries and societies to help themselves have been the main ingredient in their success. But the record also shows that development assistance has been an essential complementary factor in many achievements: the green revolution, the fall in birth rates, improved basic infrastructure, a diminished prevalence of disease and dramatically reduced poverty. Properly applied in propitious environments, aid works.

…

We have learned that development assistance will only work where there is a shared commitment of all partners. We have seen the results in countries which have grown, prospered and achieved industrialisation; they no longer depend on aid but stand on their own feet and participate in the global economy. We have seen, on the other hand, the countries in which civil conflict and bad governance have set back development for generations. And we have learned that success takes time and sustained international and local effort."

DAC goes on to affirm that:

"Sustainable development, based on integrated strategies that incorporate key economic, social, environmental and political elements, must be locally owned. … In a partnership development co-operation does not try to do things for developing countries and their people, but with them. … Paternalistic approaches have no place in this framework. In a true partnership, local actors should progressively take the while external partners back their efforts to assume greater responsibility for their own development …. When aid works best, it is a catalyst or reinforcement of other factors … successful development strategies must integrate a number of key elements. They require a sound and stable policy framework; an emphasis on social development; enhanced participation by the local population, and notably by women; good governance, in the widest sense; policies and practices that are environmentally sustainable; and better means of preventing and resolving conflict and fostering reconciliation"
civil society organisation implementing the project; external factors and occasionally corruption and fund diversion;

- NGO projects are more capable of reaching the poor than comparable government or donor programmes, however many projects were found not to be based on community wide assessments of poverty and failed to reach the poorest;

- participatory approaches were linked with successful projects, but participation at the design and wind-down stages was found to much weaker than in implementation;

- while almost all NGOs express a commitment to gender issues, many NGO projects remain “gender blind” and do not address prevailing patterns of discrimination;

- the small-scale of most NGO projects meant that they had little impact on the environment, and few incorporated any environmental assessment;

- the donor processes of project appraisal, monitoring and evaluation were absent from many projects, although NGOs increasingly undertake monitoring activities;

- financial sustainability was absent from a high proportion of projects especially those serving poorer groups where total costs could not be recovered from user fees;

- it proved impossible to assess if NGO projects were cost effective, there being an absence of data both on costs and benefits.

However, selective participation with NGOs is perceived as desirable. The Asian Development Bank, for example, believes from its own experience that through selective participation value added can be achieved in:

- innovation or adaptation, because of close knowledge of local communities and circumstances;

- accountability, participation and responsiveness to needs at the project level because of the level of contact with beneficiaries; and as a result

- sustainability.

People

The participation of communities and community organisation in development projects has increased greatly over the last decade. Decentralised community organisation is now generally seen as essential because it leads to

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78 IFAD, 1995, “Empowerment of the Poor”, Discussion Paper 1, IFAD
mobilisation additional financial and non-financial resources, better project design adapted to specific local circumstances, improved maintenance of assets and infrastructure, enhanced accountability and more equitable distribution of benefits, and where successful may stimulate the formation of further forms of local institutions.

**Some Definitions of Participation:**

- **IFAD:** "a democratic process in which people, particularly the weak and the poor, are not passive receivers of a development project at the end of a top-down approach, but are requested to identify their needs, voice their demands, and organise themselves so as to improve their livelihood with the help of the financial, technical, and human resources offered by the development project as well as their own";
- **UNDP:** "participation means that people are closely involved in the economic, social, cultural and political processes that affect their lives";
- **USAID:** "The active engagement of partners and customers in sharing ideas, committing time and resources, making decisions, and taking action to bring about a desired development objective. Participation describes both the ends and the means; both the kind of results we seek, and the way that we, as providers of development and humanitarian assistance, must nurture those results";
- **The World Bank:** "A process through which stakeholders influence and share control over development initiatives and the decision and resources which affect them".

109 Participation leads to empowerment and the increased ability to access all types of assets. It is “the replacement of a system of people’s participation in public-initiated development by one of public participation in people-initiated development"83.

**Measurement of Success**

110 Changes over time will indicate if poverty reduction strategies are working. The recent conclusions of a high level Working Group on Monitoring Poverty impact and Income Distribution84 were that monitoring systems were inadequate and that, amongst other things, future systems should be able to:

- provide comprehensive measurement of individual, family and community well-being that go beyond household income/expenditure indicators and include significant components of human and social development;
- focus on a limited number of core indicators that are easy to measure, available frequently, sensitive to changes and useful for both national and regional planning; and

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81 Webster N, 1999, “Improving Poverty Reduction: Local Organisations and Rural Poverty Alleviation”, Centre for Development Research, Copenhagen
82 Vashee B, 1997, “Revitalising EU-ACP Co-operation, How Decentralised Co-operation Can Contribute to Poverty Eradication in Africa”
83 IFAD, 1995, ibid
• provide desegregated data on poverty by geographical and administrative areas and by socio-economic subgroups.

111 This is, of course, easier said than done, but the recognition that measuring income and expenditure alone is not sufficient is important. Income and expenditure surveys provide a snapshot of the outcome of a particular intervention at a point in time. They do not necessarily provide a reliable guide to the human and social capital development that are now widely thought to underpin sustainability, yet measuring this development is essential for future project design.

The Lessons

112 The findings and conclusions of the UN Commission for Social Development\(^8\) provide guidance for policy makers that encapsulates most of the current thinking by donors, reformist governments and NGOs about effective approaches to poverty reduction. The conclusions can be summarised as:

• economic growth is essential for social development and particularly to ensure the provision of basic social services, but that one does not follow automatically from the other and that: strong and sustained political commitment to distribution of income factors; investment in human resources; and encouragement of labour intensive growth are also required if there is to be an impact on poverty;

• promoting productive employment through education and training, particularly for those in informal sectors, needs to focus on raising worker efficiency and should be regularly revised to take account of labour markets and national development needs, with particular attention being given to the non-farm sector in rural areas;

• provision of basic social services (primary education, primary health care, nutrition, family planning, clean water and sanitation) are effective in reducing poverty because they give people the skills and improved health they need to work effectively, but programmes must be targeted to ensure benefits reach the poor and self-help should be fostered;

• greater assurance of finance for basic social services is needed from Government, from mobilisation of community resources in kind, through debt relief or debt swaps, additional aid and borrowing, and the use of tax and cost recovery mechanisms;

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87 Cox A and J Healey, 1998, "Promises to the Poor, The Record of the European Development Agencies"; ODI
88 ESCAP, 1998, ibid;
the complexity of poverty needs to be recognised and interventions need to take account of local circumstances, including the possibility that some groups and institutions can stand to gain from the poverty of others and how this should be addressed;

building partnerships with the poor and encouraging self-reliance are not short-term activities and participation and empowerment of the poor and building on existing strengths are important entry points for sustainability; and

design must include institutional analysis for all partners including NGOs and other civil society organisations.

113 These principles are increasingly reflected in strategies of ODA\textsuperscript{90, 91}, but few are embodied in PRC’s current government poverty alleviation programmes. With the conclusion of the 8/7 programme, there is a window of opportunity to use this accumulated international experience in the design of PRC’s future poverty reduction programme. ADB and others can play a major role in policy dialogue, funding and technical assistance and training in this context.
## PRC Poverty Reduction Approaches and Experience

### Summary

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Summary

In its introductory section this paper outlines the characteristics of the three distinct phases in approaches to poverty reduction in People’s Republic of China (PRC) from its establishment in 1949, and summarises social and economic development indicators from 1978, the beginning of reforms. It then considers in detail the definition of poverty in PRC using the poor county methodology and reviews the issues associated with this approach. It reviews the definition of individual poverty and the various official poverty lines and the issues with these. This is followed by an examination of the trends in rural and urban poverty, and the distribution of various dimensions of poverty including geographic location, gender, minority nationality and quality of life measures. The government role in supporting poverty reduction is then reviewed followed by illustrations of NGO and private sector interventions. A detailed review and assessment of the PRC poverty reduction strategy from 1986 examines the three components of the strategy: the subsidised loan programme, the food for work programme and the development funds (fazhan zilin) programme identifying the issues with each of the programmes and assessing their effectiveness in poverty reduction. More recent innovations are outlined, and conclusions about the future of government-supported programmes and the priorities for poverty reduction in PRC are presented.

Prior to 1978 the main thrust of poverty reduction was in improving farmer’s access to all types of assets. Improvements in this phase were gained at the expense of economic efficiency because of centralised control. In 1978 the household responsibility system was introduced, providing farmers with greater control over assets and greater incentives for production. Agricultural terms of trade were also improved during the 1978 to 1984 period. As a result of these measures the number of rural poor fell from 250 million in 1978 to 117 million (15.1 percent of the PRC population) in 1984. Subsequently, between 1984 and 1989, with government policies focused on more market oriented economic growth, income inequality increased, the rate of poverty reduction slowed, and the government introduced targeted poverty reduction programmes. Between 1989 and 1994, relaxation of controls on labour migration, promotion of rural industrialisation and adjustments in the definition of poor areas led to a reacceleration of poverty reduction. In 1994 the government introduced the 8/7 programme to lift the remaining 80 million rural poor out of poverty in 7 years. The number of rural poor had declined to 34 million at the end of 1999.

Over the two decades to 1998, PRC had average GNP growth of 9.2 percent per year. GDP per capita increased from about 400 yuan to about 1,880 yuan over the same period. By 1997 the employment participation rate for the economically active population had reached about 84 percent. Participation in the agricultural sector was about 50 percent of total employment. Between 1978 and 1998 real incomes in rural areas increased 356 percent and 230 percent respectively and the incidence of absolute poverty declined by 85 percent in rural areas.

PRC uses average per capita income at the county level to target the allocation of central government poverty reduction programmes. However, there are different standards for different areas, some of them politically motivated. The averaging mechanism means that the poor in non-poor counties do not benefit. This issue has yet to be thoroughly researched, but the available research estimates that on
average only 70 percent of the population lives in poor counties. In some areas as many as 50 percent of the poor live in non-poor counties that do not benefit from central government funding for poverty reduction.

The average per capita income definitions used for determining poor counties are not the same as the national poverty line. This is set at about USD 0.66 equivalent per day based on the price of a food bundle and is universal. Critics of the poverty line highlight in particular the facts that: it does not distinguish between regional differences in the cost of living, the bundle does not include many items of actual consumption, and the standard is low by international comparison. Based on the World Bank’s more commonly recognised US 1 per day poverty line the poor population of PRC in 1999 was 106 million, about three times higher than the figure resulting from the use of the official poverty line.

Overall rural poverty fell from 250 million people in 1978 to 34 million in 1999 according to the official poverty line. There is some evidence that the regional distribution of rural poverty is changing. Between 1992 and 1997 the total number of poor in PRC reduced by 38.5 percent. In eastern PRC the reduction was 57.2 percent while in the central and western regions the reductions were 32.4 and 33.7 percent respectively. These changes in absolute numbers resulted in the proportion of poor in the western region falling by about 7 percent, but rising by 3 percent and 4 percent respectively in the central and eastern regions.

Urban poverty is more difficult to assess. The available research suggests that urban poverty fell from about 20 percent of the population in 1980 to about 6 percent in 1994. Recently, provincial governments have set up urban “minimum survival lines” similar to poverty lines, but these do not have a common base so comparison and aggregation are not possible. It is expected that the incidence of urban poverty will increase with continued lay off of workers from state owned enterprises (SOEs). The present indication is that urban unemployment will rise by 4 to 5 million per year and that the total unemployed urban population in 2000 will be about 25 million. The number of urban poor at the end of 1999 was estimated at about 12 million. There is also some evidence of increasing urban income disparity.

There is limited evidence of any gender disparity in poverty. There is no evidence of nutritional disparity, but there is disparity in terms of leisure time and education where women come off worse than men. This is most noticeable in the adult illiteracy rate that in 1995 was 9.58 percent for men and 23.24 percent for women. A high proportion of PRC’s remaining poor are minorities, living in remote mountainous areas.

Poverty reduction activities in PRC are supported by government and by NGOs. In 1986 the government established a leading group to manage poverty reduction programmes. This is now the Leading Group Office for Poverty Alleviation and Development (LGOP). It is responsible formulating national policies and plans concerning poverty reduction, co-ordinating poverty reduction activities between government departments, and raising and distributing resources for poverty reduction programmes. Under the Leading Group an executive agency, the national Poor Area Development Office (PADO) is responsible for operations. This structure of leading groups and PADOs is replicated at the provincial and county level. Some 47 government departments also participate in poverty reduction programmes.
One example of other poverty reduction initiatives is the four pilot Funds for Poor Cooperatives (FPCs) have been established by LGOP and the Chinese Academy of Social Science (CASS) since 1994. The funds are used for microfinance. Pilot microfinance offices have been established under provincial PADOs who supervise pilot schemes in Yixian County, Hebei; Danfeng County, Shaanxi; Yucheng County and Nanzhao County, Henan. Central government poverty reduction funds are used in this pilot programme.

Other examples of other poverty reduction initiatives include the operations of the All China Women’s Federation (ACWF), Project Hope and Project Happiness. ACFWs activities include training poor women in agricultural technologies, promoting mutual assistance between women’s groups, organising income generating activities and helping drop out girls return to school. Project Hope was first sponsored by the Youth and Juvenile Development Foundation in 1989 and focuses on getting drop outs back to school and improving educational infrastructure. Project Happiness is operated by the China Family Planning Association, China Population Welfare Foundation and China Population Daily. Started in 1995, it raises funds to assist poor mothers with health care and literacy development.

The private sector has also been a force in poverty reduction in PRC. Brilliant Cause is the most noticeable example in which private entrepreneurs invest in poor areas to combine employment creation with market development and profitability for the sponsors. In 1998, it had about 2,670 entrepreneur participants and total investment to date of about 7.5 billion yuan in almost 3,600 projects.

Prior to 1986, the government’s main approach was to provide relief goods and grants to poor areas. After 1986, the policy of trickle down development was adopted with the underlying assumption that economic growth and industrialisation would automatically benefit the poor. Means used by policy makers to reduce poverty have basically been the same since 1986. The main means have been provision of subsidised loans, operation of public works programmes (food for work or FFW), and budgetary grants to poor counties. Other means have included programmes to introduce new technologies to poor areas, requirements of government agencies and SOEs to enter into contracts to assist communities in poor regions, and encouragement of government departments and enterprises in eastern PRC to develop economic linkages with inland less developed areas. Between 1986 and 1989 regional targeting for fund allocation dominated. Between 1990 and 1995 regional targeting was combined with group targeting. Since 1996 village and household targeting has dominated.

Regarding the three funding programmes, there are institutional weaknesses. Local governments, empowered to allocate poverty reduction resources have been faced with multiple objectives of poverty reduction, economic growth and budgetary solvency. This has resulted in fund diversion, and trickle down has not functioned as well as hoped.

Review of the subsidised loan programme shows that conflicting interests have arisen between the Agricultural Bank of China (ABC) that is mandated to carry out the lending and has a disposition not to lend to the poor, and PADOs that are mandated to identify poor borrowers for ABC to lend to. The programme has a poor record of repayment, the reported rate being about 62 percent in 1997, and poor
credit discipline. In addition to the subsidy costs, non-repayment costs the government about 4 billion yuan per year. The programme is unsustainable other than through continued government subvention.

The food for work programme has been relatively efficient because it has bypassed county financial bureaux and disbursed funds directly to implementing agencies. Fund diversion is rare. However, FFW may have crowded out funds from local government budgets that would otherwise have been spent on poverty reduction, and there are issues in many locations about whether or not labour has been paid for the work carried out. Although poor communities have benefited from infrastructure development, the provision of wage labour in its construction is an important part of the rationale for food for work programmes. Nevertheless, the programme has remarkable achievements. Between 1984 and 1998, the FFW programme constructed 300,000 km of roads, provided safe water supply for 63 million people and 54 million livestock, and developed 3.7 million hectares of farmland, 4.9 million hectares of irrigation, 3.1 million hectares of forest and 1.6 million hectares of pasture land as well as playing an important part in improving electricity supply and communications.

The budgetary funds programme comprises various development funds for poor areas provided by central government. Their use is not transparent because of the classified nature of budget data in PRC. At worst development funds are pure budget subsidy and may have no significant additionally in poverty reduction.

More recently there have been experiments with new approaches to poverty reduction. The World Bank’s poverty reduction projects have packaged different income generating, economic and social infrastructure and financial services elements together in poor areas in a more comprehensive approach to poverty reduction and many pilot microfinance projects have been started.

It is concluded that while the poverty reduction programmes to date have been effective the emerging challenges of concentration of: the remaining absolute poor in remote rural areas; increasing income inequality; and rising urban poverty will not be so effectively met through polices that are rely on trickle-down and economic growth. There are opportunities to improve targeting, sustainability and governance. These include redefinition of poverty through improvements to the poor county system; redefinition of the poverty line or introduction of a relative poverty line in line with the international USD1 per day to provide a basis for future targeting; phasing out of the subsidised loan programme in favour of more sustainable mechanisms in rural and microfinance; and bringing to bear international experience. LGOP would have a major role in the implementation of these changes.
Introduction

There are three distinct phases in the approach to poverty reduction in PRC:

- prior to 1978, the main thrust of poverty reduction efforts involved improving farmer's access to assets;
- between 1978 and 1984, overall economic growth and improving the terms of trade of agriculture were the main strategies;
- after 1985, targeted programmes combined with a trickle-down development strategy predominated.

Reducing Rural Poverty by Improving Farmer's Access to Assets

From its establishment in 1949, PRC was devoted to building an ideal socialist country without exploitation and class disparity. To address low productivity and insufficient resources, the PRC government established a centralised planning system to assure that the resources and products that were available were relatively equally shared by all citizens, and at the same time aimed to improve farmer's access to assets. Poverty reduction in this phase was mainly realised by:

- increasing farmer's access to land (natural resources). Before 1949, the distribution of land tenure in PRC was quite unequal. It was estimated that rich landlords who accounted for 4 percent of rural households owned 50 percent of the arable lands while the poor farmers and tenants that accounted for 70 percent of rural households owned only 17 percent of arable lands in 1934. After 1949, PRC undertook nation-wide land reform reallocating the land of landlords to poor farmers and tenants. Land reform gave all farmers tenure, and succeeded in creating a relatively equal distribution of land among different classes in rural areas by 1952. Land reform removed landlessness as a primary cause of poverty. However, farmer's land tenure after the mid 1950's was transformed to co-operative and later collective ownership.

- improving farmer's access to physical assets. Through the 1950's to the mid 1970's, the PRC government used control of resources to organise nation-wide infrastructure development in rural areas, particularly bringing about improvements in irrigation and road access. It is estimated that the length of roads increased about nine fold, and the irrigated area increased by 125 percent during this period.

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improving farmer's access to financial services by building a national network of rural credit co-operatives (RCCs). By 1978, PRC had established a rural financial service network with nearly 60,000 township and city level branches and more than 350,000 village credit outlets. From 1952 to 1978 rural credit agencies provided agricultural loans of 137.35 billion Yuan to farmers.  

extending farmer's access to technological extension services. During this period, PRC established 40,000 agricultural extension agency offices at national, provincial and township level, covering almost all townships. Through extension, new agricultural technologies were introduced into traditional rural areas.

improving farmer's access to basic education and primary health services. PRC increased the number of primary schools by 1.6 times, and the number of secondary schools by 28 times in this period. The primary school enrolment rate increased from less than 50 percent to 96 percent. To develop health services, PRC established more than 50,000 township level hospitals and over 600,000 village clinics, covering 68.8 percent of all villages.

establishing a community-based social security system. During this period, PRC established a community-based rural social security system in the country as a whole, providing basic social protection for rural residents who were unemployed or unable to work.

As a result, the total national agricultural production values doubled and grain output increased 1.69 times between 1949 and 1978. The average calorie intake of rural residents increased 20 percent during this period. Poverty incidence in rural areas declined from about 80 percent to 50 percent of the population in this phase. It is estimated that the adult illiteracy rate declined by over 50 percent, and life expectancy increased nearly 50 percent during this period.

The improvements in this phase were achieved at the expense of economic efficiency. Highly centralised control over economy by the state and the equal distribution of products resulted in economic misallocation of resources and little incentive for farmers to develop management skills or invest. As a result, the strategy was limited in its potential for impact on poverty.

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**Notes:**

5 Ministry of Agriculture, ibid  
6 It is called the “five guarantees” system, and means guaranteeing farmers will be fed, clothed, housed, and will have access to health care and schooling.  
8 Zhou B, ibid  
9 State Statistical Bureau, 1987, ibid
Reducing Rural Poverty by Overall Economic Growth and Improving Terms of Trade

5 In 1978, PRC introduced the household responsibility system in rural areas. Farmers regained their right to use and manage land and their labour. This increased farmer's incentives to invest, improve management and increase productivity.

6 In this phase, the PRC Government also improved the terms of trade for farmers by increasing prices of agricultural products. It is estimated that increased agricultural production accounted for 15.5 percent of total increased income generated in this period.\(^\text{10}\)

7 Due to economic reform and agricultural product price increases, PRC sustained a high economic growth rate from 1978 to 1984. The per capita income of rural residents increased 132 percent over the period. As the result of overall economic growth in rural areas, the number of rural poor fell from 260 million, or 33 percent of total rural population in 1978 to 89 million, or 11 percent of the population in 1984.\(^\text{11}\)

Reducing Rural Poverty by Implementing Targeted Poverty Reduction Programmes Combined with a Trickle-Down Development Strategy

8 With the development of more market-oriented economic reform, economic growth no longer automatically led to poverty reduction. To the contrary, economic growth after the middle 1980's in PRC resulted in increased income inequality. As a result, the PRC Government started a targeted poverty reduction programme in mid 1980's. The goal of the programme was to reduce rural poverty by targeting areas and households. This phase can be divided into three sub-phases.

9 From 1985 to 1989, poverty reduction was mainly undertaken by implementing regionally targeted programmes without support from macroeconomic policies. According to official statistics, the number of poor in rural areas declined by 19 million during this period, or 3.8 million per year. According to World Bank estimates, the number increased by 7 million.\(^\text{13}\) No matter which figure is closer to the fact, the rate of poverty reduction in this period was much slower than in the first eight years after economic reform in 1978. This was mainly for two reasons. Firstly, macroeconomic policies in this period were unfavourable for poor areas and poor households. The government pursued policies that supported faster economic growth in coastal regions while no special consideration was given to assisting poor regions and poor farmers to participate in the benefits of economic growth. These policies worsened the terms of trade for the poor areas and separated the poor farmers from national economic growth process. Secondly, the regional targeting poverty

\(^{10}\) Xie G, 1988, “Comments on Price Change of Agricultural Products”, in Rural Economy Sketch, No 1, 1988


\(^{12}\) See End Table 1

\(^{13}\) World Bank, 1992, ibid
reduction programme did not cover the majority of the poor areas and poor households\textsuperscript{14,15}.

10 After 1989, PRC adjusted its macroeconomic policies to permit and promote the participation of poor areas and poor farmers in economic growth by relaxing controls on farmer's migration between regions and supporting labour intensive industrial development. At the same time, the definition of poor counties was adjusted to include more of the actually poor counties and poor households. Because of macroeconomic policy adjustment and improvements in targeting, the number of poor fell from 106 million in 1989 to 65 million in 1995, or by 5.86 million per year.

11 In 1994, PRC government initiated the \textit{baqi} (8-7) Poverty Reduction Plan. This to lift the remaining 80 million rural poor out of poverty by the year 2000 (within 7 years). After 1996, PRC government adjusted the targeting basis from poor regions to poor village and poor households. At the same time, the amount of funding used for poverty reduction programme was increased. Funds for three programmes almost doubled from 1995 to 1998\textsuperscript{16} (See Table 3). At the macro policy level, the government put speeding up the development of economy in backward middle and western regions where poor population concentrate in the top priority of economic policy. It was found that the household targeting programme combined with change of macroeconomic policy had a positive effect on poverty reduction. The number of rural poor had declined to 34 million by 1999.

\textbf{Social and Economic Development in PRC from 1978}

\textbf{Economic Growth}

12 Since 1978, PRC has maintained a high economic growth rate. Though fluctuating over years, the average annual GNP growth rate was 9.2 percent between 1978-1998. During this period, the GDP per capita increased from about 400 Yuan to about 1,880 Yuan\textsuperscript{17}. Sustained economic growth not only brought about increases in income level but is also closely associated with PRC’s success in poverty reduction.

\textsuperscript{14} Riskin C., 1994, “Chinese Rural Poverty: Marginalized or Dispersed?” in American Economic Review, Papers and Proceedings 84(2): 281-284
\textsuperscript{16} See End Table 2
\textsuperscript{17} See Table 1
Table 1 Selected Macro Economic and Social Development Indicators Over 1978-1998

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<td>GNP (1978=100)</td>
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<td>GDP Per Capita (Yuan)</td>
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<td>Total employment (million)</td>
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<tr>
<td>Income Per Capita (Yuan)</td>
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<tr>
<td>Rural</td>
<td>133.60</td>
<td>185.70</td>
<td>359.25</td>
<td>415.76</td>
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<td>996.89</td>
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<td>urban</td>
<td>20.8</td>
<td>15.1</td>
<td>9.4</td>
<td>7.1</td>
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<td>Crude Death Rate (per 1000)</td>
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<tr>
<td>Infant Mortality Rate (per 1000)</td>
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<tr>
<td>Adult illiteracy</td>
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<td>16.1</td>
<td>16.48</td>
<td>16.36</td>
<td></td>
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</table>

* the figure is for 1994.

Employment and Income

13 Total employment has increased 66.7 percent since 1978 because of sustained economic growth. By 1997 the participation rate of economically active population had increased to 83.56 percent. The employment structure has also changed with economic development. The proportion of employment in the agriculture sector to total employment fell from 70.5 percent in 1978 to 49.9 percent in 1997 with the development of non-agricultural sectors.

14 Because of the increase of employment and productivity, the income level of the people in both rural areas and urban areas has increased substantially since 1978. The real incomes of residents for rural and urban areas increased 356 percent

Data sources:
Tang Ping, 1999, "Farmer's Income, Expenditure and Rural Welfare Status"
Khan, 1996, "The Impact of Recent Macroeconomic and Sectoral Changes on the Poor and Women in China", ILO/SAAT, New Delhi
and 230 percent respectively from 1978 to 1998. However, with increasing income, the distribution of income has become more unequal. The available data shows that the Gini coefficient for the rural population increased from 0.212 in 1978 to 0.337 in 1998. The Gini coefficient for urban residents increased from 0.16 to 0.28 from 1978 to 1995.

**Absolute Poverty and Social Development**

15 The progress made in PRC in reducing its absolute rural poverty has been marked. The incidence of absolute poverty in rural areas has declined 85 percent since 1978. The head count ratio for urban areas reduced by 72 percent from 1980 to 1994.

16 Impressive gains in improving health and education have been made since the founding of PRC in 1949. Life expectancy at birth increased from 68.2 years in 1978 to 70.8 years in 1997. The infant mortality rate declined to 3.31 percent and adult illiteracy rate declined from 22.8 percent to 16.36 percent during the same period.

**Definition of Poverty**

**Definition of Poor Counties**

17 The official definition of poverty in PRC relates as much to the budgetary resources of the government as it does to the basic needs of the people. When the PRC Government decided to launch a large-scale poverty reduction plan in 1986, a standard was necessary for determining which counties would receive poverty reduction funds. Initially a mixed set of poverty lines to choose poor counties was adopted. The basic standard for selecting nationally designated poor counties was net income per capita below 150 Yuan in 1985. However, a higher poverty line of 200 Yuan was applied to counties in old revolutionary base areas and counties with large minority populations. For some counties, in very important revolutionary base areas and for a few minority counties with special difficulties in Inner Mongolia, Xinjiang, and Qinghai, the poverty line was set at 300 Yuan. Poor counties were chosen based on income per capita data for 1985 collected by the State Statistic Bureau (SSB).

18 In 1988, the central government also set up poverty standards for counties in pastoral regions based on income data from 1984 to 1986. All pastoral counties where the average net income per capita was below 300 Yuan and semi-pastoral counties where the average net income was below 200 Yuan were designated as national poor counties.

19 These official poverty lines were criticised by both researchers and local officials. First, the selection of 150 Yuan as the basic poverty line appeared arbitrary. Second, the poverty line was not uniform. It was obvious that political considerations

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19 See Table 1
20 Khan, 1998, ibid
21 The SSB samples 60-100 households in about one third of the nation’s counties. Income data for other counties are based on adjusted data from the Ministry of Agriculture.
played a significant role in the selection of poor counties. Third, because agricultural incomes are greatly influenced by weather, using income data for a single year may not have reflected the average income levels of different counties. According to data from the Ministry of Agriculture (MOA), of the 82 counties where the per capita net income was below 150 Yuan in 1986, 24 were not designated as poor, based on the 1985 data.

There was no adjustment of the poverty line and almost no change in poor county designation from 1986 to 1990. During this period, strong complaints were heard from poor counties that had not been designated as national poor counties, which finally led to adjustment of both the poverty lines and poor county designations in 1993. SSB carried out the new poverty calculations.

Issues with the Poor County Approach

The poor region based strategy for poverty reduction adopted by PRC Government splits poverty into two separate parts: poverty in officially designated poor counties and poverty in non-poor counties. The poor in non-poor counties do not benefit from the government's poverty reduction programme, because non-poor counties do not. Additionally, the criteria for selecting poor counties have never been unified in PRC. The criteria employed in 1980's involved political considerations and bargaining factors between central government and local governments. Another factor was a requirement that poor counties should be in geographic zones and located close to each other, so some isolated poor counties were excluded. Initially, 225 poor counties in 18 geographical zones were selected as state designated poor counties. Many poor were thus excluded from the opportunity to benefit from the government programme by this methodology.

By the late 1980's and after the number of state designated poor counties, researchers found from a 1988 national survey of over 10,000 rural households in 28 provinces that only 37 percent of poor households were located in an officially designated poor counties. Others report that about half of the poor in four southern provinces did not live in poor counties in the late 1980s.

In 1993, Chinese government made a large adjustment of the numbers and distribution of poor counties. The number of state designated poor counties increased to 592, over 40%. The adjustment improved the coverage of the poor. Recent research estimates the poor population in poor counties accounted for about 70% of the total poor population after the adjustment, but there is still considerable discrimination against specific provinces.

The study found that in the 1986 designations, poor counties in Sichuan, Guizhou, Yunnan (southwest PRC), Inner Mongolia, Henan, Hunan (central PRC), and Gansu (northwest PRC) were at a severe disadvantage, while a county was much more likely to be designated as poor if it were in the wealthier provinces of

References:

22 Riskin, 1994, ibid
23 Jalan J and M Ravallion, 1998, ibid
Fujian, Shandong, Hubei, or Xinjiang. The starkest contrast is between Gansu and Fujian: a county in Gansu was 70 percent less likely to be designated as poor than a county in Fujian. In 1993, despite a large number of newly designated counties in relatively disadvantaged provinces such as Yunnan and Guizhou, southwest provinces remained at a distinct disadvantage, along with Qinghai and Ningxia in the northwest and Anhui and Hunan in central China.25. Many favoured provinces in 1986 no longer appeared favoured in 1993. Recent statistics show that on average about half of the remaining rural poor population live outside state designated poor counties though in some instances this is higher. For example, 61.6% of the poor population in Guangxi Zhang autonomous region lived outside state designated poor counties in 1996 26.

25 Because there is no available information on national situation, here a case study of ten poor and ten non-poor counties in Guangxi is used to illustrate some of the characteristics of poverty in non-poor counties. The absolute number of poor in non-state designated poor counties in Guangxi is large though the incidence of poverty in these counties is lower compared with that in state designated poor counties. The research27 showed that the incidence of poverty in 10 non-poor counties was 5.59% in 1996. In the same year, the incidence in the poor counties was 23.57%. However, the absolute number of poor in the ten non-poor counties was similar to the absolute number of poor in the ten poor counties. In one non-poor county, the poor population was greater than the total number of poor in two poor counties.

26 Most of the poor population in the non-poor counties was found in remote areas as it is in most poor counties. There were also others, more uniformly distributed, who were poor because of the disadvantageous conditions their households had. For instance, the households with less labour, disabled people28, or victims of natural disasters were more susceptible to poverty, again as they are in poor counties. In Guangxi, minorities accounted for a large proportion in the total poor population in the non-poor counties. For example, it was found29 that the minority poor population in Quanzhou county accounted for about 50% of the poor though it was only 4.01% of the total population in the county. Poor households in the non-poor counties were found to be constrained by lack of access to physical infrastructure and public services in the same way as in poor counties.

25 Part of the measured bias against southwest provinces may be due to biases in the MOA versus SSB data. However, interviewed officials in Beijing confirmed that the number of poor counties in the poorest provinces was limited to preserve balance among provinces.


27 Zhou M, 1998, ibid

28 Poverty Alleviation Office of the China Disabled Persons’ Federation, 1998, “General Situation on Poor Chinese Disabled Persons”, Memo. The China Disabled Persons’ Federation estimated that that of the 60 million total disabled population in 1997, 17 million were absolute poor, and 12 million were rural absolute poor. This means about one quarter of the total rural absolute poor population were disabled persons.

29 Zhou M, 1998, ibid
27 The support for the poor in non-poor counties in the provinces with more poor counties is much less than in the provinces with less poor counties. Though there is a poor population in the east regions, the poor in the east have more support from local governments. For instance, the poor villages in Beijing, Jiangsu, Guangdong and Fujian, no matter whether they are in poor counties, have been financially supported by local governments. This is partly due to more available local government revenue and partly because the local governments in these regions do not need to finance poor counties as more as those in poorer provinces.

Definition of Individual Poverty

28 To determine the poverty line in a more scientific manner, SSB divided necessary living expenditures into two parts: food expenditure and non-food expenditure (clothing, housing, communication, fuel, medicine, education, entertainment, and others). The minimum income necessary for food expenditure was calculated based on a fixed food bundle that was considered enough to maintain a minimum daily caloric intake for subsistence. Non-food expenditures, which are harder to measure, were calculated as a fixed percentage of food expenditures using an Engel’s coefficient (ratio of food expenditures to total expenditures) of 0.6. This coefficient was chosen because it was comparable to that used in calculating poverty lines in other countries and also was equal to the average share of expenditures spent on food by PRC rural households in 1984, when many of the poor were just escaping from poverty.

29 To calculate necessary food expenditure, SSB assumed a minimum caloric intake level of 2,400 kilocalories as recommended by PRC’s Centre for Preventative Medicine. The food bundle contained only necessities and not items considered harmful (alcohol, cigarettes, candy) and was intended to reflect actual consumption patterns. SSB used household survey data for 1984 to determine the actual shares of grain, vegetables, fruit, meat, poultry, seafood, dairy products, oil, sugar, salt, and other items to be included in the bundle.

30 Having determined the food bundle, SSB used the following equation to generate weighted prices to calculate minimum food expenditure:

\[ P_i = P'_i \times R_i + P'_{i'} \times (1 - R_i) \]

where \( P_i \) is the weighted price of the food item i; \( P'_i \) is the official (planned) retail price of item i; \( P'_{i'} \) is the purchasing (market) price of item i; and \( R_i \) is the proportion of consumption of item i from own production. The minimum expenditure for food can be calculated from these weighted prices and the amount of different food items in the bundle. Adding the minimum non-food expenditures from the Engel’s coefficient, the poverty line in 1984 was calculated to be 199.6 Yuan.

31 For other years, SSB adjusted the 1984 poverty line to account for inflation using the national rural retail price index. However, in 1990 the prices used to value self-consumed production in calculating incomes changed from the planned price to a weighted purchasing price, and so the poverty line was readjusted accordingly. Since the early 1990s, these poverty lines have been the official poverty lines and...
used to estimate the poor population in PRC and to redetermine the nationally designated poor counties in 1993.

**Issues with Official Poverty Lines in PRC**

Concerns about PRC’s poverty lines include the following.

- The poverty lines chosen in 1986 were arbitrary and inconsistently applied, mixing political concerns with poverty alleviation goals. In addition to stated preferential treatment for minority counties and old revolutionary base areas, political appeals by individual counties sometimes affected designations. Political factors also prevented counties from losing their poor county designation even when they were no longer poor.

- Efforts to maintain balance among provinces in the number of designated poor counties may have hurt provinces in which the vast majority of counties were poor, especially in the initial designations.

- Poverty designations were based on income data for only one year, a highly imperfect proxy for chronic poverty given the variability of weather-dependent rural incomes. Expenditure data was not used, even though expenditures are a more direct and less variable measure of welfare.

- The national poverty lines do not allow for regional differences in the cost of living. The estimated that the cost of purchasing the SSB food bundle was 23 percent higher in Guangdong than in Guangxi in the late 1980s.

- There are several criticisms about how the national poverty line is determined. First, the food bundle excludes harmful consumption goods (alcohol, tobacco) even though poor households do, in fact, spend money on these items. Second, valuation of own produced goods at planned prices (before 1990) or weighted prices (after 1990) in measuring incomes and constructing poverty lines underestimates their true value. This biases incomes downward more for the poor, whose consumption tends to depend more on own-produced goods. Third, the cost of living index used to adjust the poverty line for different years is a Paasche index, and so underestimates increases in the cost of living. Furthermore, the index is for average consumption, and so underestimates the poor population’s share of grain in food expenditures and share of food in total expenditures. The direction of resulting bias depends on how fast grain and food prices rise relative to other prices.

- Regional targeting based on definition of poor counties suffers from incomplete coverage and leakage. Even with accurate targeting at the county level, many poor in non-poor counties are not helped. On the other hand, most of the population in poor counties are not poor. About half of the poor in
four southern provinces did not live in poor counties in the late 1980s\textsuperscript{30}. A 1988 national survey of over 10,000 rural households in 28 provinces found that only 37 percent of poor households reported that they were located in an officially designated poor county, with a large proportion of the poor located in PRC’s agricultural heartland rather than in peripheral regions\textsuperscript{31}. Although the officially reported poor population in PRC decreased from 125 million in 1985 to 50 million in 1997, with the new poor county designations in 1993, the rural population in areas supported by national poverty alleviation programs increased from 106 million to 199 million. Even if all of PRC’s poor were located in poor counties, the great majority of households in poor counties are not poor.

- The PRC income poverty standard is low in absolute terms. The rural poverty line in PRC is about 66 percent of the World Bank’s $1 per day poverty line, an internationally compatible line set for low-income countries. According to World Bank’s line, the poor population of PRC was 106 million in 1999, almost three times more than the figure resulting from use of the official poverty line.

**Poverty Lines of Other Agencies and Researchers**

Other agencies and researchers have made attempts to build more reasonable and internationally comparable poverty lines for PRC. The World Bank used SSB household income and expenditure survey data and an internationally comparable methodology to build poverty lines for rural and urban residents in PRC. Some important modifications have been made by the World Bank when building poverty line for PRC. First, the daily calorie intake of 2,150 kilocalories was used (as an internationally accepted level for low-income countries), rather than 2,400 kilocalories, in calculating cost for food consumption. Second, both planned prices and procurement prices were used to build two poverty lines for rural residents. Third, instead of using an assumed Engles ratio to estimate non-food cost, it used ratio of food’s budget share for poor urban households\textsuperscript{32}. The World Bank’s calculated rural poverty line was 190 Yuan in 1985 prices, which was nearly 10 Yuan less than the official line. Khan\textsuperscript{33} used SSB data and a different method to build another set of income poverty lines for both rural and urban residents in 1988 and 1995.

\begin{thebibliography}{99}
\bibitem{31} Riskin C, 1994, “Chinese Rural Poverty: Marginalised or Dispersed?”, American Economic review, Papers and Proceedings 84(2): 281-284
\bibitem{32} World Bank, 1992, ibid
\end{thebibliography}
Poverty Trends

Rural Poverty

34 The poverty lines and trends in the incidence of poverty in rural PRC are summarised in Table 2. It is clear that the incidence of poverty using different poverty lines is very different.

<table>
<thead>
<tr>
<th>Year</th>
<th>SSB's Line Poverty Line (Yuan per capita)</th>
<th>Poverty Incidence (%)</th>
<th>World Bank's Line Poverty Line (Yuan per Capita)</th>
<th>Poverty Incidence (%)</th>
<th>World Bank's Line Poverty Line ($ per day per capita)</th>
<th>Poverty Incidence (%)</th>
<th>Khan's Line Poverty Line (Yuan per Capita)</th>
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<td>10.7</td>
<td>368</td>
<td>16.09</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>304</td>
<td>10</td>
<td>304</td>
<td>10.7</td>
<td>368</td>
<td>16.09</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1992</td>
<td>320</td>
<td>9.4</td>
<td>320</td>
<td>9.4</td>
<td>368</td>
<td>16.09</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td>350</td>
<td>8.8</td>
<td>350</td>
<td>8.8</td>
<td>368</td>
<td>16.09</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td>440</td>
<td>8.2</td>
<td>440</td>
<td>8.2</td>
<td>368</td>
<td>16.09</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>540</td>
<td>7.6</td>
<td>540</td>
<td>7.6</td>
<td>368</td>
<td>16.09</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td>580</td>
<td>6.7</td>
<td>580</td>
<td>6.7</td>
<td>810</td>
<td>12.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td>640</td>
<td>5.8</td>
<td>640</td>
<td>5.8</td>
<td>810</td>
<td>12.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td>4.6</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

35 The trend in rural poverty incidence has generally been downward since 1978. The poor population in rural areas reduced from 250 million in 1978 to 42 million in 1998 by PRC official poverty line, or from 30.7 percent of its rural population to 4.6 percent." (see Table 2).

Urban Poverty

36 Lack of data makes it impossible to fully portrait the trend of urban poverty in PRC. Limited research based on sample data reveals that the incidence of poverty in PRC’s urban areas had declined in 1980’s and increased in 1990’s especially after 1992. The available research suggests that urban poverty fell from about 20 percent of the population in 1980 to 4.73 percent in 1991, but had risen to 5.9 percent in 1994.

37 In recent years, provincial governments have also set up their own urban minimum survival lines, similar to poverty lines. These survival lines have drawbacks

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34 See Table 2
36 Khan A R, 1996, “The Impact of Recent Macroeconomic and Sectoral changes on the Poor and Women in China”, ILO
for estimating poverty. They are basically budgetary poverty lines, which are
determined by local financial capability and are generally arbitrary and without a
research base. These lines have different bases and therefore cannot be used for
interregional comparison. Therefore, it is not possible to calculate aggregate poor
urban population using these lines.

38 Generally, the decline of urban poverty in 1980's was due to the management
system of state owned enterprises (SOEs) and the household registration system,
that provided improved social welfare and employment guarantees for urban
residents. Traditionally, urban residents in PRC enjoyed full employment and social
benefits including housing, health services and education. In the 1990's, especially
after 1992, the conditions enjoyed by urban residents changed as a result of SOEs
reform. Urban residents employed by SOEs are increasingly affected by
unemployment, and SOEs can no longer rely on state support to avoid bankruptcy.

39 The integration of the PRC economy into global economy has worsened the
market conditions for many SOEs and their ability to provide social services. Some
traditional industrial sectors, such as textile and traditional manufacture, have had to
reduce the scale of production or produce new products. Other industrial enterprises
have needed to reduce the numbers of employees to compete internationally. As the
result of SOE reform and adjustment of national industrial structure, the number of
laid-off workers has increased rapidly since 1992. The registered unemployed people
in urban areas increased from 4.2 million to 6.4 million in the same period37 38.

40 By official definition, only urban residents who are registered unemployed are
regarded as unemployed. This excludes unemployed that have not registered. A
recent study estimated that the number of laid-off workers increased from three
million in 1993 to about 18 million in 1998 (UNDP, 1999). This study also estimated
that the unemployment rate increased from 3.3 percent-3.7 percent in 1993 to 7.9
percent-8.5 percent in 1998 in urban areas. If this estimation is true, it means the
incidence of poverty in urban areas has increased to at least 8 percent in 1998
because the major income of urban residents is from employment.

41 It is expected that the poverty incidence in urban areas will continue to
increase because there is still surplus labour in recent SOEs need to be removed
with the deepening of SOE reform. One study expected that labour demand in urban
areas will decrease by four to five million each year in the next three years and the
total unemployment by the year 2000 might increase to about 25 million39. Urban
poverty is likely to continue to rise.

Regional Distribution of Poor Population

42 Though the basic trend of rural poverty decline is apparent in all provinces,
the rate of decline is uneven in different regions. SSB data shows that the number of
rural poor population for the country as a whole reduced 38.5 percent from 1992 to

37 SSB, 1997, “China’s Regional Economy in the 17 Years of the Era of Reform”, SSB
Issues and Countermeasures for Employment”, Liaoning People’s Publishing House
1997. At the same time, the number in the eastern region reduced 57.2 percent while the central and western regions reduced 32.4 percent and 33.7 percent respectively. As the result of differential rates of change, the regional distribution of poor rural population in the period also changed. The proportion of the total poor in PRC in the eastern region reduced from 23.23 percent to 16.17 percent with the proportion of central and western regions increased by 3.09 and 3.94 percentage points respectively.

**Table 3** Change in the Regional Distribution of Poor Population 1992-1997

<table>
<thead>
<tr>
<th>Year</th>
<th>National</th>
<th>Eastern Regions</th>
<th>Central Regions</th>
<th>Western Regions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>80,656</td>
<td>18,739</td>
<td>25,085</td>
<td>36,832</td>
</tr>
<tr>
<td></td>
<td>100.00</td>
<td>23.23</td>
<td>31.10</td>
<td>45.67</td>
</tr>
<tr>
<td>1997</td>
<td>49,623</td>
<td>8,026</td>
<td>16,966</td>
<td>24,631</td>
</tr>
<tr>
<td></td>
<td>100.00</td>
<td>16.17</td>
<td>34.19</td>
<td>49.64</td>
</tr>
<tr>
<td></td>
<td>Absolute change 1992-1997</td>
<td>31,034</td>
<td>10,713</td>
<td>8,119</td>
</tr>
<tr>
<td></td>
<td>% change over 1992-1997</td>
<td>38.5</td>
<td>57.2</td>
<td>32.4</td>
</tr>
</tbody>
</table>

**Gender and Poverty**

43 There is limited evidence on gender disparity. A recent sample survey on nutrition intake in six poor counties shows that there was no gender difference in poverty in the undernourished population. However, there is gender disparity in terms of leisure time and access to education. A sample survey conducted in eleven provinces showed that the daily leisure time enjoyed by women for 1990 was 63 minutes and 55 minutes less than that by men for rural and urban areas respectively. There is also a higher illiteracy rate for adult women.

**Table 4** Selected Indicators by Gender in 1995

<table>
<thead>
<tr>
<th>Selected indicators</th>
<th>Male</th>
<th>Female</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adult illiteracy rate</td>
<td>9.58</td>
<td>23.24</td>
</tr>
<tr>
<td>Proportion of children under 5 who are underweight</td>
<td>16.5</td>
<td>17.3</td>
</tr>
<tr>
<td>% of children aged 7-12 not in primary school</td>
<td>1.5</td>
<td>1.8</td>
</tr>
<tr>
<td>Infant mortality rate (1/1000)</td>
<td>32.4</td>
<td>33.5</td>
</tr>
</tbody>
</table>

---

40 See Table 3
41 By Chinese official classification, the eastern region includes Beijing, Tianjin, Hebei, Liaoning, Shandong, Shanghai, Jiangsu, Zhejiang, Fujian, Guangdong, Guangxi and Hainan. The central region consists of Jilin, Heilongjiang, Shanxi, Inner Mongolia, Anhui, Jiangxi, Henan, Hubei and Hunan. The western region includes Shaanxi, Qinghai, Gansu, Ningxia, Xinjiang, Sichuan, Chongqing, Yunnan, Guizhou and Tibet
42 See Table 4
44 ACWF, 1999, “Basic Situation of Poverty Alleviation Activities with ACWF’s Involvement”
Poverty Amongst Minority Populations

44 In PRC many of the rural poor are minority people. A high proportion of minority people live in remote and mountainous areas. Of the 592 official designated poor counties, 255 are minority nationality autonomous counties, account for 43 percent of the total poor counties. In 1995, the population with per capita income less than 500 Yuan in 255 minority poor counties was 27.87 million, about 40.5 percent of the total population in all poor counties in same income level.

Regional Income Disparity

45 Rural-urban income disparity has been a major source of regional inequality since 1978. However, income inequality within rural areas is much more serious than within urban areas. Regional variations in natural conditions, quantity and quality of land and opportunity for employment in off farm activities, influence relative income. The weakening of advantage of urban residents in obtaining steady income from traditional SOEs in the 1990's led to the increase of income inequality within urban areas.\(^{47}\)

Table 5 Urban-Rural Income Disparity and Their Contribution to Regional Inequality\(^ {48}\)

<table>
<thead>
<tr>
<th>Year</th>
<th>Income ratio of top quintile over bottom quintile</th>
<th>Income ratio of urban residents over farmers</th>
<th>Decomposition of income inequality in terms of Gini (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Urban</td>
<td>Rural</td>
<td>Between Urban and Rural</td>
</tr>
<tr>
<td>1978</td>
<td>1.43</td>
<td>1.98</td>
<td>1.76</td>
</tr>
<tr>
<td>1979</td>
<td>1.38</td>
<td>1.91</td>
<td>1.69</td>
</tr>
<tr>
<td>1980</td>
<td>1.41</td>
<td>1.89</td>
<td>1.56</td>
</tr>
<tr>
<td>1981</td>
<td>1.34</td>
<td>1.85</td>
<td>1.60</td>
</tr>
<tr>
<td>1982</td>
<td>1.36</td>
<td>1.81</td>
<td>1.65</td>
</tr>
<tr>
<td>1983</td>
<td>1.40</td>
<td>1.93</td>
<td>1.74</td>
</tr>
<tr>
<td>1984</td>
<td>1.44</td>
<td>2.16</td>
<td>1.90</td>
</tr>
<tr>
<td>1985</td>
<td>1.49</td>
<td>2.00</td>
<td>1.74</td>
</tr>
<tr>
<td>1986</td>
<td>1.45</td>
<td>2.11</td>
<td>1.78</td>
</tr>
<tr>
<td>1987</td>
<td>1.51</td>
<td>2.20</td>
<td>1.94</td>
</tr>
<tr>
<td>1988</td>
<td>1.53</td>
<td>2.25</td>
<td>1.97</td>
</tr>
<tr>
<td>1989</td>
<td>1.53</td>
<td>2.37</td>
<td>1.95</td>
</tr>
<tr>
<td>1990</td>
<td>1.51</td>
<td>2.15</td>
<td>1.85</td>
</tr>
<tr>
<td>1991</td>
<td>1.57</td>
<td>2.32</td>
<td>1.91</td>
</tr>
<tr>
<td>1992</td>
<td>1.60</td>
<td>2.34</td>
<td>1.90</td>
</tr>
<tr>
<td>1993</td>
<td>1.68</td>
<td>2.48</td>
<td>1.88</td>
</tr>
<tr>
<td>1994</td>
<td>1.86</td>
<td>2.58</td>
<td>1.93</td>
</tr>
<tr>
<td>1995</td>
<td>1.83</td>
<td>2.76</td>
<td>1.95</td>
</tr>
<tr>
<td>1996</td>
<td>1.87</td>
<td>2.73</td>
<td>2.05</td>
</tr>
</tbody>
</table>

Poverty Based on Living Standards

46 Table 6 shows the changes in selected indicators of living standards between 1990 and 1997.

\(^{47}\) See Table 5
Table 6  
Selected Indicators of Living Standards 49

<table>
<thead>
<tr>
<th>Indicators</th>
<th>1990</th>
<th>1997</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per capita consumption expenditure (Yuan)</td>
<td>803</td>
<td>1384.72</td>
</tr>
<tr>
<td>Rural</td>
<td>585</td>
<td>996.50</td>
</tr>
<tr>
<td>Urban</td>
<td>1279</td>
<td>2016.96</td>
</tr>
<tr>
<td>Per capita housing area (m²)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rural</td>
<td>17.8</td>
<td>22.5</td>
</tr>
<tr>
<td>Urban</td>
<td>6.7</td>
<td>8.8</td>
</tr>
<tr>
<td>% of households that lack access to durable housing in rural areas</td>
<td>37.97</td>
<td>24.41</td>
</tr>
<tr>
<td>Infant mortality rate(1/1000)</td>
<td>32.9</td>
<td>33.1</td>
</tr>
<tr>
<td>Maternal mortality rate(1/100000)</td>
<td>88.9</td>
<td>61.9*</td>
</tr>
<tr>
<td>Adult illiterate rate</td>
<td>22.2</td>
<td>16.15</td>
</tr>
<tr>
<td>net primary enrolment ratio</td>
<td>97.8</td>
<td>98.6</td>
</tr>
<tr>
<td>% of population that lack access to safe water</td>
<td>24.5</td>
<td>13.3*</td>
</tr>
<tr>
<td>% of population that lack access to primary health</td>
<td>10</td>
<td>7.7</td>
</tr>
<tr>
<td>% of households that lack access to sanitation (rural / urban)</td>
<td></td>
<td>79.89 /39.03*</td>
</tr>
<tr>
<td>% of population that lack access to electricity</td>
<td></td>
<td>11.65*</td>
</tr>
</tbody>
</table>

Note: * refers to figure for 1996. ** for 1995.

Consumption

Consumption expenditure is a more direct and less variable measure of welfare than income. Lack of data for classifying consumption expenditure makes it impossible to estimate the distribution of population by expenditure class. A sample of data for six poor counties showed that the incidence by consumption expenditure was slightly bit higher than that by income 50 (Wu, 1997). On average, national consumption expenditure per capita increased 72 percent from 1990 to 1997 51. In this period, the gap of consumption expenditure between farmers and urban residents declined because rural residents increased their expenditure faster than their urban counterparts.

Research Institute of All China Women’s Federation and Department of Social, Science and Technology Statistics, SSB, 1998, ibid
Khan, 1998, ibid
Leading Group Office for Poverty Reduction under State Council and Rural Survey Team,


51 See Table 7


**Education**

48 In 1990’s, the access of people in poor areas to education has improved. Several specialist programmes have pioneered this: Project Hope (xiwang gongcheng), the Spring Bud Plan (chunlei jihua), the Poverty Alleviation Programme for Education, and the Children’s Development Plan in Poor Areas. These programmes provide assistance for the children in poor areas to study in school. Recent statistics showed that the drop out rate of school children declined to 0.69 percent by 1998\(^ {52}\). Nationally, the net primary enrolment rate increased from 97.8 percent to 98.5 percent from 1990 to 1997\(^ {53}\). Partly because more young people became literate, and partly because of work to eliminate illiteracy in the adult population, the national wide adult illiteracy rate fell from 22.2 percent in 1990 to 16.15 percent in 1997.

**Health Status**

49 The access of people to health services has also improved in the 1990’s. The most recent statistics show that 89.5 percent of all the villagers in rural PRC had access to a health station or clinic at the end of 1998\(^ {54}\). The proportion of population that lack access to primary health service reduced from 10 percent to 7.7 percent from 1990 to 1997. Public health conditions have also improved. Through the Food for Work Programme and other public health programmes, the proportion of population that lack access to safe water fell from 24.5 percent to 13.3 percent in this period. The PRC government has also made efforts to improve sanitation. For example, the total investment for remoulding toilets in rural areas in 1995 was as high as 3.04 billion Yuan\(^ {55}\). All these achievements have made contributions to improved health status. Life expectancy at birth has increased 1.8 years from 1990 to 1997. At the same time, the maternal mortality rate reduced from 88.9 per 100,000 to 61.9.

**Housing**

50 Housing conditions have improved in 1990's because of increasing income. From 1990 to 1997, the per capita housing areas in rural and urban areas have increased 26.4 percent and 31.3 percent respectively. The percentage of households that lack access to durable housing in rural areas reduced from 37.97 percent to 24.41 percent in this period. However, in some minority poor areas, there is the situation in which people live with livestock.

**Social Insurance**

51 Generally speaking, the poor are more vulnerable than other groups in the society because they cannot support themselves with their own income and assets and are more exposed to shocks due to natural disasters and illness. Traditionally,
poor households have been able to obtain support from community by participating in the social safety net. Households could support one another by offering presents to the households in the community on the occasion of a marriage, a funeral or if there was sickness.

52 After the co-operative movement in middle 1950's, all the farmer's households were involved in commune and brigade based social security net. Farmers enjoyed social security through the so-called "five guarantees" system, which provided guarantees for farmers on feeding, clothing, housing, health care and schooling. However, this social safety net was weakened with the dissolution of people's commune system. Current social security situations vary with the economic development levels of the regions. In developed regions, fast growing TVEs provide financial support for the township and villages to help the poor in need.

53 In poor areas, farmers have to depend mainly on their own family or the community in which they live to in times of hardship. The collective insurance still exists in some areas. At the end of 1997, there was 3 million farmers enjoying "five guaranties" 56, of which 20 percent lived in old people's homes.

54 In the process of reform deepening, PRC has speeded up its experiment and development of health insurance and pension insurance in rural areas in 1990's. 1997, there was 82 million rural residents in about 2000 counties participated in pension insurance 57, which was about 10 percent of the total rural population. The pension fund accumulated has increased to 13 billion. The coverage of social insurance in urban areas is much higher than in rural areas. There was 85.05 million staff and workers participated primary pension insurance and 15.9 million staff and workers bought health insurance by 1998 58.

Regional Disparity of Living Standard

55 Though obvious improvement has been made in living standard of the people in country as a whole, the difference in living standard between different regions is still serious. Table 8 presents some selected indicators of social development in regions of varied income levels and locations in 1996.

Table 7 Regional Disparity of Social Development in 1996 59

<table>
<thead>
<tr>
<th>Illiteracy Rate (%)</th>
<th>Enrolment Rate of schooling age children (%)</th>
<th>Doctors served for per 1000 Persons</th>
<th>Patient beds owned per 1000 persons</th>
<th>Unemployment rate in urban areas (%)</th>
<th>Incidence of poverty in rural areas (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>National average</td>
<td>13.30</td>
<td>97.09</td>
<td>2.05</td>
<td>2.83</td>
<td>4.14</td>
</tr>
</tbody>
</table>

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58 SSB, 1999, ibid
Bottom quintile | 17.08 | 97.56 | 1.69 | 2.13 | 5.19 | 29.20
Top quintile   | 8.83  | 99.74 | 2.93 | 3.68 | 3.03 | 0.20
Eastern region | 9.70  | 99.48 | 2.25 | 3.15 | 3.64 | 2.05
Central region | 10.79 | 99.10 | 1.69 | 2.60 | 3.88 | 5.61
Western region | 20.63 | 91.88 | 2.14 | 2.63 | 5.06 | 28.68

Note: the unemployed people compose of complete unemployed and those who work less than 24 hours per week.

56 The illiteracy rate of the regions at top quintile income level was 51.7 percent lower than that of the regions at bottom quintile income level. For recent education and health service capacity, the regional variation was not so serious. The urban unemployed population and rural poverty population was highly regionally concentrated. The urban unemployment rate and incidence of poverty in rural areas in western regions was 9 percent and 13 times higher than that in eastern regions.

Governance and Poverty

Poverty Reduction Activities Supported by Government

57 In PRC, poverty reduction activities are usually divided into two types: those supported by the government and those supported by NGOs and civil society. Government supported poverty reduction activities are of two types: those financed directly by central budget and those financed by local governments and government departments.

LGOP and PADO

58 In order to ensure the leadership and management of central government over poverty alleviation programmes, the Government of PRC established a National Leading Group for Economic Development in the Poor Areas under the State Council (LGEDPA) in 1986. The name of this agency changed to the Leading Group Office for Poverty Alleviation and Development (LGOP) in 1993. The national Leading Group, is an inter-ministerial task force with representatives from all ministries concerned with poverty and rural development. The Leading Group is responsible for:

- making national policies, decisions and plans concerning poverty alleviation, including determining the strategy for poverty alleviation, defining the targets for poverty reduction programmes and formulating operational plans for distributing resources for poverty reduction programmes;
- co-ordinating poverty reduction among government departments and regions;
- raising and distributing resources for poverty reduction programmes.

59 Under the national Leading Group, an executive agency, the national Poor Areas Development Office (PADO) is responsible for regular tasks, such as collecting the information relating to poverty reduction, supervising and inspecting the progress of poverty reduction programmes, making annual plans for poverty reduction fund distribution. The national PADO has right to make recommendations to the State Council through LGOP and approves the subsidised loan allocations to different provinces each year. The Leading Groups and PADOs at the provincial and county levels perform similar functions. The county PADOs have responsibility to prepare
and approve the projects that apply to using poverty reduction funds. In townships of official designated poor counties, Leading Groups are also established. Usually, one special poverty reduction cadre is assigned to be responsible for the activities relating to poverty reduction in each township.

**Government Departments**

60 Forty-seven government departments participate in the decision and policymaking concerning national poverty reduction programmes, propose and implement poverty reduction plans, and assist specified poor regions to reduce poverty. Government departments usually set up their own PADOs and provide assistance for the poor counties with which they are in contact by raising resources by themselves for the counties.

**Fund for Poor Co-operatives (fupinshe)**

61 The first Fund for Poor Co-operative (fupinshe), FPC, was established in Yi county, Hebei province in 1994 by the Rural Development Institute (RDI), CASS in cooperation with LGOP. RDI operated the first microfinance pilot project in Yi county with the help of some international donors by replicating Grameen Bank model in late 1994. The group-based lending methodology adopted by the microfinance experiment has gradually been adopted by the government after 1996 because the experiment had successfully solved two tough problems facing to government poverty reduction programmes, poor targeting and low repayment rate. Therefore, FPCs are established in poor areas to operate microfinance using the government’s poverty reduction funds. FPCs have been set up in four poor counties and townships.

62 In Yunnan and Guangxi, a microfinance office is established under the provincial PADO to supervise the operation of microfinance of FPCs in counties. Provincial PADOs or microfinance offices are responsible for making operation and management regulations and for raising and distributing funds for FPCs in poor counties. County FPCs are usually set up in and managed by county PADOs. They perform the functions of mobilising and organising poor households in small groups on a voluntary basis, lending funds to small group members, and supervising loans and collecting repayments.

**Financial Institutions in Poverty**

63 The formal financial institutions, PBC, ABC, ADBC and RCC, play the same roles as government departments. What differs is that they are charged by the central government to distribute and supervise the largest poverty reduction resource: subsidised loans.

**NGOs Supported Poverty Reduction Programmes**

**All-China Women’s Federation (ACWF)**

64 From the late 1980s, ACWF has used its close relationship with government departments and poor women as well as its nation-wide network down to village level to carry out poverty reduction activities. ACWF targets poor women and combine providing income generation opportunities with social development activities such as family planning and reducing illiteracy of women. A recent survey shows that ACWF
has assisted 2.188 million poor women out of poverty since 1986\textsuperscript{60}. ACWF’s activities include the following.

- Training poor women to master new applied agricultural technologies and production techniques. It is estimated that more than five million poor women in 23 poverty stricken provinces and autonomous regions have received training through ACWF by 1998.

- Taking "Women’s Poverty Alleviation Action" (jinguo fupin xingdong) to fight poverty. It was planned that ACWF would reduce the poor population by one million in five years from 1996. By 1997, 588,000 poor women had been lifted out of poverty through ACWF assistance.

- Promoting mutual assistance of women between and within regions. One means is to assist poor women to increase income and reduce poverty through "Hand in Hand Action" (shou la shou). For this ACWF advocates richer and / or well-educated women assist poor women to get richer “hand in hand” with them by providing technical and financial support. A 1997 estimate shows that 660,000 poor women had received assistance through this way in 1996\textsuperscript{61}. Another action is to encourage and organise the women in the east to assist the poor women in the west.

- Organising poor women in small groups to launch microfinance-based income generation activities. Microfinance has been used by ACWF as an important since 1989 when the Women Federation in Luliang prefecture, Shanxi, started to use rotation lending as a way to help the poor women to reduce poverty. By 1996, this kind of activity had assisted 240,000 poor people escape from poverty. Since 1996, ACWF has made efforts to expand microfinance activities, particularly in Yunnan, Guangxi, Anhui and Shaanxi.

- Undertaking "Spring Bud Plan" (chunlei jihua) to help drop-out girls return to school. This plan is managed by China Children’s Fund (CCF) in ACWF. CCF raises funds from overseas and domestic agencies and individuals. It is estimated that the plan has raised over 200 million Yuan and helped 900,000 girls return to school.

\textbf{Project Hope}

65 Project Hope was launched by the Youth and Juvenile Development Foundation (YJDF) of the All-China Communist Youth League in 1989. The project focuses on improving education conditions and assisting school drop-outs go back to school. YJDF mobiles funds through donations and helping donors build direct contact with grant receivers. The funds are used for constructing primary school buildings or paying tuition for the students of poor households. The project had raised

\textsuperscript{60} ACWF, 1999, “Basic Situation of Poverty Alleviation Activities with ACWF’s Involvement”

\textsuperscript{61} Chen Muhua. 1997. Speech in Conference on National " Women PA Action" and "Double Learning and Double Competition".
1,611 million Yuan and built 7,111 primary schools by the end of 1998\(^62\). A recent assessment of Project Hope demonstrated the significant role the project plays in developing education in poor areas. The project covered 96.3 percent townships and 63.3 percent village schools in the state designated poor counties and provided financial support for 30.9 percent of all drop-out children.

**Project Happiness**

Project Happiness is operated jointly by China Family Planning Association, China Population Welfare Foundation and China Population Daily. It started in 1995. Its mission is to raise funds to help the poor mothers with health care, literacy development, and raising their social and economic status by improving their access to resources. The funds are raised from domestic and international donors. The project uses a revolving fund to assist poor mothers with income generating activities combined with requirement for strict family planning. At the initial stage, about 10,000 poor mothers in nineteen counties received financial support to run the economic activities such as cash crop planting and livestock raising. By the end of 1998, the project had raised funds of 60 million Yuan and financed over forty thousand poor mothers in twenty-four provinces and autonomous regions\(^63\).

**Private Sector Supported Poverty Reduction Programmes**

The private sector has been an important force in PRC's poverty reduction. It contributes to poverty reduction in two ways: through stimulating local economic growth in poor areas by making use of local resources and expanding local market, and by creating employment opportunities for poor farmers locally and in coastal provinces. The private sector accounts for about 10 percent of all employment (Liu, 1997). In 1995 about 15 percent of the total labour force in 592 poor counties had short term or long term jobs in the regions out of the home county (PADO and SSB, 1996). Most of these jobs are provided by private sector or joint venture enterprises in the coast regions.

**Brilliant Cause (guangcai shiye)**

Brilliant Cause was started in 1994. It is an organisation founded by private entrepreneurs, dedicated to helping poor farmers. These entrepreneurs treat provision of assistance to the poor as a brilliant cause. This view reflects Chinese traditional culture in which assisting the poor after one gets rich is regarded as a good virtue by society. Brilliant Cause is characterised by a combination of profit motive and aiding the poor. Private entrepreneurs invest in poor areas and create employment and development opportunities for the poor, but they also profit from their investment. In this sense, their involvement in poverty reduction is selective.

It was reported that there were 2,669 private entrepreneur participating in the cause with total investment of 7,535 million Yuan in 3,598 poverty reduction related projects by 1998. The involvement of these private enterprises had provided jobs of

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\(^{62}\) YJDF, 1999.

\(^{63}\) Guangming Daily, March 29, 1999
0.38 million for farmers in poor areas and helped 1.53 million poor people get lift out of poverty.\(^6^4\) In addition, the Brilliant Cause has provided training for 329,700 farmers.

**Review and Assessment of PRC Strategy for Poverty Reduction Since 1986**

**Goals and Assumptions**

Prior to 1986, the main approach was to provide relief goods and grants through the social welfare system, where the goal was to maintain the minimum living standard of the poor. The PRC Government adopted new strategies in 1986 to assist poor households. The goal was to foster economic development in poverty stricken areas and thereby reduce poverty.

With the socio-economic reforms and introduction of a more market-oriented system, the PRC Government embraced the concept of trickle down development, that assumed that the effect of economic growth and industrialisation would automatically and logically benefit the poor.

Poverty was regarded as being primarily a rural and localised phenomenon with the poor concentrated in particular areas. According to the official estimates, about 70 percent of the poor were concentrated in particular counties,\(^6^5\) which made it possible to combine poverty alleviation with regional economic development. The poverty problem in mid-1980s was seen to be characterised by income shortage and under-developed resources. Thus the government believed that a key constraint facing poor farmers in generating income was the lack of available capital and an inability to access the formal credit system. The PRC central government initiated some large-scale projects. Most of the expenditure consisted of subsided loans designed to assist poor farmers in developing commodity production and entering the market.

The government system was viewed as the most effective administrative system for poverty reduction.

**Means**

The means that the policy makers used to help the poor to escape from poverty were mainly focused on promoting economic growth, though some attention was paid to income redistribution. The major means were to:

- provide subsidised loans, public works, and budgetary grants. The subsided loans were issued for cropping, raising livestock, agricultural processing, and construction and mining activities that required little investment and yield rapid returns;

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• introduce applicable technologies to the poor areas. Steps were taken to strengthen technological extension networks and personnel training. A special programme ‘Sparkle’ was operated to support technological innovation and extension in poor areas;

• require government agencies and large-scale state owned enterprises (SOEs) at all levels to undertake responsibility on a contract basis for assisting the communities in poor regions;

• encourage government departments and enterprises in the eastern developed regions to develop economic linkages with inland less developed areas for mutual benefit.

75 Efforts were also made to mobilise social resources in addition to resources raised through the Government system. A successful example is Project Hope. The project created awareness of the suffering of poor children and mobilised social forces to make contributions to improvement of education conditions and help drop-outs return to school in the poor areas. Another example has been the encouragement of urban residents to donate used clothes and quilts to the poor.

76 Although there have been changes in macro economic policies and targeting strategies in 1986 and 1994, the means that have used to reduce poverty have not been fundamental changed.

Targeting of Poverty Reduction Strategy

77 Changes in the targeting strategies for poverty reduction can be summarised as:

• before 1985: disaster-stricken population;

• 1986-1989: regional targeting dominated;

• 1990-1995: regional targeting combined with group targeting; and

• after 1996: village / household targeting dominated.

78 Before 1994, the targeting had been problematic and criticised. Some surveys, for monitoring as well as for academic purposes, show and confirm that the number of poor people in designated poor areas accounted for a small part of the total poor population. The approach to poverty reduction through regional economic development left many of the real poor population uncovered. It was estimated that about 70 percent of poor households lived in the official defined poor counties in 1986. However, it is reported that about half of the poor in four southern provinces did not live in poor counties in the late 1980s. By 1998, this figure for the country as a whole was estimated to reduce to about 50 percent.

66 Leading Group Office of Poverty Alleviation, 1989, ibid
67 Jalan J and M Ravallion, 1998, ibid
Regional targeting has not benefited the poor in non-poor areas and has benefited the rich in poor areas. Because of this, the PRC Government in 1996 decided to return the focus of lending to providing direct loans to poor households, and to emphasise targeting to the extreme poor households who are unable to adequately feed and clothe themselves. Some measures have been taken to guarantee the resources provided for the poverty alleviation programme to be transferred directly to poor farmer's households rather than through intermediate agencies and companies as before.

Institutional Issues

According to the recent sociological analysis on the delivery system, institutional weakness has been one of the major factors detracting from effective targeting. For instance, local governments are empowered by the central Leading Group to be in charge of distributing and supervising the funds for poverty reduction programmes at a local level. However, almost all local governments in poor areas are faced with competing, multiple goals: poverty reduction, economic growth and budgetary solvency. This situation forces compromise. Because budgetary insolvency directly threatens the normal working of local governments and there are lower tax rates for enterprises that may make more contribution to poverty alleviation than others, local governments have more incentive to use poverty reduction funds for industrial enterprises of higher tax rate. As long as the use of poverty reduction funds is not strictly regulated and enforced, local governments may and probably will divert the funds to other uses.

In practice, trickle down to the poor did not work well, as in many other countries. From an economic perspective, fiscal decentralisation resulted in divided interests within the government administrative system. For local governments, helping the poor is only one of many goals, and this may be subordinated to other more pressing goals. Moreover, given the responsibility for utilisation of poverty reduction funds, some local governments have replaced the target group of the poor with the non-poor.

From a social perspective, economic growth may have benefited higher income people more than the poor. The economic reforms and social transition have caused the pattern of interest groups to change at the macro-level, and polarisation has come to the surface. The income gap has increased between families, units, regions, and between rural and urban people. Those poor, whose income just lifts them above the poverty line, can very easily fall back into absolute poverty in years.

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71 Shen H, 1997, ibid
of bad harvest. The widening gap in income distribution has become a concern for social stability72 73.

Assessment of the Main Poverty Reduction Programmes in PRC

83 Provision of subsidised loans, public works and budgetary grants for poor areas have been three main means used by the PRC government to reach its poverty reduction goals since 1986.

Subsidised Loan Programme

Programme Description

84 Many decision-makers in PRC believe that providing subsidised loans is necessary and helpful for the poor to escape from poverty. This arises from two implicit beliefs about the economic situation of poor households. Firstly, there is a belief that the poor have a shortage of available funds and are either unable to access the formal credit market because they lack necessary assets for mortgage and collateral. Secondly, there is a belief that the poor can not afford to pay a full market interest rate. Based on these beliefs about the economic situation of poor households, LGOP has been providing subsidised loans for the poor as a key means to reduce poverty since its establishment in 1986.

85 Before 1994, PRC’s subsidised loan programme was really a group of programmes administered by different agencies to reach different target groups. Programmes began in 1984 before the establishment of LGOP. One was a subsidised loan programme administered by the People’s Bank of China that distributes one billion Yuan annually to revolutionary base areas, minority regions, and remote areas. Another was a smaller directed loan programme of unsubsidised credit for the same target groups run by Agricultural Bank of China (ABC).

86 When the Leading Group was established in 1986, the major new poverty programme it initiated was a subsidised poverty loan programme for nationally designated poor counties, administered by ABC. Over time, this programme became the largest and most important loan programme targeted at poor areas. In 1988, two additional programmes were set up, one targeted at pastoral areas, the other to support the development of county-run enterprises in nationally designated poor counties. After 1994, all of these subsidised loan poverty programmes were combined together to form a single poverty loan programme under Agricultural Development Bank (ADB). The amount of subsidised poverty loans changed over time. In 1980's the amount increased slightly in nominal terms but declined in real terms. In recent years, the amount has increased substantially74. The interest rate on the main subsidised poverty loans has been 2.88 percent annually prior to September 1999 and 3.00 percent since then.

72 Shen H, 1996, ibid
74 See End Table 2
Administration

87 LGOP, which has representatives from all ministries concerned with poverty and rural development, approves the subsidised loan allocations to different provinces each year. The national Poor Area Development Office (PADO) is the implementing office that makes recommendations to LGOP and oversees fund allocation. Leading Groups and PADOs at the provincial and county levels perform similar functions in approving loan allocations to counties and townships. At the county level (and the provincial level for large projects), loans are allocated for approved projects. These projects also must be approved by the ABC (ADB from 1994 to 1998), which disburses the loans and has the right to reject loans that it feels are poor credit risks. ABC provides the loans at the subsidised interest rate and collects a compensatory payment from central government. Loans are typically for a period of three to five years.

88 One institutional change designed to separate commercial and policy lending was the establishment of the ADB in 1994. With this reform, poverty loans became the responsibility of the ADB rather than ABC. It was hoped that this separation would reduce the conflicts over approval of poverty loan projects since the ADB had a policy rather than commercial orientation. Initially ADB offices were established at the provincial level, and county level ABC branches were paid a fixed fee to administer policy loans on their behalf.

89 This institutional reform produced more problems than it solved. ABC officials had less incentive than before to monitor poverty loans since profits or losses on the loans no longer appeared on their account. The fees paid by ADB were lower than the true cost of administering the loans. There was an even greater incentive to divert such loans to more profitable uses. The result was that loan performance and repayment worsened. In addition, even though ADB was a policy bank, its managers were under great pressure to limit the financial haemorrhaging and so had an incentive to be concerned about repayment rates at the expense of meeting targeting objectives. The ADB concept has now been abandoned and subsidised lending for poverty returned to ABC.

Lending Priorities

90 When the subsidised loan programme was begun in 1986, the government believed that a key constraint facing poor farmers in generating income was the lack of available capital and an inability to access the formal credit system. The government also felt it was important to provide technical assistance and other services. Based on this premise, in the first phase of lending, priority was given to distributing subsidised loans directly to poor households to develop cropping, animal husbandry, and agricultural processing. An official survey at the end of 1987 showed that in the first year of the programme, 92 percent of subsidised loans were distributed directly or indirectly to farm households, rather than to county, township, or village enterprises.

This pattern of loan distribution ended by 1989 when the Leading Group adopted a policy to encourage the development of economic entities (jingji shiti) for assisting the poor. Economic entities were enterprises engaged in some kind of productive or service activity that helped poor households to escape poverty. The new policy stipulated that at least half of the employees of economic entities had to be from poor households in order to qualify for subsidised loans. This change in lending priority was based on the view that most poor households could not make good use of subsidised loans on their own because they lacked the necessary technological and management ability and could not achieve economies of scale in operation. In contrast, economic entities such as collectively managed orchards or companies selling agricultural or sideline products were managed by professional personnel that could co-ordinate activities on a larger scale. An important goal of the reform was to improve the productivity of loans and achieve higher repayment rates.

The problem with lending to economic entities was that the connection to poor households was much less direct, which compromised the original targeting goals of the programme. Many of the loans were given to township and village enterprises (TVEs) or county-owned enterprises, which increased the local revenue base for local governments but did not greatly benefit poor households. The failure of the programme in reaching the poor was criticised by researchers and some local leaders. Moreover, the repayment rate on loans did not increase markedly. At the national work conference on poverty in September 1996, the PRC Government decided to return the focus of lending to providing direct loans to poor households.

Targeting Issues

PRC’s subsidised loan programme has been widely criticised for not reaching the poor. Many of the reasons centre on the political economy of local government institutions in PRC.

One broad source of targeting problems stems from the dual goals of the programme to reach the poor and to promote economic development. First, to provide incentives for effective loan use and repayment, local poverty officials often incorporate past performance as a criterion competing with poverty status in awarding new loans to lower levels. Second, many local officials believe that the poor are incapable of managing projects successfully and prefer to promote economic development by lending to enterprises, economic entities, and large farmers.

Even more important, poor targeting occurs because of the incentives facing local officials. There are three local players with a stake in the use of subsidised loans: the local Leading Group and PADO, the local government, and ABC. Usually, local poverty officials may compromise targeting objectives to meet the dual goals of the programme. Local government officials also are concerned with generating revenues and furthering overall economic development, not just in poor areas, which may lead them to support diversion of funds to enterprises or investment in more promising regions. This is especially true given the acute fiscal crisis hitting local

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Wu G, 1994, ibid

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governments in poor areas. ABC officials face strong profit incentives and so care about loan repayment above all else. Because they disburse the funds, they can veto proposed projects put forward by the local PADO if they feel the likelihood of repayment is low. This has led to numerous conflicts between bank officials and poverty officials, with the resolution favouring different sides in different cases.

Even when loans are approved, ABC officials have an incentive to shorten the period of the loan (so that loans can be repaid quickly at higher rates), delay loan disbursement, or divert loans outright.

**Repayment**

There are numerous anecdotal reports of low repayment rates on poverty loans in PRC. It is claimed that 35 percent of all subsidised poverty loans and 60 percent of loans for industrial projects were not repaid on time. Average rates of repayment of 29 percent and 55 percent for four counties in Yunnan and 5 counties in southern Shaanxi, respectively are also reported. Similarly low rates of repayment are reported for counties in Hebei and Henan.

Full evidence on loan performance nation-wide is available in a report sponsored in 1995 by PRC’s Science and Technology Commission, which summarises national data on timely repayment, overdue loans, and defaulted loans for four main subsidised loan programmes from 1991 to 1993. In no year does the timely repayment rate for any programme exceed 70 percent. For the largest programme, the subsidised loan programme administered through ABC, the repayment rates for the three years average 54 percent. Such low repayment rates are well below financially sustainable rates of repayment, and considerably lower than repayment rates on regular ABC loans. Cumulative overdue loans and defaulted loans for all the programmes are a very high percentage of loans coming to term, with overdue loans well exceeding 100 percent of loans coming to term in each year.

Among the four programmes, the repayment rate for county enterprise loans is the lowest in two of the three years, in each case falling below 40 percent. The People’s Bank loans also perform relatively poorly, followed by the main subsidised loan programme and the regular poverty loan programme. The low repayment rate on county enterprise loans is striking given the increase in the share of subsidised loans allocated to county enterprises during the same three-year period.

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77 Park A et al, 1996, ibid
78 Li J and G Li, 1993, “The Use of Poverty Alleviation Funds and Economic Development in China’s Poor Areas (fupin zijin de shiyong he pinkun diqu de jingji fazhan),” Rural Economy and Society (nongcun jingji he shehui)
79 Zhou B and H Gao, 1993, “Summary of Poverty Research and Practice (dui pinkun de yanjiu he fan pinkun shilue de zongjie),” in The Tribune of Economic Development (kaifa luntan), No 1
80 Li J and G Li, 1993, ibid
81 China Science and Technology Commission Research Group, 1995, “Assessment of China Poor County Data (zhongguo pinkun xian tongji celiang zhibiao pingjia ji qi shuju kaifa yanjiu baogao). See End Table 3
99 The statistical data from ADB showed the repayment rate of subsidised loans has increased in recent years, but is still very low. It reported the rate of 61.93 percent in 1997.

100 While it is true that many projects have failed, particularly industrial projects ill-suited to the economic and marketing environment in poor areas, low repayment should not automatically be equated with failing projects, since households and enterprises may choose to default on loans even when they are able to repay. Credit is heavily rationed in PRC and is particularly inaccessible to the rural poor, who lack collateral, desire small loans, and face more risky economic environments. Successful repayment of a poverty loan is unlikely to lead to graduation to formal sector loans, and this decreases repayment incentives. The subsidised nature of the loan and its targeting based on poverty status also create the perception that the loan is a welfare transfer rather than a commercial loan. The low and even negative real interest rates of the loans provide an incentive for farmers to delay repayment for as long as possible. Farmers with small loans know that costly enforcement of loan repayment by financial institutions is unlikely to occur. These same problems have resulted in low repayment rates for directed credit programmes elsewhere.

The Food-for-Work (FFW) Programme

Programme Description

101 In recent years, targeted investment spending funded by the national government’s Food-for-Work Programme (yigong daizhen) has financed a large share of the construction of roads, water works, and agricultural infrastructure in poor areas. Funding for the programme has increased rapidly during the 1990s, partly because of the perceived success of the programme. Originally conceived as a way to productively use excessive stocks of surplus grain procured by the government after the bumper harvest of 1984, the programme is organised around multiple multi-year projects administered by the State Planning Commission (jiwei) and its provincial and county counterparts. After an initial experimental project from 1984 to 1987 in 10 provinces, a small second project was begun in 1989. Larger projects were begun in 1991, and with the renewed emphasis on combating rural poverty in 1993, funding for FFW projects increased dramatically from that year.

102 Funds for the projects bypass county finance bureaux. Rather, coupons redeemable for grain, cloth, or industrial goods are transferred directly to relevant county agencies (such as the Transportation Bureau or Soil and Water Conservation Bureau), who disburse them. Resources are provided in-kind to state marketing agencies or coupons are made redeemable through state banks. By policy, resources supplied by the national government should be matched by provincial, prefecture, and county governments. But in practice, due to revenue scarcity local contributions are often limited or non-existent. The resources are used to pay the material and labour costs for infrastructure projects in poor areas. The original focus

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83 See End Table 3
of the projects was on roads and drinking water, but the scope of projects has since expanded to rural investments of all types.

**Targeting Issues**

103 One reason FFW programmes have been praised and targeted for expansion is that because the funds bypass local budget bureaux. To date relatively few funds have been diverted for other uses, which has become common for many earmarked budgetary items, especially in poor counties. There is concern that expanding the scope of FFW will make it more difficult to monitor and increase the incentives for local governments to think of ways to divert the funds to other uses, decreasing the programme's effectiveness. Another disadvantage of creating too many channels for funding local agencies is that it hurts the transparency of the fiscal system, and effectively reduces the planning authority and capacity of local units.

104 Another targeting issue related to fund diversion is the possibility that local governments are substituting FFW projects for other funds that would have gone toward infrastructure construction. In other words, FFW funds may merely displace other funds and so do not greatly increase the amount of infrastructure constructed. There is little evidence to quantify the extent of such crowding out, but given the acute fiscal pressures hitting poor areas, some crowding out is likely.

105 Targeting issues also surround the actual FFW projects. These include the location of the projects, whether labourers are paid, and who participates in the construction work. Because FFW projects are investment projects, as with subsidised loans, local leaders inevitably balance the economic return of projects with the effect of projects on helping the poor. The return to building a road to a very remote village, for example, will be low given the sparse populations served and the high cost of constructing roads in mountainous terrain. Villages that have greater population, favourable environmental conditions, more surplus labour, and which are less remotely located are more likely to be involved in projects.

106 One important issue in assessing the poverty alleviation role of FFW projects is the cost borne by local residents in the form of uncompensated labour effort. Because funds are limited, in many areas FFW funds are used to pay for material supplies while labour is supplied through *yiwugong* (essentially a labour tax). In some areas with FFW projects, the amount of *yiwugong* may surpass regulated limits (usually a maximum of 30 labour days per year). Even when workers are paid, the amount is often lower than the going wage. These costs to the poor in the form of foregone leisure or other income-earning activities must be weighed in assessing how well the programmes are targeted and how much they benefit the poor. It is entirely possible that the labour tax associated with FFW projects taxes the poor more, since they are more likely to have surplus labour that can be tapped for construction work.

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84 Park A et al, 1996, ibid

It is reported that 40 percent of households in a sample in Sichuan, Ningxia, and Shandong worked without receiving any pay. Older, male labourers with less land and more education are more likely to participate in projects. They also found that for most labourers (78 percent), time spent working on FFW projects did not detract from income-earning activities but rather decreased leisure consumption only.

**Effect of Food for Work Programme**

Compared with assessment of the effect of subsidised poverty loan programme, it is easier to assess the FFW programme because the programme can create tangible products. The State Development Planning Commission provided data on the effects of FFW programme from 1984 to 1998. In this period, government had totally provided FFW fund of 31.3 billion Yuan. Totally 300,000 kilometres roads had been newly built or rebuilt. 63 million people and 54 million livestock had acquired access to safe drinking water under the programme. Over 55 million mu (3.67 million hectares) of basic farmland had been developed which increased irrigation areas by 73 million mu (or 4.87 hectares). 46 million mu (3.07 hectares) of forest and orchards and 24 million mu (1.6 million hectares) of pasture had been established. 42,000 square kilometres of erosion areas had been brought under control. In addition, the FFW programme has also played important roles in improving electricity supply and communications.

**Development Funds (fazhan zijin)**

**Programme Description**

Compared with the subsidised loan and FFW programmes, PRC has a much longer history of providing budgetary subsidies to poor regions. From 1949 the government adopted a centralised financial management system in which all local revenues of provinces and counties were turned over to the central government and all expenditures required by regions were appropriated by the central government. In this system, those regions whose expenditures were more than their revenues automatically received budgetary subsidies.

Even with the fiscal decentralisation reforms in the early 1980s, the central government continued to provide budgetary support for poor regions. Budgetary subsidies in PRC include two broad types. One type can be called subsistence subsidies, which are given to sustain the normal operations of local governments in poor areas. For the 592 poor counties in 1994, these subsidies were equivalent on average to about half of local revenues.

The second type of budgetary subsidies provided to assist economic development of poor areas are targeted development funds, which unlike subsistence subsidies are considered a key component in the government’s poverty alleviation plan. Development funds comprise four categories, only two of which are included in the poverty investments listed by the national PADO. These are the

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**Notes**

86 Zhu L and J Zhongyi, 1995, ibid
“Development Fund for Assisting Undeveloped Areas” (budada diqu fazhan zijin), begun in 1980, which allocates 800 million Yuan each year to poor areas, including old revolutionary base areas and autonomous counties of minority nationalities; and the sanxi fund, begun in 1983, which allocates 200 million Yuan each year to 47 counties in three north-west prefectures. The amount of funding for these purposes did not increase appreciably through the late 1980s and early 1990s, shrinking in real terms. In more recent years, the amount of development funding has doubled.

The other two types of development funds are a budgetary subsidy begun in 1977 for infrastructure construction in border areas to build leading industries and improve roads, communications and education; and a financial revolving fund to support less developed areas. This latter fund includes the following parts: a budgetary fund for assisting the poor set up in 1988; a fund for meeting the basic needs of residents of minority nationalities regions set up in 1990; and an additional fund for assisting the poor, set up in 1992. The revolving funds are lent to enterprises and other economic entities, which are required to repay the principal as well as a 2 to 4 percent management fee after one to three years. These funds in many ways resemble subsidised loans, but are administered through the fiscal rather than the financial system. In total, there has been more than 200 million Yuan in revolving funds each year since 1992. Some provinces also have made original development fund allocations into revolving funds.

Targeting Issues

Of the three main poverty programmes, least is known about the distribution and use of budgetary development funds because of the classified nature of budgetary data in PRC. Still, a number of targeting concerns warrant mention. First, because the development fund programme began before the designation of poor counties in 1986, many of these funds were and continue to be given to counties not officially designated as poor, which may increase coverage but also increases leakage.

Second, just as for FFW funds, it is possible that poor counties will substitute development funds for other budgetary resources that would have been allocated for similar purposes, reducing the impact of such funds on realised investment. Assuming perfect fungibility, development funds at worst act as a pure budget subsidy, so should help local governments in poor counties meet their own fiscal agendas, even if these lack the development focus that central leaders would prefer. However, if these transfers also affect the subsistence transfers negotiated between levels of government, the crowding out problem could be much more severe. In poor areas where budgetary crises have forced governments to delay or suspend wage and other payments to cadres, there also is the danger that funds will be diverted to non-productive use altogether.

Regulations stipulating that development funds be used to benefit poor households by developing projects probably prevent full crowding out as described above. However, local governments have a much stronger influence on the use of

See End Table 2
these fund than subsidised loans or FFW funds, so the danger of biases toward revenue-producing enterprise investments is greater, even though the success rate of such projects and their benefits to the poor are much less.

**The Effectiveness of PRC’s Three Poverty Reduction Programmes**

116 To date, there is limited evidence on the effectiveness of PRC’s poverty investments. According to SSB estimates, the number of rural poor in PRC fell very gradually from 1985 to 1989, the first 4 years of PRC’s poverty programme, but then fell much more quickly in the 1990s to reach 42 million in 1998. These overall measures of poverty, however do not isolate the effect of poverty programmes, since progress or lack of progress in reducing the poor may reflect factors other than poverty investments, especially those that affect the pace of overall economic development. Some have argued, for instance, that poor areas stood to gain more from market and commercialisation reforms since the planning system forced them into production patterns that went against their comparative advantage to a greater extent than in richer areas. Rising urban incomes have also translated into greater demand for many of the speciality and other products produced in mountainous, cooler climates.

117 A simple way to estimate the effect of targeting poverty reduction programme is to compare the difference of growth rate of per capita income of rural residents between the national average and the officially defined poor counties over 1992 to 1998. Though the ratio of per capita income for poor counties over national average fluctuated over time, it is clear that per capita income in poor counties has increased faster than national average. This demonstrates to some extent that the targeting of poverty reduction programmes has been effective in officially designated poor counties.

118 An assessment of whether being located in an officially designated poor county affects growth in household expenditures utilising SSB panel data (1985 to 1990) on households in four southern provinces (Guizhou, Yunnan, Guangxi, and Guangdong), has shown that living in a national poor county increases consumption by 1.1 percent per year, though this gain is offset by growing divergence in consumption due to other reasons. The rate of return on poverty investments is estimated to be 12 percent.

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89 See End Table 5
90 Ravallion and Jyotna, 1996, ibid
91 It is pointed out that this may overestimate the programme’s effect since some public expenditures on the programmes may not be included, funds may be used for consumption rather than investment purposes, and community variables may omit factors that give poor counties advantages in achieving income growth.
Recent Innovations and Adjustments to the Poverty Reduction Strategy

World Bank’s Southwest Regions Poverty Reduction Project (SWPRP)

119 The World Bank has assisted PRC in the implementation of the ‘8-7 Plan’ and complements Government expenditure with its financing. The World Bank has sharpened the poverty focus of its lending to agriculture, health, and education projects by targeting funding to the poor counties.

120 The World Bank’s strategy for poverty reduction is to assist the central and local governments to develop income generating programmes, continue development of sustainable techniques to upgrade marginal agricultural lands, and incorporate major water storage, transfer, irrigation, drainage and flood control schemes into projects. In selected areas, programmes for TVE development, health, education and market inter-mediation also receive World Bank support.

121 SWPRP assists the poor in 35 of the poorest counties in Guangxi, Yunnan and Guizhou Provinces. The project has multiple objectives:

- to significantly reduce absolute poverty in 35 of the poorest counties in south-western PRC;
- to demonstrate the effectiveness of a multi-sectoral rural development approach to poverty reduction;
- to upgrade poverty monitoring system at the national and local levels; and
- to facilitate a market-friendly growth in labour mobility from the poor areas.

122 The poverty monitoring survey for SWPRP in 1998 shows the results of the project activities in past three years. Its key findings are:

- poverty incidence has dropped:
  - the incidence of poverty (numbers of households below the poverty line) in project villages decreased from 31.5 percent in 1995 to 21.3 percent in 1997, which is 4.5 percentage points more than that in non-project villages. Poverty has been reduced faster in project villages than in non-project villages. In terms of the impact on income, SWPRP results show a higher rate of increase of net income at project villages.

- targeting has been effective:
  - the survey confirms targeting has been successful in terms of village coverage and the selection of households with lower income, through it

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92 The poverty monitoring system is a core part of the institutional component in this project to examine and test the effectiveness of a multi-sectoral poverty reduction project.
showed the households around the poverty or just below the poverty line were most likely to be included in the project.

- infrastructure construction and social service development have been successful:
  - it was found that project villages had made great progress in the infrastructure construction and social service development, such as power and water supplies, road building, primary schools and clinics using participatory methods.

**Participatory Methods for Poverty Alleviation Projects**

123 Participatory rural development differs from the poverty-relief method used in the past. By the traditional method, poverty-alleviation was mainly dependent on government support and poverty-stricken farmers were passive relief recipients. Participatory projects emphasise and encourage community participation by villagers and households in the whole process of decision making and implementation. Villagers' active participation is considered crucial for solving the issue of poverty once and for all and for maintaining sustainable rural development. In the late 1990s, some pilot projects based on participatory principles and run by the Poverty-Alleviation Office have proved successful.

124 In its broad sense, participation is both a means and an end for the strategy of poverty reduction. As an end, it is the fulfilment of basic human needs, since the poverty-stricken people should be the subject of development and have a role in decision-making in the processes that shape their lives. As a means to an end, participation makes it possible for the poor to attain their social and economic objectives in the context of development. The use of participatory methods in PRC is innovative and important for exploring mechanisms for more effective targeting sustainability.

**Microfinance**

125 The introduction of microfinance is also new approach in PRC. With the targeting policy refocusing on individuals in late 1990s, it has been introduced and well accepted. Following the microfinance model of Grameen Bank in Bangladesh, a group of rural policy researchers and local activists started-up the microcredit project in north PRC. Their exploration focused on two main concerns facing PRC rural financial institutions: sustainability and outreach to poor rural women. The strict procedure of loan programme includes group formation, peer review, phased loans, saving mobilisation, weekly loan repayment, transparent transactions, and group responsibility.

126 The characteristics of microfinance programmes in PRC so far indicate:

- targeting is effective with procedures ensuring that the projects directly reach the poor, in particular the poorest rural women;
PRC Poverty Reduction Approaches and Experience

- repayment is good at around 95 percent repayment on time. According to CICETE/UNDP\textsuperscript{93} annual report about microcredit in 35 counties in 1998, the portfolio in arrears was 1.198 percent;

- the recent start-up of most microcredit projects in PRC means that they have yet to achieve financial sustainability.

127 In recent years, the PRC government has begun to accept microfinance and is beginning to encourage scaling up.

Future Developments

The Emerging Challenges

128 While the PRC poverty reduction programme has been extraordinarily successful, the emerging challenges are difficult because they cannot easily be solved only through investment or through economic growth, the engines of success so far. Specifically:

- For the remaining 34 million hard core poor, half are said to lack access to productive land, 25 percent have land but lack water, and 25 percent live in remote mountainous regions.

- Low levels of economic and social infrastructure and human resource development inhibit effective poverty reduction in remote mountainous areas, often occupied by minority nationalities. Only three-quarters of children in the central provinces and one-third in the western provinces receive the mandated nine years basic education.

- Many of the poor are still barely above the poverty line, and remain vulnerable to economic or environmental shocks such as declining agricultural prices, outmigration of able bodied labour and flooding.

- There are more than 120 million rural unemployed, growth in productivity is increasingly difficult to achieve, and falling product prices have resulted in depressed annual growth of about 1 percent. In mountainous areas development is hampered by low levels of farmer education, and the need for significant investment in erosion control.

- There is increasing inequality between rich and poor, with urban incomes more than twice those of rural households on aggregate and significant regional differences reflecting the relatively rapid growth of coastal province economies.

- Reform of state-owned enterprises (SOEs) is swelling the ranks of the unemployed. Under a reform programme started in 1996, lay-offs from SOEs had reached about 18 million by the end of 1998 are expected to continue to grow at 4 to 5 million per year to the end of 2000.

- Urban poverty is rising as a consequence of SOE lay-offs, the dismantling of the traditional benefits such as housing and social welfare and from the in-migration of rural people.

129 These factors, together with the opportunities to improve targeting, sustainability and governance need to be addressed in future poverty reduction. From the analysis of the existing programme, the key issues to be addressed in the future are:

- the definition of poverty and the poverty line;

- improvements in targeting poverty reduction efforts;
improvements in the sustainability of poverty reduction programmes;

improvements in governance in terms of both effectiveness and efficiency; and

bringing to bear relevant international experience in poverty reduction so that PRC programmes can benefit from aid effectiveness and other international research94.

The latter shows that there are many lessons that could be applied to the existing PRC government programmes and many considerations for the future design of government and ODA projects.

The Definition of Poverty and the Poverty Line

The poor county system, while perhaps an effective tool in the past, is now demonstrated to be in need of revision. It is suggested that a sound approach would begin with the identification of the actual location of the poor that would provide the justification for the allocation of resources on a nation-wide basis. The allocation of resources at the county level could be maintained, but every county would qualify for a share of the resource. The resource could be allocated on a per capita basis though this would not necessarily be the most efficient use of central government funding because some counties even though they may have a large poor population may also have a large rich population and a strong revenue base. Therefore, it may be more appropriate to introduce some kind of "means testing" system for counties which would provide support for poverty reduction on a sliding scale related to overall county revenues. It is possible that a minimum level of per capita public expenditure in poor areas (focused on economic and social infrastructure) could be agreed at the county level, and that in addition to entitlements on the "means tested" basis additional funding could be made available for counties that exceeded the targets on a pro rata basis. Significant research effort is needed to develop these ideas and should be initiated with a proper analysis of the distribution of the poor and the existing composition of local government spending.

In due course this approach could be refined further. At the county level targets for different poverty and quality of life indicators could be set (for example literacy, child mortality, life expectancy etc) within the context of mini county level development plans (similar to the comprehensive development frameworks (CDFs) being developed at a national level with the World Bank in some countries95). Funding could then be allocated in relation to achieving these development targets.

PRC’s universal income poverty line of about USD 0.66 per day is below the international standard of USD 1 per day and has been set in relation to available government resources. The definition of income poverty needs to be reconsidered taking account of rural, urban and regional differences in consumption and expenditure patters, prices and terms of trade and the resulting lines used as the

94 See paras 95-113 of appendix A5 “International Poverty Reduction Approaches and Experience”
95 See appendix A5 “International Poverty Reduction Approaches and Experience”
basis for identifying the poor population within counties, in turn giving rise to county allocations of central government poverty reduction funding. Provincial governments providing funding to counties would use the same method. While it is recognised that it will be politically difficult for the government following the success of the 8/7 programme to redefine absolute poverty and in doing so again increase the number of absolute poor, the introduction of higher poverty lines is necessary if future targeting is to be effective. Some countries have two poverty lines: an absolute poverty line and a relative poverty line. Others address specific segments of the population such as the poorest ten percent. There is much merit in this latter approach because it creates a long-term agenda independent of income levels and can be used to tackle the needs of the poor as well as the absolute poor.

**Improvements in Targeting, Sustainability and Governance**

134 Changing the definition of poverty and the poverty line are both potentially good ways to improve targeting because the poor population (including the urban poor) will be more clearly identified and the poverty line more sensitive to regional and urban/rural differences.

135 It is difficult to improve targeting in the subsidised loan programme because of its inherent biases to lend to enterprises rather than individuals and the pressures on ABC staff that encourage them to lend to the non-poor. The subsidised loan programme is in fact counter-productive in addressing poverty reduction and needs to be phased out in favour of more market oriented banking services and microfinance mechanisms.

136 Improving the additionality of the food for work programme and the development funds programmes is problematic without transparency in local government spending. Eventually the programme could become part of county level CDFs, but transparency in budgeting and audit of local government expenditure are prerequisites for improving targeting.

137 All components of the present government poverty reduction programme are not self-sustaining. They are sustainable for as long as the government contributes the resources. However, sustainability of certain elements of the programme could be substantially improved. The phasing out of the subsidised loan programme and the introduction of market based banking services for the poor is the first step and will have the greatest impact in terms of freeing up central poverty reduction funding for the development of other non-recoverable investments such as in education and health.

138 Good governance is central to poverty reduction. PRC has established a national network of Poor Area Development Offices (PADOs) and the commitment to poverty reduction is strong. PRC is unique in this level of commitment. However, as local governments have been required to become financially self-reliant, many are focused on growth and revenue issues rather than poverty reduction. This has led in
many areas to the poor being denied access to centrally allocated poverty funds that have been diverted to other purposes.\textsuperscript{97}

139 In terms of effectiveness, there are opportunities to improve impact on poverty through the adoption of policies that result in greater self-sustainability and the testing and roll-out of sectoral project design guidelines that draw on recent PRC and international experience. In terms of efficiency, there are opportunities to improve targeting, reduce leakage, and leverage and crowd in resources for selected investments.\textsuperscript{98}

**Bringing to Bear International Experience**

140 It is important to develop widespread ownership of new ideas being introduced in PRC for poverty reduction, both on a project basis and in the government's own programmes. International agencies supporting the PRC poverty reduction effort would like to see the ownership of new paradigms evident not only at national level but at provincial and local government levels so that they have confidence in the governance of projects at the implementing agency level.

141 To do this, central government through LGOP will need to develop an education and awareness programme at the provincial and county levels, eventually on a national scale. The first steps will involve developing this awareness and applying the international lessons learned in selected project initiatives and in the pilot testing of new approaches such as CDFs, social investment funds, challenge funding and parallel financing. Subsequently, case study material from these initiatives can support promotion of successful ideas nation-wide. This process will take several years, partly in order to learn from the successful interventions using new methodologies and partly because the new methodologies themselves will take time to be understood at local government level because they are less prescriptive and formulaic than the present approaches.

**The Role of the Leading Group Office for Poverty Alleviation and Development**

142 Examples of the key roles that LGOP could play in the future include:

- redefinition of the income poverty line to address the shortcomings in the present definition;

- development of indicators for the wider definition of poverty and development of poverty measurement techniques that help to capture the status of poverty in relation to the wider definition;

- piloting of new funding mechanisms and sources that can supplement budgetary resources and may in due course justify the more rapid reduction in relative poverty through the greater and more efficient application of such resources;

\textsuperscript{97}See paras 77-108 of appendix A6, “PRC Poverty Reduction Approaches and Experience”

\textsuperscript{98}These are more particularly described in Chapters 3, 4 and 5 of this report covering microfinance, voluntary rural mobility, agroindustry and rural infrastructure.
• pilot and in due course roll out more sustainable designs for poverty reduction, particularly in the areas of rural finance and microfinance;

• the development and replication of the means for better targeting and impact of poverty reduction funding involving policy measures, organisational systems and sectoral guidelines for better project design;

• foster better governance at the provincial and sub-provincial levels in the use and management of poverty reduction funds from both government and other sources; and

• a role in the overall management of any new funding mechanisms adopted nationally.

143 These roles can be integrated with ODA country assistance strategies for poverty reduction on an agency by agency basis, helping programmes to be government rather than donor driven, while specific design lessons from international experience\textsuperscript{99} can be incorporated into the government’s own projects.

\textsuperscript{99} See paras 23-30 of appendix A5 “International Poverty Reduction Approaches and Experience”
## End Table 1  Poor Population Estimated by SSB (1978-1995)

<table>
<thead>
<tr>
<th>Year</th>
<th>Rural Population (000)</th>
<th>Poor Population (000)</th>
<th>Proportion (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978</td>
<td>803,200</td>
<td>250,000</td>
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</tr>
<tr>
<td>1984</td>
<td>843,010</td>
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<tr>
<td>1985</td>
<td>844,200</td>
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</tr>
<tr>
<td>1986</td>
<td>850,070</td>
<td>131,000</td>
<td>15.5</td>
</tr>
<tr>
<td>1987</td>
<td>857,130</td>
<td>122,000</td>
<td>14.3</td>
</tr>
<tr>
<td>1988</td>
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<td>11.1</td>
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<tr>
<td>1989</td>
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<td>1990</td>
<td>895,900</td>
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</tr>
<tr>
<td>1991</td>
<td>905,250</td>
<td>94,000</td>
<td>10.4</td>
</tr>
<tr>
<td>1992</td>
<td>911,540</td>
<td>80,000</td>
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</tr>
<tr>
<td>1993</td>
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<td>-</td>
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<tr>
<td>1994</td>
<td>915,190</td>
<td>70,000</td>
<td>7.6</td>
</tr>
<tr>
<td>1995</td>
<td>916,750</td>
<td>65,000</td>
<td>7.1</td>
</tr>
<tr>
<td>1996</td>
<td>919,410</td>
<td>58,000</td>
<td>6.3</td>
</tr>
<tr>
<td>1997</td>
<td>915,140</td>
<td>50,000</td>
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</tr>
<tr>
<td>1998</td>
<td>915,250</td>
<td>42,000</td>
<td>4.6</td>
</tr>
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</table>

## End Table 2  Funding Amounts for Three Main Poverty Programmes, 1986-1998 (million Yuan)

<table>
<thead>
<tr>
<th>Year</th>
<th>Subsidised Loans</th>
<th>Food-for-Work</th>
<th>Budgetary Grants</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>2,300</td>
<td>900</td>
<td>1,000</td>
<td>4,200</td>
</tr>
<tr>
<td>1987</td>
<td>2,300</td>
<td>900</td>
<td>1,000</td>
<td>4,200</td>
</tr>
<tr>
<td>1988</td>
<td>2,900</td>
<td>100</td>
<td>1,000</td>
<td>4,300</td>
</tr>
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<td>1989</td>
<td>3,000</td>
<td>600</td>
<td>1,000</td>
<td>4,600</td>
</tr>
<tr>
<td>1990</td>
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<td>1,800</td>
<td>1,000</td>
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<td>1,600</td>
<td>1,000</td>
<td>6,700</td>
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<td>3,500</td>
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<td>1993</td>
<td>4,500</td>
<td>4,000</td>
<td>1,200</td>
<td>10,700</td>
</tr>
<tr>
<td>1994</td>
<td>4,500</td>
<td>4,000</td>
<td>1,300</td>
<td>10,800</td>
</tr>
<tr>
<td>1995</td>
<td>5,500</td>
<td>4,000</td>
<td>2,800</td>
<td>15,000</td>
</tr>
<tr>
<td>1996</td>
<td>8,500</td>
<td>5,000</td>
<td>3,300</td>
<td>18,300</td>
</tr>
<tr>
<td>1997</td>
<td>10,000</td>
<td>5,000</td>
<td>3,300</td>
<td>18,300</td>
</tr>
<tr>
<td>Total</td>
<td>57,600</td>
<td>29,900</td>
<td>18,000</td>
<td>105,500</td>
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## End Table 3  Repayment Performance of Poverty Loans

<table>
<thead>
<tr>
<th>Year</th>
<th>Poverty Loan Type</th>
<th>Loans due (billion yuan)</th>
<th>Timely Repayment Rate (percent)</th>
<th>Outstanding overdue loans since 1986</th>
<th>Accumulated defaulted loans since 1986</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Overdue loans (billion yuan)</td>
<td>Overdue loan rate</td>
<td>Defaulted loans (billion yuan)</td>
</tr>
<tr>
<td>1991</td>
<td>Total</td>
<td>1.73</td>
<td>53</td>
<td>2.45</td>
<td>142</td>
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<tr>
<td></td>
<td>ABC subsidised loans</td>
<td>1.04</td>
<td>55</td>
<td>1.42</td>
<td>136</td>
</tr>
<tr>
<td></td>
<td>PBC poverty loans</td>
<td>0.33</td>
<td>51</td>
<td>0.52</td>
<td>158</td>
</tr>
<tr>
<td></td>
<td>ABC regular poverty loans</td>
<td>0.15</td>
<td>63</td>
<td>0.27</td>
<td>181</td>
</tr>
<tr>
<td></td>
<td>County enterprise loans</td>
<td>0.21</td>
<td>39</td>
<td>0.24</td>
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<tr>
<td>1992</td>
<td>Total</td>
<td>2.35</td>
<td>55</td>
<td>3.42</td>
<td>145</td>
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<tr>
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<td>ABC subsidised loans</td>
<td>1.40</td>
<td>57</td>
<td>2.03</td>
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<td>PBC poverty loans</td>
<td>0.45</td>
<td>47</td>
<td>0.71</td>
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<td></td>
<td>ABC regular poverty loans</td>
<td>0.18</td>
<td>57</td>
<td>0.27</td>
<td>149</td>
</tr>
<tr>
<td></td>
<td>County enterprise loans</td>
<td>0.31</td>
<td>57</td>
<td>0.40</td>
<td>128</td>
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<tr>
<td>1993</td>
<td>Total</td>
<td>2.93</td>
<td>48</td>
<td>4.00</td>
<td>137</td>
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<tr>
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<td>ABC subsidised loans</td>
<td>1.83</td>
<td>51</td>
<td>2.43</td>
<td>133</td>
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<tr>
<td></td>
<td>PBC poverty loans</td>
<td>0.51</td>
<td>37</td>
<td>0.78</td>
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<td>ABC regular poverty loans</td>
<td>0.20</td>
<td>70</td>
<td>0.28</td>
<td>141</td>
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<tr>
<td></td>
<td>County enterprise loans</td>
<td>0.38</td>
<td>36</td>
<td>0.52</td>
<td>135</td>
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</table>


## End Table 4  Repayment Rate of Subsidised Loans

<table>
<thead>
<tr>
<th>Year</th>
<th>Repayment Rate (%)</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>65</td>
<td>Zhou, 1993</td>
</tr>
<tr>
<td>1991</td>
<td>53</td>
<td>CSTC, 1995</td>
</tr>
<tr>
<td>1992</td>
<td>55</td>
<td>CSTC, 1995</td>
</tr>
<tr>
<td>1993</td>
<td>48</td>
<td>CSTC, 1995</td>
</tr>
<tr>
<td>1996</td>
<td>43.95</td>
<td>CADB, 1998</td>
</tr>
<tr>
<td>1997</td>
<td>61.93</td>
<td>CADB, 1998</td>
</tr>
</tbody>
</table>

## End Table 5  Change in Net Per Capita Income of Rural Residents for the Country as a Whole and for Poor Counties

<table>
<thead>
<tr>
<th>Year</th>
<th>National Average (Yuan)</th>
<th>Poor Counties (Yuan)</th>
<th>Per capita income of poor counties compared to national average (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>784.00</td>
<td>416.69</td>
<td>53.15</td>
</tr>
<tr>
<td>1993</td>
<td>992.00</td>
<td>483.70</td>
<td>48.76</td>
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<tr>
<td>1994</td>
<td>1221.00</td>
<td>648.30</td>
<td>53.10</td>
</tr>
<tr>
<td>1995</td>
<td>1577.70</td>
<td>823.90</td>
<td>52.22</td>
</tr>
<tr>
<td>1997</td>
<td>2090.10</td>
<td>1240.00</td>
<td>59.33</td>
</tr>
<tr>
<td>1998</td>
<td>2160.00</td>
<td>1318.00</td>
<td>61.02</td>
</tr>
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</table>
Summary

Introduction
Capital Accumulation and the Importance of Sustainability
Definitions of Microfinance
Outreach

The Evolution of Rural Microfinance
Informal Finance
Directed Poverty Lending
The Emergence of Microfinance
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The Lessons
Summary

This paper defines poverty and poverty reduction and provides a rationale for the objectives of efficiency and sustainability in poverty reduction programmes. Two definitions of microfinance are then discussed and the conceptual link between microfinance and microenterprises is established. The main features of microfinance programmes and aspects of programme outreach are reviewed. A brief history of microfinance is provided, including a review of informal finance and directed poverty lending. An overview of economic conditions in Latin America and Asia is provided and then a review of international experience in microfinance focusing on these two regions is undertaken by type of microfinance organisation. The types examined include government owned banks, specialised microfinance banks, commercial banks, non-governmental organisations (NGOs), non-banking financial intermediaries, credit unions and co-operatives, village banks and stand-alone government and donor microfinance programmes. Case studies are provided to illustrate points of best practice for microfinance that will effectively reduce poverty and lessons are drawn for consideration in the People's Republic of China (PRC) context.

Poverty can be defined as a lack of the human, social and physical capital required for economic well being, and poverty reduction as the transfer to and accrual by the poor of human, social and physical capital to the point at which their economic well being can be assured. Microfinance can transfer physical, human and social capital, and represents a potentially efficient and sustainable poverty reduction mechanism. Efficiency is important because of scarcity of resources. Sustainability is important because accrual of human, social and physical capital by the poor is a long-term process.

A useful conceptual link between poverty reduction and microenterprises can be made, since many poor people are employed in such enterprises. A financial systems approach advocates sustainable provision of financial services to microenterprises to address poverty reduction, income improvement, productivity growth and sustained employment.

Microfinance methodologies incorporate innovations that reduce lending costs and risks and serve poor clients without normal collateral requirements on a sustainable basis. These innovations characterise microfinance and include: small loans for short periods with frequent repayments and little or no collateral; incentives for good repayment; high real interest rates that cover costs; large loan portfolios per loan officer with financial incentives for good performance; decentralised and simple lending procedures and close client supervision; and high loan repayment rates, often of 95 percent of more.

Proponents of using agricultural development banks for microfinance delivery hope to take advantage of their rural infrastructure and experienced personnel, rather than going to the time and expense of creating new microfinance institutions. However, the vast majority of these banks have failed to serve the rural poor and be self-sustaining, because of their project-based programmes, subsidised loan interest rates, high transaction costs, lack of savings services and overall lack of attention to their own sustainability. The success of the exceptions has required a dynamic agricultural sector; macroeconomic equilibrium and a sound fiscal system committed...
to reform; a legislative, regulatory and supervisory framework; and an autonomous and healthy institution with good loan portfolio quality, independent programme design and implementation, competent staff, and an appropriate information system. In PRC, the only candidate for this role, the Agricultural Bank of China (ABC), is currently characterised by a lack of autonomy, poor quality loan portfolio, lack of expertise in microfinance, and unsuitable information system.

Banks specialising in microfinance have started to make their appearance internationally. Most of these are NGOs that have made or are making the transformation into banks. The advantage of this approach is the firm commitment the new bank brings to microfinance. The disadvantage is that the transformation from NGO to bank is a slow, difficult and costly process requiring investment in information technology, changing the corporate culture and overcoming minimum capital barriers established under local law. Given their generally small size and limited capacity for sustainability, only a small fraction of NGOs can make the transition. There are no existing specialist microfinance banks in PRC and no clear candidates for a transformation into a specialist microfinance bank.

Commercial banks typically cite high risk, high costs, low profitability and cultural barriers as the chief reasons that prevent their entry into microfinance. Commercial banks also face some internal constraints. However, commercial banks have organisational and structural features that lend themselves to successful microfinance operations: they are regulated institutions under prudent management; many have the branch networks to enable them to reach a large number of clients; they have well-established internal controls and administrative and accounting systems; their private capital ownership structures tend to encourage sound governance structures, cost-effectiveness, profitability, and sustainability; they have access to their own sources of funds (deposits and equity); and their ability to offer loans, deposits, and other financial products make them attractive to microfinance clients. The main lessons of commercial banks that have successfully entered the microfinance market are: committed and visionary leadership is required; profit must be the principal motivation; there must be a strategic fit between the bank and the new market; successful microfinance operations require a different set of operating procedures, extensive investments in appropriate information technology, training, staff incentives, a wide network of bank offices and hours of operation convenient for microfinance clients; and managers need to focus on operational efficiency and delinquency control as part of profit generation. The model of the commercial bank that establishes a new microfinance subsidiary is of interest in the PRC context because of the lack of a good fit between microfinance operations and the existing corporate culture of PRC commercial banks, and the lack of existing microfinance institutions large enough to be capable of moving into this role.

NGOs have developed methodologies that are key to the success to date of microfinance in addressing poverty reduction. However, many NGOs have experienced serious problems of sustainability, suggesting there may be serious flaws in the NGO approach. The most successful and advanced microfinance providing NGOs transform themselves into regulated financial institutions. Using NGOs as a major component of broad-based provision of microfinance services in PRC is problematic, because of the quasi-legal status of existing microfinance projects in the country and the small size of all existing pilot microfinance projects.
Specialised non-bank financial intermediaries for microenterprises may take the form of finance companies, private financial funds, or other legal forms. Their common characteristic is that they are not considered banks under local legislation and so are exempt from minimum capitalisation requirements and the strict regulatory and supervisory regime applied to banks. Recognition that microfinance organisations have special organisational and operational characteristics that flow from the unique nature of their loan portfolios is important in the PRC context.

Credit Unions do not exclusively target the poor or define their mission as serving the poor. However, they feature many of the characteristics of good microfinance providers and have competed successfully with other microfinance providers because they: tie savings to loans to maintain balanced growth; can establish operational self-sustainability in rural areas; are part of a world-wide network that has created its own industry standards; can react to financial market reforms and to new demands and competition; and depend upon each other to achieve economic benefits. Lessons include: self-help groups, independently established, can be operated in a financially prudent, self-sustaining manner without the imposition of regulation from outside; and such institutions serve a valid financial intermediary role in rural areas.

Village banks are intermediaries between the sponsoring agency, which makes one loan to the village bank, and the member/borrowers. Credit to members is linked to savings, and loan sizes to the amount saved by each borrower. Evaluation of village banking programmes indicates that their benefits are both economic and social. The village bank model is of interest in the PRC context because it offers a way to link a larger organisation, such as a commercial bank, with a specialised microfinance institution based at the local level.

Government and donor programmes for provision of financial services to the poor are operated in many countries. These may evolve into microfinance banks or a variety of other organisational types. These types of programmes tend to suffer all the problems attributed to government-operated subsidised credit programmes, including high default rates, lack of sustainability and the suppression of the development of a viable rural financial infrastructure. In the PRC context, such programmes have in most areas outworn any emergency or humanitarian justification they may originally have had and in most areas are now preventing the development of a permanent financial infrastructure.
Introduction

Capital Accumulation and the Importance of Sustainability

1 Poverty has been defined in many ways. Early definitions related to the income of poor people, often related to calorie intake requirements or a bundle of goods. Later definitions have taken account of wider aspects of poverty, including education, gender equality, infant and maternal mortality, health and the environment. In general, however, poverty is accepted as a lack of the human, social and physical capital required for economic well being. It is “the deprivation of material requirement for minimally acceptable fulfilment of human needs”.

2 Therefore, poverty reduction therefore consists of the long-term transfer of human, social and physical capital to the poor, and its accrual to the point at which their economic well being can be assured. Microfinance systems can transfer not only physical capital, but human and social capital as well, and is a potentially efficient and sustainable mechanism to achieve this transfer.

3 Efficiency is important because of scarcity of resources. In 1995, out of more than 500 million profitable micro and small businesses world-wide, less than 2 percent had access to financial services from sources other than money lenders. About 95 percent of the approximately 900 million poor people in the Asia Pacific region have little access to institutional financial services. If 30 percent of all low-income entrepreneurs were to gain access to institutional finance, financial intermediaries’ total worldwide loan portfolios in microloans would expand from USD 2.5 billion (in 1995) to about USD 90 billion. Such an increase in funds on loan in the form of microloans will be achieved by about 2005, given current growth trends. The main challenge, therefore, will be in expanding the capacity and resources of financial intermediaries providing microfinance services, including lending and savings services. Inefficient use of resources cannot be tolerated if these targets are to be met.

4 Sustainability is important because sufficient accrual of human, social and physical capital by the poor cannot be accomplished within one or two years. Achieving an income that exceeds the poverty line is not sufficient to assure long-term economic well being: only accumulation of capital can provide this assurance. Because they start from such a low base, the poor require many cycles of investment and return to accumulate the necessary amount of capital. A long-term sustained effort is thus mandatory. Short-term, “project” approaches are almost certain to have no lasting impact on poverty reduction: even those that manage to bring the poor above the poverty line, as defined by income measures, will fail to provide the poor with sufficient capital to withstand the first natural disaster, business downturn or family emergency that occurs.

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1 Refer to paras 1-5 of appendix A1, “International Poverty Reduction Approaches and Experience”.
2 World Bank, 1999, “Understanding and Responding to Poverty”.
4 CGAP, 1995, Focus Note No 3.
5 Asian Development Bank, 1999, “Microfinance Development Strategy (Draft)”. 
The Social Dimension – Grameen Bank, Bangladesh

The ability of microfinance programmes to help the poor is well known. Perhaps the most visible is the highly successful experiment based on mutually liable, self-regulating borrower groups of the Grameen Bank in Bangladesh. An equally important but less well known development benefit of these programmes is their contribution to building social capital – they build relationships, networks, and formal and informal institutions that link individuals and help them achieve specific objectives. Microfinance institutions also influence how markets operate, and they shape the relationship between civil society, the state and markets.6

The social orientation of the Grameen Bank’s work is illustrated by its “16 Decisions”7, listed below.

- We respect the four principles of the Grameen Bank – we are disciplined, united, courageous and workers – and we apply them to all our lives.
- We wish to give our families good living standards.
- We will not live in dilapidated houses. We repair them and work to build new ones.
- We cultivate vegetables the whole year round and sell the surplus.
- During the season for planting, we pick out as many seedlings as possible.
- We intend to have small families. We shall reduce our expenses to a minimum. We will take care of our health.
- We educate our children and see that they can earn enough money to finance their training.
- We see to it that our children and homes are clean.
- We build latrines and use them.
- We only drink water drawn from a well. If not, we boil the water or we use alum.
- We will not accept a marriage dowry for our son and we do not give one to our daughter at her marriage. Our centre is against this practice.
- We cause harm to no one and we will not tolerate that anyone should do us harm.
- To increase our income, we make important investments in common.
- We are always ready to help each other. When someone is in difficulty, we all give a helping hand.
- If we learn that discipline is not respected in a centre, we go along to help and restore order.
- We are introducing physical culture in all centres. We take part in all social events.

Definitions of Microfinance

5 Poor people lack access to institutional credit for investment and consumption needs. They also lack access to safe savings vehicles to smooth consumption, save for lump-sum expenses and build investment capital, and to other services such as payment transfer services and insurance.

6 Microfinance is usually defined as the provision of financial services, including credit, savings and other services, to low-income clients8, who are often engaged as labourers, in marginal farming or in very small enterprises in the informal sector. The Asian Development Bank (ADB) defines microfinance as “the provision of a broad range of financial services such as deposits, loans, payment services, money transfers and insurance to the poor and low-income households and microenterprises”9.

7 Some attempts have been made to more closely define the income levels of microfinance clients, usually in relation to poverty levels or per capita gross domestic

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7 Grameen Bank website.

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product (GDP). The Consultative Group to Assist the Poorest (CGAP) defines microfinance as lending to the poor, defined as those living below the official poverty line in each country, while "the poorest" are defined as those living below 50 percent of the poverty line. However, despite targeting low-income clients, "microfinance is not charity, but investment".

Some useful conceptual links have been made between microfinance and microenterprises. In this context, microfinance sets out to stimulate the growth and development of microenterprises through the provision of financial services. The Inter-American Development Bank (IADB) defines microfinance as the provision of financial services to microenterprises, which in turn defines as businesses with less than 10 employees. These include one-person enterprises (that is, self-employment). Microenterprises may be small, but their cumulative impact is huge: microenterprises employ more than 120 million people in Latin America. Yet less than five percent of microenterprises have access to formal sources of financial services.

### Microenterprises in Latin America

More than 80 percent of the jobs in Latin America and the Caribbean are provided by enterprises with less than 10 workers, and 50 percent of these are family-run businesses. Particularly fast-growing are small businesses owned by women. Up until the 1970s, however, the microenterprise sector was viewed as "informal" and was seen as an (often illegal) underground economy of tax avoiders, criminal activity and disguised unemployment. During the 1970s, however, the view of microenterprise changed to one where it was seen as beneficial in that it provided employment for the poor. Most recently, this has changed again, from viewing microenterprise as a survival tactic of the poor to viewing it as a legitimate business activity. The new view is that microenterprises are not passive beneficiaries to be assisted, but clients who deserve appropriate services from governments, banks and others.

### Financial Systems Approach

A financial systems approach to provision of financial services to microenterprises advocates sustainable provision of financial services to address poverty reduction, income improvement, growth in productivity and sustained employment. Under this approach, financial institutions need to: adopt a market perspective that is responsive to the preferences and needs of the target group; recognise that savings are as important as credit for microenterprises; and insist on their own financial viability.

### Summary of Features

The features that microfinance institutions attempt to achieve can be summarised as:

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• easy access and minimum transaction cost to clients;
• reduced or eliminated restrictions on the use of borrowed funds;
• repayment of loans on terms convenient to borrowers according to their cash flow;
• interest rates and charges that are not exorbitant but which cover the costs of service provision including operations costs, cost of funds and loan losses;
• innovative repayment motivators and replacement of traditional collateral with alternatives;
• peer monitoring based on local knowledge;
• encouragement of savings, and provision of savings services in addition to credit services; and
• low administration costs\textsuperscript{16}.

11 Many of these features require ongoing and concerted effort on the part of microfinance providers. Current thinking is that only the pressure to become self-sustainable provides the impetus to achieve this ongoing and concerted effort, and microfinance providers that attempt to achieve these features using only administrative motivations are unlikely to succeed.

12 Microfinance providers (Microfinance Institutions, or MFIs) include government owned banks, specialised microfinance banks, commercial banks, NGOs, non-banking financial intermediaries, credit unions and banking co-operatives, village banks and stand-alone government and donor microfinance programmes\textsuperscript{17}. ADB divides providers of microfinance services into three main types\textsuperscript{18}: formal institutions, semi-formal institutions such as NGOs, and informal sources such as money lenders and shopkeepers. Successes and failures can be found in each type of MFI.


\textsuperscript{17} Almeyda G and Branch B, 1999, "The Case of Union Popular and Union Progresista Amatitlaneca (UPA) Credit Unions", Case Studies in Microfinance.

\textsuperscript{18} Asian Development Bank, 1999, "Microfinance Development Strategy (Draft)".
Outreach

13 Outreach is generally broken down into six aspects:

- **depth** refers to the ability of microfinance to reach the poorest of the poor;
- **breadth** refers to the number of clients;
- **length** is the length of time over which the microfinance provider offers financial services;
- **scope** or variety refers to the number and kind of services that are offered;
- **worth** or quality refers to how valuable microfinance services are for particular clients; and
- **cost** is a measure of how expensive these services are for the client, including price and transaction costs.\(^{19}\)

14 Depth is central to the question of the usefulness of microfinance in poverty reduction. Whether microfinance is capable of reaching the poorest of the poor is one of the most hotly debated topics in microfinance at present. This debate centres on whether microfinance should be targeted exclusively at the very poor, or whether it has a wider financial system function. Evidence suggests that providing self-sustainable microfinance services to the poorest of the poor is very difficult\(^{20}\), but no final conclusions have yet been reached. Some microfinance institutions have targeted the poorest of the poor but have not achieved self-sustainability. Others have targeted a range of income groups, including the very poor, and have achieved self-sustainability. Demand for microfinance services is a result of their worth being greater than their cost. This is the situation for successful microfinance providers that find that demand for their services outstrips their ability to supply those services. Because of economies of scale, breadth is related to sustainability, which in turn is the key to the length of time that services can be offered. Scope matters because credit is not the only microfinance service that is of importance to clients. Focusing on credit does not take account of the central role of savings for the poor in accumulating capital.

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The Evolution of Rural Microfinance

Informal Finance\(^1\)

15. The rural poor use informal financial services for the same reasons as they may use formal sources of financial services: to increase their productive capacity, share risks and smooth consumption.\(^2\) Informal financial transactions can be defined as those that are not regulated by central bank regulatory authorities. Informal financial services, including credit and savings services, can be classified into three categories: individuals specialising in lending and/or savings services, such as moneylenders or savings collectors; personal or business relations, including extended family members; and organisations such as rotating savings and credit associations (ROSCAs) providing full financial intermediation.

16. Moneylending covers a wide range of financial arrangements with interest in the range of 0 to 100 percent per month. While a few registered, professional moneylenders exist in some countries, most commercial moneylending is undertaken as a part-time activity, using surplus funds from other sources such as a trading business.

17. Savings collectors are common in West Africa. They take regular deposits (often daily or weekly) of an amount determined by each client and return the accumulated sum at the end of a stipulated period (usually a month), minus 1 day's deposit as commission. These 'mobile bankers' form a symbiotic relationship with market traders, protecting their daily earnings from competing claims and ensuring working capital to restock supplies at the end of the month. They sometimes extend 'advances' to their clients before the end of the month and occasionally lend to non-clients, though lending is constrained by their lack of a capital base other than monthly collections.

18. ROSCAs are pervasive in most countries. ROSCAs are closed membership groups where all members pay set amounts at regular intervals (monthly, weekly or daily) to a common pool, which is taken by each member in turn (in a fixed order, randomly or by bidding). All recipients but the last receive the pooled sum sooner than if they had saved the same amounts alone. Some ROSCAs continue over long periods and develop supplementary insurance, loan and welfare funds or save toward a common objective.

19. Traders and shopkeepers often supply inputs or cash advances to farmers, linked to purchase of produce at a discounted price. In many countries, landlords often lend to their tenants.

20. Savings and credit associations raise savings from and make loans to members. A variety of membership organisations come under this heading, sometimes raising money from shares as well as deposits. Unlike ROSCAs, they are relatively large and open to new members. They may be legally registered as a co-operative or the savings and credit arm of a co-operative formed for other purposes.

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Credit unions are registered as such and represent a more formal form of savings and credit association based on share capital. Credit unions are increasingly coming under the regulation of central bank authorities under non-bank financial institution legislation.

21 Informal lenders succeed through information based on personal and social networks. They use bilateral, character-based relationships to achieve high repayment rates without relying on formal collateral or appraisals. They pre-screen clients by focusing on specific groups. By focusing on a narrow niche of known clients, they avoid the high processing and monitoring costs that deter formal financial institutions. Informal methods yield loan administration costs that are, surprisingly, below those of banks operating much larger loans: banks often report operating costs on the order of 12 to 19 percent of amounts loaned, while informal moneylenders and associations are generally under 3 percent (partly because they carry little overhead). Furthermore, repayment rates tend to be higher for informal lenders. Studies indicate that informal agents bear lower relative losses on their small loans than banks do on larger ones, contrary to the common perception that small loans are costly and risky. This indicates that, with appropriate methods, it is possible to efficiently serve market niches that are excluded by the methods of commercial banks.

22 The isolated, personalised nature of informal relationships can provide substantial monopoly power (especially when the legal framework restricts moneylending). This can result in wide differences in interest rates across different segments within the formal sector.

**Directed Poverty Lending**

23 Alarmed at the perceived usurious nature of informal credit, and convinced that rural poverty was primarily due to poor agricultural productivity, many governments during the 1970s and 1980s attempted to direct credit to poor farmers for poverty reduction. These efforts were usually characterised by:

- project-based programmes through government or donor controlled agencies, development banks or agricultural banks;
- provision of funds to farmers, often with credit in a package with other “inputs” such as seed and fertiliser;
- credit for productive purposes only, with loans for consumption and non-farm purposes restricted or prohibited;
- subsidised interest rates for farm loans, with loans for small farmers at particularly low rates;
- no consideration of total transaction cost to the borrower;

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24 As an example, refer to World Bank, 1975, “The Assault on World Poverty – Problems of Rural Development, Education and Health” (quoted in box 1 page 1 of Appendix A2, “PRC Poverty Reduction Approaches and Experience”).
government-sourced funds for lending and little or no savings mobilisation; and

little attention to the sustainability of rural financial institutions\textsuperscript{25}.

Results were mixed, with high default rates and lower than expected adoption of modern agricultural technology. However, the main negative result may have been the suppression of development of a viable rural financial infrastructure. This occurred because the institutions established to provide the credit could not survive without continuous subvention, at the same time as they priced potentially sustainable financial services out of the market. Many of these characteristics are present in the PRC government subsidised loan programme.

**The Emergence of Microfinance**

Microfinance emerged in the 1980s, showing results superior to the old-style agricultural development programmes. The informal nature of microfinance, uncontrolled by governments and donors, allowed the providers of microfinance (often NGOs) to freely innovate. The microfinance institutions themselves designed innovations that enabled them to reduce lending costs and risks and serve poor clients without the collateral normally required. These innovations included:

- small loans mostly for working capital for short periods, sometimes only a few weeks, with frequent repayments;
- incentives for good repayment, primarily guaranteed access to repeat (and sometimes larger) loans;
- high real interest rates, sufficient to cover costs;
- large loan portfolios per loan officer, frequently 75 to 100 groups or 200 to 500 borrowers, with financial incentives for efficiency and good loan portfolio performance;
- little or no collateral, with solidarity group guarantees or assets with high personal use value as collateral;
- decentralised and simple lending procedures and close client supervision; and
- high loan repayment rates, often of 95 percent of more\textsuperscript{26}.

Microfinance has progressed in many areas, particularly Latin America where it has received close attention for many years. In the face of growing evidence that lending to the poor using microfinance techniques can be a profitable activity, microfinance has started to mobilise commercial resources in much the same way as mainstream banking. Again, Latin America is in the vanguard of these developments.


\textsuperscript{26} Yaron J, 1994, “What Makes Rural Financial Institutions Successful?”
A surprisingly large number of Asian countries have made little progress in adopting the new microfinance methodology. Financial reforms and liberalisation programmes have been carried out by most governments over the past decade, in many cases resulting in a general improvement of the policy environment. However, many fundamental problems that existed in the 1970s still exist today, including:

- state-owned banks in many countries operate mandatory credit schemes;
- interest rate subsidies and interest rate ceilings on loans to the poor continue, especially for farmers;
- targeted credit programmes, subsidised refinance funds and restrictions on clientele served still exist;
- the sustainability of financial institutions continues to be secondary, with many weak institutions overburdened with non-performing loans surviving only with government subvention;
- continuing lack of attention to savings mobilisation;
- persistent focus by policy-makers on agriculture instead of rural financial institutions that deliver financial services to the farm and non-farm communities; and
- lack of modernisation in computer and communications facilities to support provision of modern full-service banking.

Other restrictive policies still prevail in many countries and continue to undermine microfinance development. Few policies facilitate partnerships between formal sector financial institutions and NGOs and other community-based, grass-roots organisations to provide microfinance services.

Asia has generally made less progress in commercialising microfinance than Latin America. This is for a variety of reasons including a reluctance to allow market forces to enter this sensitive market, a desire to exclude outside “cultural” influences and other reasons which differ from country to country, including recurrent natural disasters, conflicts, lack of infrastructure, religious prohibition and directed or socialist market economic policies.

The Recent Economic Environment

The economies of Latin America and Asia have experienced prolonged periods of sluggish development, rapid periods of economic progress, monetary and fiscal crises and a gradual return to stability. Although there are profound differences between the regions, and each country has undergone each of these conditions and trends in varying degrees and at differing times, some convergence of experience is evident.

Latin America

31 Currently there are four major influences on microfinance development and poverty reduction efforts in Latin America:28:

- **growing economic integration and competition**, due to closer integration of the region’s economies and an increasing export orientation, forcing greater efforts to increase productivity and quality while reducing costs. Political stability, a favourable macroeconomic climate and relatively cheap land and labour have attracted foreign investment. This is similar to the PRC situation.

- **reduced government spending**, most noticeable in social spending (health and education), the financial system and infrastructure, has led to an increased reliance on market economics, incorporation of new actors such as NGOs, and a search for a new balance between public and private sector responsibilities. Similar re-balancing of costs, benefits and responsibilities are taking place in PRC.

- **increasing degradation of natural resources**, on which the majority of the poor are highly dependent for survival. The links between poverty and destruction of the natural environment have become clearer in recent years and this is leading to changes in rural poverty reduction strategies. Environmental degradation is also a concern in PRC.

- **the relationship between gender, ethnic groups and poverty**. Rural women produce up to 50 percent of the food consumed in the region and now own and operate 30 to 60 percent of all microenterprises. Over 400 indigenous ethnic groups are estimated to total 35 to 40 million people, each with its own language, culture and practices. Studies have shown a close correlation between ethnicity and poverty, with 80 percent of the region’s indigenous population living below the poverty line. PRC also has many ethnic groups, many of which live in poverty.

32 Rural areas are largely devoid of financial services. In order to make rural populations “bankable”, rural financial market development programmes are including support for such things as:

- active enforcement of an appropriate legal and regulatory framework;

- reducing risks associated with investment by promoting insurance, futures markets and hedging;

- reduction of market distortions and government interference in the allocation and pricing of financial assets;

- development of new financial products with appropriate risk control mechanisms;

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• development of a variety of well-regulated and efficient second-tier private financial intermediaries such as co-operatives, rural savings banks, farmers associations and NGOs, which have a presence in the communities and which use methods such as group lending, village banking and revolving fund programmes and which provide savings services; and

• rationalisation of the role and nature of publicly owned financial institutions and designing means of co-operation between formal and non-formal institutions.

Asia

33 During the past three decades, Asia has experienced very high economic growth. Growth has been concentrated in the east and southeast, with countries such as PRC, Indonesia, Korea, Malaysia and Thailand growing at rates of 5 to 10 percent per year. Other regions have also made significant economic progress, with slower-growing countries such as Bangladesh, India, Nepal, Pakistan and Sri Lanka growing at 2 to 5 percent per year. Many countries experienced substantial real increases in per capita income. Many of the high-growth countries at the same time have experienced a transformation of the nature of their economies, with a decline in the importance of agriculture and high growth in industrial and service sector activities.

34 These high economic growth rates had a significant positive impact on poverty reduction in general 29. However, the regional recession that started in mid-1997 reversed the trend of poverty reduction in some Asian countries. The recession had little impact on PRC, beyond a reduction in incoming foreign investment and a decrease in export demand. However, especially in the hardest hit countries of Indonesia, Malaysia, Thailand, Korea and Philippines, economic progress slowed or reversed. After years of poverty reduction effort, the number of people living in poverty in these countries increased substantially almost overnight. Since October 1998, the situation in most countries has improved substantially, and by mid-1999 the worst seems to be over 30. However, in some countries the legacy has been political instability, and a growing disparity between rich and poor.

The Macroeconomic Importance of Microfinancial Services

35 Dominant economic structural characteristics and recent macroeconomic trends have important implications for microfinance policy. Agriculture with limited development of technology and infrastructure remains a vulnerable in many economies to climatic factors and to internationalisation of economies. Poverty indicators in many countries continue to show that the poor are predominantly rural, and diversification of non-farm activities does not only improve household income but also creates a more viable opportunity for risk-taking in agricultural diversification. These activities require small investments at the farm and microenterprise level suited to microcredit.

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36 In parallel, mobilisation of deposits can provide additional resources for local investment and the associated rise in the monetisation of financial resources helps to stabilise currencies. As a result microenterprise and small-scale businesses can gain increased access to finance, providing increased opportunity for economic growth. This in turn can increase government revenues and reduce dependence on external assistance.

The Effectiveness of Microfinance in Poverty Reduction

Government Owned Banks

37 Most traditional commercial banks show little interest in serving the rural poor because of their lack of viable capital and the high transaction costs of the small loans that suit them. In the past three decades, this has led to governments setting-up credit programmes designed to increase access by the rural poor to formal institutional credit. Many of these programmes have been run through government owned agricultural or rural development banks.

38 The vast majority of these banks have failed to achieve their objectives to serve the rural poor and be self-sustainable, because of their project-based programmes that provide credit for productive purposes only, their subsidised loan interest rates with particularly low rates for small farmers, the high transaction costs of their services to borrowers, their lack of savings services and the scant attention they have paid to their own sustainability.

39 While banking systems are strengthened through better supervision, in response to external scrutiny, they have often tended to shift their focus onto their best clients, to improve portfolio performance, rather than reach out to new, smaller clients. Banks continue to have difficulty with small transactions because of high costs, perceived risks, collateral-based methodologies, and strong incentives to lend to the public sector.

40 However, there are some notable exceptions, including the Bank for Agriculture and Agricultural Co-operatives (BAAC) of Thailand and Bank Rakyat Indonesia (BRI) of Indonesia. Proponents of using agricultural development banks for microfinance delivery to rural areas point to these examples as potential models. They hope to take advantage of the rural infrastructure and experienced personnel of these banks, rather than going to the time and expense of creating new microfinance institutions.

41 The population of Thailand in mid 1998 was 61.8 million, with a population density of 119 per square kilometre. The population growth rate in recent years has fallen to about 1.5 percent. About 49 million people (80 percent) live in rural areas. GNP per capita was US$ 2,200 in 1998. Nationally, primary education enrolment is high (97 percent), although the figure is considerably lower for secondary education (40 percent). Adult literacy is high at about 94 percent. Non-agricultural enterprises provide an increasingly important source of income for rural dwellers: for agricultural households, non-farm production accounted for 42 percent of income in 1994, compared with only 9 percent in 1975. Two years after the onset of the East Asian financial crisis, Thailand’s economic prospects have improved significantly. Recovery, though still in its early stages, has been helped by the fiscal stimulus, growing exports, and the rebound in the manufacturing sector. Real GDP is now projected to grow by 3-4 percent in 1999. Both investment and consumption indicators are strengthening, and export as well as import volumes have been growing rapidly.

42 BAAC was established in 1966. The bank's capital came from deposits from the public and commercial banks, shares, capital increases and loans from the Bank of Thailand, Government Savings Bank and foreign bilateral sources.

43 The bank provides financial facilities to assist farmers, farmer's groups and co-operatives to develop farming as a gainful livelihood. The bank provides below market rate loans; guarantees loans or farm credits from other sources; provides deposit services; issues, buys or sells bills of exchange or other transferable instruments; buys government bonds, and other financial services. The bank's policy is to strengthen agricultural co-operatives financial structure; promote group responsibility in acquiring farm credits or bargaining power; provide credits particularly to low-income earners in rural areas; help farmers to solve production, marketing and debt problems; and help farmers to qualify for the bank's long-term investment credits.

44 The bank's branches increased from 118 in 1989 to 364 in 1998, and the number of farm customers has increased from 2,815,441 families in 1989 to 4,325,084 families in 1994. Credit outstanding has increased almost threefold from 33,822 million baht in 1989 to 99,000 million baht in 1994. Operating funds have increased from 48,091 million baht in 1989 to 134,532 million baht last year.

45 As BAAC has adapted to meet the varying needs of a changing market, it has also come to be internationally recognised as one of the few sector-specialised, government-owned rural microfinance institutions which has demonstrated a notable degree of success in carrying out it mandate without substantial need for government subsidies. The most notable features of BAAC's success are its tremendous loan outreach to Thailand's rural poor and its impressive savings mobilisation. BAAC

34 Source: BAAC website.
reaches an estimated 82 percent of all farm families in Thailand and the bank’s average outstanding loan size was US$ 1,161 at the end of 1995.

46 BAAC has developed innovative delivery systems to offer its services with very low administrative costs of about 2.8 percent of total assets and a modest though fluctuating subsidy dependence. Although BAAC’s aggressive expansion of its lending portfolio has brought a vast new clientele into the formal financial sector, limitations on the kinds of activities for which BAAC is legally permitted to lend have led to loan repayment difficulties on some types of loans and have dampened the bank’s overall loan recovery rates. Timely loan repayment rates average 86 percent with much of the arrears balance repaid belatedly, leading to very small eventual loan losses despite an exclusive focus on agriculture and agriculture-related enterprises which are vulnerable to the vagaries of nature and volatile fluctuations in input-output prices.

47 BAAC has funded its substantial loan outreach primarily through vigorous efforts to mobilise rural savings over the last ten years. BAAC’s deposit-to-loan-ratio has increased from 31 percent in 1986 to 78 percent in 1996. Since the mid-1980s, BAAC has increasingly focused on raising voluntary savings in both variable and fixed-term deposit products tailored to the demand of rural Thai clientele. System-wide savings mobilisation efforts in the last decade have tripled BAAC’s share of savings and time deposits held by commercial banks outside the Bangkok metropolitan area, rising from less than three percent to almost 10 percent. Energetic savings mobilisation, which is one of the criteria used by BAAC managers to assess branch staff performance and award bonuses and promotions, has transformed some BAAC branches into self-financing units, wherein deposit growth has outpaced that of credit portfolios.

Indonesia - Transformation of a State-owned Development Bank – BRI

48 Indonesia had a population of 203.7 million in mid-year 1998, with a population growth rate of 1.6 percent. About 62 percent of these live in rural areas. Average gross national product (GNP) per capita is US$ 680. Eighty-five percent of the adult population is literate. With an average growth rate of 7.1 percent between 1985 and 1995, a real GDP growth rate of 7.8 percent in 1996, a poverty reduction from 60 percent of the population to 11 percent, and an overall improvement in general living standards, Indonesia was seen as a "model of development". In the two years since the crisis hit East Asia, Indonesia has been subjected to unprecedented economic, social and political pressures. Over the past six months, the trend has been for the better, with signs of economic stabilisation, the success of the parliamentary elections in June and significant progress made on the broad economic reform program 38.

49 The recession has caused a substantial increase in the number of people living in poverty in Indonesia39. The tremendous social gains made over the past thirty years are at risk of being reversed. Latest estimates show that the number of poor as a share of the population roughly doubled from about 11 percent in 1996 to

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18-20 percent in 1998. The recession has reduced opportunities for employment in the formal sector, forcing more people into the informal sector. Combined with higher poverty, this has increased the number of potential microfinance clients. Simultaneously, the profitability of micro-enterprises has fallen, reflecting increased competition and reduced demand.

50 Indonesia is also a centre of microfinance activity. Most microfinance services in Indonesia are provided by formal financial institutions. BRI Unit Desa system provides most microfinance services and there are a large number of smaller rural banks. There are few specialist private sector microfinance institutions. Some governments (for example, Brazil, India and Tanzania) have attempted to reform existing state-owned development finance institutions to carry out microfinance operations. These reforms are often modelled BRI, which is state-owned. However, the success of BRI is an anomaly among state-owned banks.

51 BRI underwent considerable transformation at a significant cost to become a politically autonomous, client-oriented, well-managed and profitable institution. Several key factors led to its success. These were:

- a stable macro-economic environment;
- strong leadership within BRI to steer the reform effort with unwavering political support from the government;
- considerable and prolonged backing in financial and human resources from the government and external agencies;
- liberal financial sector policy that allowed BRI to design its own products and price them according to cost-recovery principles;
- complete operational autonomy for the unit desas without any government mandates on reaching lending targets of population groups;
- large investment in professionalising the human resource base through staff training, merit-based recruitment and performance incentives; and
- clear and transparent financial reporting and accountability.

52 Of these, two are critical: strong political support and financial and human capital. In the case of BRI, the transformation took place in the context of the broader devolving of the government’s control over the financial sector. In other circumstances, reforming state-owned development banks, particularly on issues such as removal of interest rate subsidies and rigid targeting of certain population groups can prove insurmountable.

**Specialised Microfinance Banks**

53 Banks specialising in microfinance have started to make their appearance in the 1990s. Most of these are NGOs or other non-bank financial institutions (NBFIs) that have made or are making the transformation into banks. Notable examples of

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40 CGAP “State-owned Development Banks in Microfinance”, Focus Note No 10, August 1997.
IADB supported NGOs that have converted into regulated financial entities include PRODEM in Bolivia, ADEMI in Dominican Republic and AMPES in El Salvador\(^{41}\). The advantage of this approach is the firm commitment the new bank brings to microfinance. The disadvantage is that the transformation from NGO to bank is a slow, difficult and costly process requiring investment in information technology, changing the corporate culture and overcoming minimum capital barriers established under local law. Given their generally small size and limited capacity for sustainability, only a small fraction of NGOs can make the transition.

In most cases, these new banks are not regulated and supervised on the same basis as commercial banks. Governments have provided for these institutions on an exception basis, or by changing existing legislation and regulations, or by developing new legislation and regulations. Existing legislation and regulations do not apply to these institutions because their client base and thus their methodology and the nature of their loan portfolio are quite different from those of commercial banks.

The process involved in the transformation from NBFI to bank puts pressure on the organisation, both financially and organisationally, as a more formal approach to the provision of services is adopted. NGOs in particular, because of their predominantly social orientation, have to go through a pronounced attitudinal change to become banks. Some have had to split their operations, retaining social functions in a rump NGO and moving financial services into the newly formed bank.

**Bolivia - From NGO to Bank - PRODEM to BancoSol**

BancoSol\(^{42}\) became the first private commercial bank specialising in microfinance when the Bolivian authorities licensed it in 1992. BancoSol holds only 1 percent of the assets of the Bolivian banking system but serves over one third of the system's borrowers. Its loan portfolio is about five times its equity.

BancoSol is regulated by the Superintendent of Banks, with capital and financial reporting requirements comparable to traditional commercial banks. However, BancoSol is allowed to maintain much simpler loan documentation and is not required to classify its non-guaranteed loans in a high-risk category.

BancoSol was chartered in 1992, but its predecessor PRODEM, a grant-funded non-profit organisation, was founded in 1987. PRODEM developed an effective lending methodology that allowed it to build up a sound loan portfolio. In 1992, PRODEM transferred 14,300 clients and a loan portfolio of US$ 4.0 million to BancoSol, which gave BancoSol an immediate source of revenue and a base from which to expand. BancoSol inherited cost-effective lending methods, experienced, highly motivated staff and a reputation of being a sustainable and serious lender from PRODEM. In addition, it had an important network affiliation with ACCION International.

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59 In 1992 BancoSol embarked on an ambitious growth path. Expansion of its office network and loan portfolio allowed BancoSol to extend services to many more poor clients, but BancoSol had to deal with two primary challenges that microfinance institutions face as they grow: increasing financial pressures, and changing demands on management.

60 As a regulated bank, BancoSol gained access to commercial funds from private sources, which are more plentiful and flexible than donor funds. Further, legal authorisation to mobilise deposits allowed BancoSol to offer savings facilities to its clients, thereby improving the quality of its services. Despite these advantages, BancoSol's experience with rapid growth was accompanied by severe financial pressures.

61 The switch from donor funding to more expensive commercial loans and deposits meant the average cost of funds rose from 4 percent per year at the time of transformation to 12 percent by mid-1995. At the same time, transformation inhibited BancoSol's revenue generating capacity because legal reserve requirements reduced the proportion of assets placed in the high-return loan portfolio. In addition a growing portfolio of larger loans earned lower effective interest rates. These factors reduced BancoSol's return on performing assets and cut its operating margin by 13 percentage points.

62 BancoSol's growth resulted from expansion of its branch network from 4 to 32. This lowered "productivity" (portfolio outstanding per unit of inputs, such as branches or loan officers). The expansion entailed costs from new banking infrastructure, staff, monitoring systems, and communications before the expanded capacity generated sufficient income.

63 BancoSol compensated for rising costs by increasing the revenue-generating capacity of each loan, not by raising interest rates but by increasing loan sizes and terms to maturity, increasing interest income without increasing operational cost per loan. The increase in loan size compensated for the rise in costs per loan and allowed BancoSol to remain financially viable.

64 There are three sources of loan size growth in microfinance institutions:

- policy-induced increases: due to changes in an MFI's lending criteria which may reflect a search for wealthier clients, which could be a form of mission drift;

- information-induced increases: as a result of accumulating knowledge about the clients' capacity to repay, which does not constitute mission drift; and

- client-induced increases: as a result of a demand for larger loans among repeat clients, which also does not constitute mission drift.

65 In the earlier years of BancoSol there was a brief period of policy-induced loan size increases. The larger loans caused some repayment problems, possibly due to overextending borrowers' debt capacity, and the policy was revised. Subsequently, the information- and client-induced loan size increases have been the
primary source of portfolio expansion as clients have gained access to larger loans over time.

66 Rapid growth and transformation into a bank also forced BancoSol to adapt its organisational structure and culture. During the PRODEM stage, it had an informal office culture that encouraged innovation, commitment to the organisation's mission, and recognition of individual contributions to a team effort. The management hierarchy was simple and flat, relying heavily on interpersonal relations. This internal culture fit well with a lending methodology based on trust between the organisation and its clients.

67 The informal culture became less suited to the larger institution. It proved difficult to integrate new staff and branches within the existing culture. Management needed improved information systems to cope with an expanding portfolio, more standard lines of authority and communication and a more businesslike approach to decision-making.

68 BancoSol adapted by designing a stricter management structure, improved systems, and new chains of command. Experienced bankers, human resource managers, experts in asset and liability management, and management information systems specialists were recruited. However, BancoSol has retained the personalised contact with the clientele that explains low cost and risks of lending through simple procedures and instruments tailored to the clients' demands.
Commercial Banks

Large commercial banks typically cite high risk of default, high costs to service many small accounts, low potential for profitability and socio-economic and cultural barriers as the chief reasons that prevent their entry into micro-finance. Commercial banks also face some internal constraints such as:

- **institutional commitment.** The entry of commercial banks into micro-finance is frequently dependent on a handful of visionary board members rather than based on an institutional mission;

- **organisational structure.** Commercial banks find it difficult to integrate micro-finance within a larger bank culture and structure that is not geared toward a high volume, small loan size business;

- **financial methodology.** Most commercial banks lack the financial methodologies to reach and retain low-income clients who require small amounts of capital;

- **human resources.** Issues of recruitment, training, and performance-related incentives require specialised consideration and effort, because micro-finance operations are labour-intensive and require people with special skills;

- **cost-effectiveness.** Traditional bank mechanisms and overhead structures make it difficult for banks to minimise processing costs, increase staff productivity, and rapidly expand micro-finance loan portfolios, which are necessary to cover costs and earn profits;

- **regulatory compliance.** Fulfilling reporting and regulatory requirements to reflect micro-finance operations calls for new procedures that both commercial banks and government regulators have yet to develop.

Despite these constraints, commercial banks have several organisational and structural features that can lend themselves to successful micro-finance operations:

- they are regulated institutions fulfilling conditions of ownership, financial disclosure and capital adequacy to help ensure prudent management;

- many have the physical infrastructure, including branch networks, to enable them to reach a large number of microfinance clients;

- they have well-established internal controls and administrative and accounting systems to keep track of large numbers of transactions;

- their private capital ownership structures tend to encourage sound governance structures, cost-effectiveness, profitability, and sustainability;

- access to their own sources of funds (deposits and equity capital) frees them from depending on scarce and undependable donor resources; and

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• the ability to offer loans, deposits, and other financial products make them attractive to microfinance clients.\textsuperscript{44, 45}

71 With technological innovations such as smart cards and automated tellers making inroads into transition economies, commercial banks may become more involved in microfinance, through methodologies similar to those used with overdrafts and credit cards.\textsuperscript{46} Commercial banks, because of their experience with such technologies, are well placed to move into this potential market.

72 Some commercial banks, such as Hatton National Bank in Sri Lanka and the Bank of Nova Scotia in Guyana, have already successfully entered the microfinance sector. As a measure of how widespread this trend is, a conference in November 1996 brought together 20 commercial banks from Asia, Africa and Latin America, engaged in microfinance. Four administrative structures predominate in the approach of commercial banks to this market:

• independent structures:
  • microfinance subsidiaries, with their own lending policies, staff and information systems, which report to the larger bank. Examples include Banco del Desarrollo’s microfinance subsidiary in Chile, the Unit Desa system of the Bank Rakyat Indonesia and the Scotia Enterprise Program of the Bank of Nova Scotia in Guyana.
  • lending through NGOs, such as Banco Wiese in Peru.

• integrated structures:
  • semi-independent microenterprise units lending directly, with administrative and financial functions integrated into the larger bank. Examples are Banco Agricola Comercial, El Salvador, Banco del Pacifico, Ecuador and Financiera Familiar, Paraguay.
  • fully integrated operations where small business credit officers also handle microenterprise clients. Examples include Centenary Bank, Uganda, Multi-credit Bank, Panama and Caja Los Andes, Bolivia.

73 It appears that the more specialised and independent the microfinance unit, the easier it is to institute appropriate microfinance lending methodologies, policies and procedures and to avoid interference from the larger bank culture. Although this


\textsuperscript{46} Kuiper K, “Short-term Microfinance: Commercial Banks Can Do It”, CGAP; and “Credit Cards: A New Wave in Microfinance?”, Microenterprise Development Review, Volume 1 Number 1, Inter-American Development Bank, May 1998.
autonomy represents and additional cost, it secures an appropriately structured operating environment for microfinance\textsuperscript{47}.

**Moneysops in the Philippines**

74 A few formal banking institutions in the Philippines have extended their lending activities to the poor\textsuperscript{48}. In particular, the Philippine Commercial and Industrial Bank (PCIB) in 1973 launched its Moneysop scheme. A Moneysop occupies a stall in the marketplace and provides working capital loans to the vendors in the market. The Moneysop has the same hours as the market and is open early in the morning.

75 Loans are at an interest rate of about 3 percent per month. Repayments are collected from the vendors’ stalls by a Moneysop officer. In spite of this, arrears levels are high compared with other lending schemes and the scheme has not been as successful in attracting deposits as the credit unions. Nevertheless, the scheme has grown and is now a major activity of PCIB.

**Banco de la Empresa S.A.**

76 Banco de la Empresa (Enterprise Bank) is a real but disguised private commercial bank in an unidentified Latin American country\textsuperscript{49}. Enterprise Bank decided to take part in a line of credit from IADB designed to encourage banks to serve the microenterprise sector by proving that it could be profitable. In four years, Enterprise Bank more than tripled its micro and small loan portfolio, extending over 4,000 loans for a total of US$ 3.8 million. The Enterprise Bank stopped relying on the IADB line of credit and mainstreamed microlending, seeing it as a promising market in an increasingly crowded and competitive commercial banking sector. Microenterprise lending became the fastest growing and most profitable lending activity.

77 The main reasons why Enterprise Bank became involved in microfinance were visionary leadership, increased banking competition and changes in the regulatory framework. The strategy adopted was to increase the number of rural branches, quickly achieve a critical mass of small loans through the purchase of the microfinance portfolio of an NGO, and modernise the bank’s management information system to handle the increase in the number of loans and increase efficiency. Young loans officers were recruited for the microfinance programme, and highly performance–oriented compensation schemes were established for these employees.

78 The programme is not without problems. Loan collection performance needs to be improved, with arrears averaging 20 percent. Methodology changes to address this problem are being discussed.


\textsuperscript{48} Virtual Library on Microcredit website.

\textsuperscript{49} Wenner M and S Campos, ibid.
Linking Commercial Banks and Microfinance Institutions – Guarantee Funds in Latin America\textsuperscript{50}

79 In recent years, ACCION International has worked to develop mechanisms to allow microfinance institutions to access commercial funding. These efforts have included the Latin America Bridge Fund and the ACCION Gateway Fund.

80 The Latin America Bridge Fund was established in 1984. It is funded by loans from a number of foundations, private investor, and religious organisations and operates by providing a guarantee on loans made by local commercial banks to ACCION affiliates. By sharing some of the risk in extending loans to microfinance institutions, the Bridge Fund induces commercial banks to enter into business relationships with microfinance institutions. Typically, first time loans by commercial banks are guaranteed up to 90 percent by the Bridge Fund. Over time, as the relationship between the microfinance institution and the bank develops, the proportion of guarantee drops progressively; and in some cases the guarantee has been eliminated altogether. These guarantees are extended only to ACCION's affiliates that in turn are required to meet both financial and non-financial criteria established by the Bridge Fund.

81 ACCION International maintains three layers of protection for its Bridge Fund:

- each affiliate must maintain a loan-loss reserve equal to a minimum of 2 percent of the outstanding microenterprise portfolio;
- the Bridge Fund itself maintains a loan-loss reserve equal to 5 percent of the outstanding letters of credit; and
- all loans made to the Bridge Fund are pooled with each investor sharing a proportional burden of the risk. To date, no investors in the Bridge Fund have suffered any losses from their investments.

82 As a result of this new guarantee mechanism, by May 1996 the Bridge Fund had been capitalised with US$ 6.6 million and ten of ACCION's 18 affiliates had successfully taken advantage of the Fund. On average, the Fund guarantees 50 percent of the commercial bank loans extended to ACCION affiliates, which means that the Bridge Fund leverages approximately twice its value in loans made to microfinance institutions. Over time, mature affiliates using the Bridge Fund mechanism have become regular and trusted clients of local banks. As a result, the Fund has been able to provide letters of credit for additional affiliates. Despite the substantial resources mobilised by the Bridge Fund, demand among local affiliates for commercial capital far outstrips the current supply.

83 In the Gateway Fund, an experimental equity instrument for microfinance institutions in the ACCION network, equity investments are made in very mature microfinance institutions, usually those in a position to be licensed. An advantage of providing equity over debt is that equity can be used by the microfinance institution to leverage commercial loans, thus expanding the available resources several times over. Moreover, equity investments provide investors with decision-making power in

the microfinance institution with a voting position on the microfinance institution’s Board.

84 The Gateway Fund will be capitalised by a mix of donor grant funding and private investors from the capital markets. While there has been no experience with this sort of instrument in the micro-finance industry, ACCION hopes this experimental mechanism will prove to be a successful tool for mobilising commercial resources for its affiliates.

Non-Government Organisations

85 Between the 1970s and the early 1990s several separate strands in development assistance began to come together. The first was mounting concern that poverty was not responding to growth oriented development efforts, lending a new sense of urgency to the development assistance field. Second, NGOs, hitherto somewhat on the periphery of the mainstream actors in development, began to be looked at more seriously as partners, because they seemed to be positioned at the grassroots to deal directly with poverty. Third, the dimensions and efficiency of the informal sector were becoming apparent as more studies of it were undertaken. Fourth, as some important experiments involving small amounts of credit aimed at very poor people (notably the Grameen Bank) showed that the poor, especially poor women, were highly reliable borrowers, replications of these experiments spread, with NGOs in the forefront 51.

86 The microfinance methodologies developed by NGOs have been key to the success to date of microfinance in addressing poverty reduction. The World Bank has estimated that as of mid 1996 there were more than 1,000 microfinance institutions in over 100 countries, each reaching a minimum of 1,000 clients and with a minimum of three years of experience (absent these restrictive criteria the total number of microfinance projects/programs may well be 5 to 10 times that number). A sample survey of these organisations revealed that approximately 73 percent were NGOs, 13.6 percent Credit Unions, 7.8 percent commercial banks and the rest savings banks.

87 However, a World Bank Sustainable Banking for the Poor survey of microfinance providers 52 has led to questions about the place of NGOs in the microfinance field. Of the organisations surveyed, commercial banks accounted for 78 percent of the total number of outstanding microloans and Credit Unions 11 percent. NGOs accounted for only 9 percent, and savings banks (which are not primarily in the credit business) just 2 percent. Also, commercial banks accounted for 68 percent of the total outstanding loan balance, savings banks 15 percent, credit unions 13 percent and NGOs 4 percent. In terms of numbers of clients, commercial banks and credit unions showed significantly greater overall outreach than NGOs. While NGOs’ outreach, on average, was deeper; it was also narrow – NGOs reach some very poor people, but they do not reach many.

Sixty-nine percent of the surveyed institutions were created after 1980. The vast majority of these new institutions are NGOs, and there is strong evidence that the birth-rate of NGO run microfinance programs and projects continues at a steady pace. Those microfinance operations which did not meet the criteria for inclusion in the survey (those less than three years old and reaching fewer than 1,000 clients) are far more likely to be NGOs. There may be thousands of projects, particularly among the domestic NGO communities that are reaching anywhere from 20 to several hundred borrowers. NGOs are also more aggressive in expanding their loan portfolios, an indication of their newness, as well as a reflection of the pressures to go to scale. The 1993-1994 median loan portfolio growth rate of NGOs was 49 percent, a rate twice that of savings banks and credit unions.

However, many NGOs have experienced serious problems of sustainability, suggesting there may be serious flaws in the NGO approach. These flaws appear to emerge from organisational and governance issues. At the same time, NGOs generally have ignored the demand for savings services by their clients. All of these are areas where commercial banks may have an advantage over NGOs. The most successful and advanced microfinance providing NGOs have transformed themselves into regulated financial institutions.

Many NGOs operate other economic and social programmes in addition to their microfinance schemes. Some operate other ventures such as retail outlets for products or central market facilities for agricultural produce. However, for the most part, if other services are offered they are usually non-financial in nature, sometimes involving a strong social consciousness that may stem from the individual microfinance institution’s roots as an NGO or other aid-oriented organisation. Provision of other services, such as literacy, health education and legal counselling, together with financial services, tends to decrease the “banking” culture within the microfinance institution. In fact, few people working in microfinance institutions see themselves as “bankers”. Most view themselves as providing a stopgap arrangement to meet their clients’ financial needs until the clients are able to interact with formal banks directly. This view of the institution as a temporary facilitator as opposed to a permanent institution diminishes the motivation to achieve scale and self-sustainability. Such organisations operate as projects, with a long-term dependence on donors, and have little compulsion to cover costs and achieve profits.

Bangladesh - The Grameen Bank - a Pioneering Example

Bangladesh, a primarily agricultural country, became independent in 1971. It is one of the poorest countries in the world, with a per capita income of US$ 360. The number of people living in poverty declined during the early 1990s, from 59 percent of the population in 1991-92 to 53 percent in 1995-96. Available data indicates this trend has continued into the late 1990s. Bangladesh has a population of 125 million (1996) and with 827 people per square kilometre has one of the world’s highest population densities. Bangladesh was relatively unaffected by the Asian financial crisis: in 1998, growth was 5.7 percent. However, Bangladesh suffers

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from recurrent natural disasters (in 1998, extensive flooding damaged much of the infrastructure in the country and caused a 10 percent drop in agricultural production\(^\text{56}\)) that hold back its progress. In addition, poor governance has repeatedly been cited as a barrier to development \(^\text{57}\). Partly for this reason, private sector growth is seen as the key to the country’s development, and preparations are being made to broaden financial sector reforms\(^\text{58}\).

92 Bangladesh is a centre for microfinance activity and innovation and provides good examples of NGO initiatives to reduce poverty through microfinance. Of the Bangladesh microfinance institutions, Grameen Bank and Bangladesh Rural Advancement Committee (BRAC)\(^\text{59}\) are the most famous.

93 The underlying premise of the Grameen Bank is that, in order to emerge from poverty and exploitation by moneylenders, middlemen and landlords, landless peasants primarily need access to credit, for which they have no collateral. Grameen Bank set out to prove that loans could be made to and repaid by the landless poor without collateral and that this would enable them to escape from the cycle of low income, low savings, low investment, low income.

94 Grameen Bank loans are small, but sufficient to properly finance the small projects undertaken by the borrowers. Grameen restricts its loans to the poor through a means test, which allows a maximum of 50 decimals of average agricultural land and household assets of not more than the value of one acre of agricultural land in the area concerned.\(^\text{60}\) Interest rate on all loans is 16 percent. Repayment rate is high, reported to be 98 percent.

95 Grameen Bank operates through units set up with a Field Manager and a number of bank workers. Each Field Unit covers about 15 to 22 villages. The Field Manager and workers start by visiting villages to familiarise themselves with the local environment, identify potential borrowers and explain the purpose, functions and mode of operation of the bank to the locals. Groups of five prospective borrowers are formed. In the first stage of lending, only two of the five receive a loan; the group is closely monitored for a month to ensure the members are conforming to the rules of the bank and only if the first two borrowers repay the principal plus interest over a period of fifty weeks do the other members of the group receive a loan.

96 Highlights of the Grameen Bank’s credit delivery system\(^\text{61}\) include:

- an exclusive focus on the poor, ensured by:
  - establishing clearly the eligibility criteria for selection of targeted clientele and adopting practical measures to screen out those who do not meet them,

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59 See following section.
61 Grameen Bank website.
• in delivering credit, assigning increasing priority to women, and
• gearing the delivery system to meet the diverse socio-economic development needs of the poor;
• organising borrowers into small homogeneous groups, to facilitate group solidarity and participatory interaction;
• specifying special loan conditionalities that are particularly suitable for the poor, including:
  • very small loans given without collateral,
  • loans repayable in weekly instalments spread over a year,
  • eligibility for a subsequent loan dependent on repayment of the first loan,
  • a focus on individual, self-chosen, quick income generating activities that employ the skills that borrowers already possess,
  • close supervision of credit by the group as well as bank staff,
  • a stress on credit discipline and collective borrower responsibility of peer pressure,
  • special safeguards through compulsory and voluntary savings to minimise the risks that the poor confront, and
  • transparency in all bank transactions, most of which take place at centre meetings;
• simultaneous undertaking of social development agenda (as reflected in the Bank’s 16 Decisions), in order to:
  • raise the social and political consciousness of the newly organised groups,
  • focus increasingly on women from the poorest households, whose urge for survival has a greater bearing on the overall development of the family, and
  • encourage monitoring of social and physical infrastructure projects;
• design and development of organisation and management systems capable of delivering programme resources to targeted clientele, a major requirement of which is training and motivating staff to allow gradual decentralisation of operational authority and delegation of administrative functions, and involving trial and error and gradual adjustments on a continual basis; and
• expansion of the loan portfolio to meet the diverse development needs of the poor, including loans for housing, building latrines, installation of tubewells, purchase of inputs for seasonal cultivation, joint enterprises undertaken by
the group and the centre, and projects undertaken by the entire family of a seasoned borrower.

The Bangladesh Rural Advancement Committee - A Multiservice NGO

BRAC was started in 1972 as a relief measure following the war. Following this, it evolved into a community development organisation providing health, family planning, education and economic support to the disadvantaged. In 1974, BRAC started to provide credit. BRAC had 1.5 million active microfinance clients at the end of 1996.

BRAC believes that credit alone is insufficient to overcome poverty and thus has a two-phased approach to microfinance which focuses first on rural development and then on credit. Under its Rural Development Programme (RDP), BRAC organises women of households that own little land and rely primarily on wage labour into village organisations of about 40 members. Initially, BRAC provides functional education that teaches numeracy, literacy and civil rights. BRAC also offers training in income-generating activities. Only after a period of training, usually one year, credit is made available. First loans are small, usually USD 25, but subsequent loans increase in amount. After four years activity in one location, RDP ends and is replaced by BRAC’s Rural Credit Programme (RCP) which acts more like a regular microfinance institution.

In addition to RDP and RCP, BRAC offers non-formal primary education and provides a range of health services. In addition, it has some for-profit divisions including a chain of retail shops, cold storage facilities for agricultural produce and a publishing house. BRAC has avoided the pitfalls of its size and array of programmes by separating management and costs of each of its different arms, thus building accountability.

BRAC’s RDP provides credit to the poor, working through the following stages:

- classes are held separately for men and women in a process called “conscientisation”;
- separate village organisations for men and women are formed;
- training is organised for the group members;
- following these activities (which generally take about six months), members become eligible for credit; and
- technical and logistical support is provided for the income generating activities.

The amount of the loans vary depending on the nature of the income generating activity, from hundreds of Taka to millions. All loans bear an interest rate

of 16 percent. Terms are dependent on the nature of the activity: short term (less than 12 months), medium term (12 to 36 months) and long term (more than 3 years) are available.

102 Each branch of the RDP covers approximately 45 to 50 villages (average population 1,200). The branch has a Manager assisted by four to five programme organisers. Each programme organiser is assigned to about 5 villages or 10 village organisations.

Dominican Republic - Association for the Development of Enterprises (ADEMI) - a South American Example

103 Dominican Republic is one of the most densely populated countries in the Caribbean, with a population of 8.3 million and a population density of 165 inhabitants per square kilometre. Population growth is 1.8 percent. The country suffers from widespread poverty, notably in rural areas. Officially, 21 percent of the population live below the poverty line, but 27 percent lack ready access to safe water, resulting in a high prevalence of water-borne diseases. Maternal mortality rates are among the highest in the region, and 30 to 40 percent of children under six suffer from moderate to severe malnutrition. About 83 percent of the adult population is literate. Dominica is considered a lower-middle income country with a per capita GNP of US$ 1,770 in 1999. Inflation was 8.3 percent in 1997. Agriculture currently accounts for about 20 percent of GDP, compared with 22 percent in 1975. Industry’s share of the economy has shrunk to 30 percent as services, notably tourism, have boomed. Growth in agriculture averaged only 0.6 percent per year during 1985-95. Rural poverty has fuelled rapid migration to urban areas (which now account for 64 percent of the population), especially to the capital city of Santo Domingo. About 70 percent of the urban population live in barrios or low-income neighbourhoods. Roughly 20 percent of the economically active population is openly unemployed and another 25 percent is estimated to be underemployed. The lack of formal employment opportunities has led to significant participation in the informal sector as well as to emigration to the United States, Venezuela and other countries.

104 Two successful businessmen and a community development specialist formed ADEMI in the Dominican Republic in 1982. From the start, it adopted a business approach to the provision of microcredit to the poor, with locations of branches, setting of interest rates, compensation of staff and collection policy set on the basis of best business practice. Initially it was supported by private donations and technical and financial support from international aid organisations, including IADB, USAID, GTZ, ACCION and EIB. Loans were initially made on a group basis, but this was abandoned in favour of individual loans made on the basis of careful personal screening. ADEMI grew rapidly but suffered several crises that almost led it into bankruptcy, most notably due to a period of high disbursements and declining collection rates. This led at one point to the resignation of the entire management team and many of the staff.

The introduction of a strongly performance-oriented compensation system for its staff led to great increases in efficiency. Client staff ratios increased from 45 to 140 while collection rates improved. ADEMI has always charged positive real interest rates, even during periods when inflation exceeded 60 percent. It reached full financial self-sustainability in 1991.

ADEMI has adopted a national commercial bank as its partner, locating its branches close to those of the bank. All transactions are done through the bank, including loan disbursements and repayments, and savings services are offered to its clients by the bank. This serves to draw its clients into the formal financial system. However, ADEMI made a decision not to aim for graduation of its clients, but to graduate itself through increasingly sophisticated products to serve its developing clients. In 1993 it opened a lending window for medium sized enterprises. In 1996, it issued the ADEMI Mastercard, paving the way to future automation of its microfinance operations.

Pakistan - Aga Khan Rural Support Program

Pakistan is a highly populated, relatively low-income country. It has a population of 131.6 million population density (169 per square kilometre) and a population growth rate of 2.5 percent. About 64 percent of people live in rural areas. Illiteracy is widespread and only half of men and a quarter of women aged 15 and over can read and write. While Pakistan's social welfare indicators have improved over the past two decades, progress remains slow and the challenges daunting. Only 40 percent of the population is literate (28 percent of women), compared to the average literacy rate of 49 percent in South Asia and 53 percent in low-income countries worldwide. Despite some improvements, gender disparities in education remain, with 62 percent of Pakistan's girls enrolling in school compared to 80 percent of its boys. In the early 1990s, Pakistan had real GDP growth of around five percent annually while inflation remained in the range of 10 percent to 12 percent. GDP per capita as of 1996 was US$ 406; in purchasing power parity, this was US$ 2,230. GDP contribution by sector in 1996 was 49 percent for services, 26 percent for industry, and 25 percent for agriculture. The labour force of 36.7 million is split between sectors somewhat differently with 47 percent in agriculture, 17 percent in services, 17 percent in mining and manufacturing, and 19 percent in other economic activities.

Pakistan has serious problems of deteriorating infrastructure, low literacy levels, and persistent sectarian and political violence. In addition to the scarcity of access to potable water, Pakistanis face other environmental concerns, including deforestation, soil erosion, and desertification. Living is particularly hard in the Northern areas where earthquakes and other natural disasters are more common and severe. The Northern areas used to be virtually ignored by Pakistan's government. The area is not an electoral region, but rather a federally administered

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area of Pakistan. They have had almost no basic services (electricity and roads, for example) and most villagers are subsistence farmers, barely surviving in the valleys that snake through the barren mountainsides.

109 The Aga Khan Rural Support Program (AKRSP) began operations in 1982 with the broad mission to improve the productivity and welfare of families in the communities of Chitral and the Northern Areas of Pakistan. The World Bank made a thorough evaluation of the AKRSP in 1995. As of the end of 1995, AKRSP had mobilised US$ 7.5 million in deposits and had US$ 5.6 million in outstanding loans. AKRSP’s financial services reach more than 100,000 households, over two-thirds of the estimated rural population in the program areas.

110 AKRSP is an NGO subject to a number of different provincial and state requirements under the general regulation of the Government of Pakistan. The Board of Directors of AKRSP is largely comprised of members of the Aga Khan Foundation network. The Board responds to issues raised by AKRSP management and decides operating policies. The Board negotiated on behalf of AKRSP management with the donor on how best to use their funds.

111 Since 1982, among its other activities, AKRSP has worked to organise village-level institutions. By the end of 1994, 1,834 Village Organisations (VOs) and 763 Women’s Organisations (WOs) had been established with 101,304 total members. In both VOs and WOs, the groups select a president and a manager. The president is often an older person of local prestige who might be illiterate. The manager is usually literate and most are farmers. Loan and deposit services are integral parts of VO/WO activities and are directed by the Credit and Savings Section of AKRSP. The outstanding loan portfolio at the end of 1994 was US$ 4 million and the deposit balance was US$ 6.9 million.

112 Program acceptance and good levels of outreach were due to the effective strategy AKRSP devised for getting villagers involved. Using AKRSP grant resources and know-how, combined with village labour, village after village was organised around the use of a Productive Physical Infrastructure (PPI) project. The PPI, which was usually an irrigation system, road or footbridge, was the initial incentive for community organisation, and a genuine source of economic development. To manage the PPIs, AKRSP formed the VO/WOs, but these were meant to endure and be the local force behind development long after the PPI had been completed.

113 In 1983 as part of AKRSP’s inception, provisions were made for small-sized loans from AKRSP to the VO/WOs for distribution to members; and medium-sized loans were taken primarily by the VOs themselves. AKRSP introduced obligatory savings to mobilise capital and the use of credit from village organisations to assist small farmers. Later on, AKRSP shifted its focus to village organisation/women’s organisation credit programs (VOCP/WOCPs) that linked amounts borrowed to money saved. The VOCP/WOCPs made savings a more attractive proposition. Still more recently, beginning in 1992, AKRSP launched a microenterprise program. This was a considerable departure from the basis on which AKRSP had historically allocated credit and the Microenterprise Program has been far more risky. It was followed in 1995 by a new program of corporate and commercial credit designed to support enterprises linked directly with village and women’s organisation commercial interests.
114 Unfortunately, the capacity for financial self-sustainability however, has not kept pace with the program’s increasing outreach. AKRSP’s savings and credit operations are increasingly subsidised, loan portfolio quality is declining, and loan portfolio risk is increasing as the program expands its services and activities.

Non-Bank Financial Intermediaries

115 Some countries in Latin America, notably Peru and Bolivia, have adopted new regulations to allow for the creation of specialised non-bank financial intermediaries for micro and small businesses. These may take the form of finance companies, private financial funds, or other legal forms. Private Financial Funds (PFFs) in Bolivia and Small and Microenterprise Development Entities (EDPYMEs) in Peru are regulated, supervised financial institutions that offer limited banking services and have capital and reserve requirements tailored to microfinance rather than standard commercial banking. New entrants into the market include Caja de Los Andes, FIL and FA$$IL in Bolivia and CREDINPET in Peru. Their common characteristic is that they are not considered banks under local legislation and so are exempt from minimum capitalisation requirements and the strict regulatory and supervisory regime applied to banks.

Bolivia - Regulated Microfinance Institutions

116 Bolivia is a poor country in the Latin American context. It has a population of 7.9 million, of whom 67 percent live below the poverty line, and a population growth rate of 2.4 percent. Only 37 percent of the people live in rural areas, which are sparsely populated, especially in the mountainous areas. Agriculture accounts for about 25 percent of GDP. GNP per capita is US$ 1,000 and 83 percent of the population is literate. Bolivia began its stabilisation and adjustment programs in 1985 after a period of rapidly deteriorating economic conditions. Having successfully stabilised its economy, Bolivia has had modest rates of growth in the 1990s. Nevertheless, the education level of the population is limited and health indicators, although improving over the last few years, remain among the worst in the continent.70 Per capita income remains low, at US$ 700 in 1995, and a highly skewed distribution of income means that rural dwellers in particular are very poor. Bolivia is a centre for microfinance activity in Latin America and the world. In 1997, the microfinance portfolios of the country’s 14 MFIs grew by 45 percent while the number of clients grew by 16 percent to reach a total portfolio value of approximately US$ 90 million and 200,000 clients.

117 Under a 1993 banking law, Bolivia licenses a new class of financial intermediary called PFFs. These are designed to provide financial services to micro and small enterprises and individuals for purchasing durable goods. Solvency and reserve requirements are the same as for banks, however minimum capital is only about 30 percent of that for banks. PFFs are not allowed to offer some financial

services such as chequing accounts, foreign trade operations and trust services. PFFs are allowed to accept non-traditional items, such as jewellery or furniture, as collateral, unlike conventional banks. PFF licenses will be given only to institutions whose management has extensive experience in microfinance. Caja de Los Andes was the first to receive a PFF license.

Credit Unions and Banking Co-operatives

118 Credit unions and banking co-operatives are legally constituted, member-driven, self-help financial institutions. The legislation under which they are constituted may differ, as may the name (“credit union”, “savings and credit co-operative” or “banking co-operative”), but all are organised by, comprised of and owned by their members, who agree to save their money together and to make loans to each other at reasonable rates of interest using those funds. Members are usually people with some common bond, for example working for the same employer or belonging to the same labour union or other organisation. Banking co-operatives often arise out of farm co-operatives, which have traditionally served rural communities by providing transport, primary processing, and marketing services for agricultural products, and negotiating prices on bulk purchases of goods such as fertiliser. From granting credit against expected crops, these organisations sometimes evolved into full financial service providers.

119 A credit union is a democratic, not-for-profit organisation. Members vote in the election of directors and committee representatives. The international credit union operating principles, adopted by the World Council of Credit Unions (WOCCU), outlines the basis credit union philosophy of co-operation, equality, equity and mutual self-help. All are self-sustainable: they rely on their own capital.

120 WOCCU statistics show that in 1997, there were 13,988 credit unions in Asia with 8.6 million members; and 2,035 credit unions in Latin America with 5.4 million members. Credit unions are particularly popular in Sri Lanka (8,424 credit unions) and Indonesia (1,400 credit unions). Venezuela has the most credit unions in Latin America, with 456. In 1991, around 10 to 20 percent of loans from credit unions in developing countries were to microenterprises, with a total outstanding balance of US$ 150 to 300 million. They feature many of the characteristics of good microfinance providers, including character-based lending, minimalist lending programmes, peer group risk management, savings mobilisation, low-cost service delivery, financial systems development, and efficient portfolio and operations management systems.

121 Credit unions are of interest because they tend to expand their services rather than their clientele. While many credit unions in developing countries offer only basic savings and loan services, the Credit Union League of Thailand (CULT), for example, in addition to savings and loans offers: a loan insurance programme to

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76 The term “credit union” is used in the remainder of this section and means both credit unions and banking co-operatives.
78 Credit Union League of Thailand website.
cover borrowers in the event of permanent invalidity of death; a life insurance system with a pension component; risk funds for its members in the event of fraud or default; mutual funds to cover cremation costs; and specific programmes for women and young people.

Credit unions have competed successfully with other microfinance providers because they:

- tie savings to loans in order to maintain balanced growth: this means that the institution relies upon mobilising owners’ share capital and savings to finance its operations;
- are financially self-sustainable in low-income communities;
- can establish operational self-sustainability in rural areas with a membership ranging from 800 to 25,000;
- are part of a world-wide network of credit unions that has created its own industry standards (such as the PEARLS system to monitor the performance of credit unions);
- have been able to react to financial market reforms and to new demands and competition;
- depend upon each other to achieve economic benefits: for example, members of any credit union in a group can enter any other credit union or branch office to receive services.

Credit unions serve a diverse range of members from the community. They do not exclusively target the poor or define their mission as serving the poor. Their membership base is the economically active, ranging from the poor to middle-income groups and varying across occupational groups. Guatemalan credit unions continuously seek to diversify their membership, incorporating people of different income and wealth in order to build a heterogeneous and stable membership. Thus, Guatemalan credit unions provide an example of sustainable financial institutions that provide low-income people with much-needed access to important financial services. The main weakness of credit unions for microfinance delivery is their lack of incentive to go outside their founder group, either to mobilise deposits or to provide credit services.

Guatemala - Credit Union Unión Popular

In December 1996, the new Guatemalan government signed a peace treaty expected to bring an end to almost 40 years of internal armed conflict that had severe, adverse social and economic impacts upon the Guatemalan people. Among Central American countries, some of which also experienced political and economic crises in the past decades, Guatemala ranks below average in most social indicators. Despite a per capita GNP of US$ 1,640, Guatemala is in the grip of both poverty and inequality. According to a 1995 World Bank Poverty Assessment, within

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a population of 10.8 million and a population growth rate of 2.7 percent, approximately 75 percent live below the poverty line. Almost 58 percent (over six million) live below the extreme poverty line. About 60 percent of the population live in rural areas, and 85 percent of these are poor. The indigenous population makes up some 40 percent of the Guatemalan population, distributed in 22 groups, each with its own language. Eighty percent of indigenous people live in rural areas, and more than 90 percent are poor (compared to 66 percent of the non-indigenous population). Overall, only 67 percent of the adult population is literate\(^{80}\).

125 Private banks dominate the Guatemalan financial sector. In 1995, the total banking loan portfolio was US$ 1,145 million, 95 percent of which (US$ 1,090 million) was in private banks. In 1988, there were 20 banks with 262 branch offices, while at the end of 1996 there were 789 commercial bank branch offices in the country. More than half of them are in the capital, Guatemala City. In 1995, for example, 92 percent of private bank loans and 53 percent of state bank loans were disbursed in the capital city. Quetzaltenango, the second largest city, only received 1 percent. Friends, relatives and moneylenders also provide informal financial services. Among the institutions that provide financial services outside the jurisdiction of the Superintendency of Banks are the finance companies (empresas finanziadoras, specialising in consumer lending), credit unions, non-governmental organisations, pawnshops, and consumer stores\(^{81}\).

126 There are 35 credit unions affiliated with the Guatemalan national federation, owned by 151,630 low and low-medium income individuals who have already accumulated US$ 20.5 million in share capital, US$ 42.7 million in savings and US$ 77.8 million in total assets. Their share capital and savings are invested in a US$ 53.1 million loan portfolio that finances their microenterprises and agricultural activities, housing improvements, and personal loans. Among the same group of shareholders, the ratio of savers to borrowers is approximately 3 to 1. Credit unions compare well with the loan portfolio of the most advanced microcredit NGOs in Guatemala.

127 A technical assistance project working with the national federation and its affiliated credit unions adopted an approach to strengthening member credit unions that comprised three elements:

- no external funds to the credit unions for on-lending;
- subsidised technical assistance and training to be used to shift the credit union paradigm prevalent at the time; and
- financial assistance to be provided to write off historical losses on a quid-pro-quo basis by establishing financial discipline and meeting growth targets and multiple counterpart commitments.

128 The project provided assistance in savings mobilisation, financial management, and credit analysis to a core group of credit unions. New policies and operating standards were developed to improve financial services and management

\(^{80}\) World Bank Country Report September 1999.
skills. This was followed by aggressive marketing programs to enhance the credit unions’ public image and attract new members. Key policies included: competitive pricing for savings and loans; intensive mobilisation of local savings; maintenance of adequate liquidity to satisfy unanticipated withdrawals of savings; application of new lending criteria centred around capacity-to-pay analyses, credit history, and available collateral; creation of loan loss reserves in relation to delinquency; reduction of non-productive assets; capitalisation of all net earnings; and use of marketing programs to improve public image.

129 Unión Popular is a rural community credit union founded in 1972, whose mission is to improve its 11,062 members’ social and economic conditions through the implementation of financial services and projects. Unión Popular requires a mandatory deposit of US$ 0.87 in shares and US$ 17 in passbook savings to become a member. Its lending supports much of the local agricultural production. It has aggressively pursued savings mobilisation by de-emphasising shares and aggressively promoting a varied range of deposit services. Its members have a total of shares plus savings equivalent to US$ 4,670,577 and US$ 3,409,794 in loans outstanding. It therefore provides a true financial intermediation role in the community.

130 The number of outstanding loans per credit staff member is 316. The credit union makes a large number of loans, based on the average savings and share balance of the borrower and his/her past credit history and debt capacity. Also, many borrowers already had a credit history in the credit union. The lending methodology of the credit union differs from that of NGOs specialising in microcredit: these groups typically dedicate more time to screening borrowers and evaluating and monitoring loans. In addition to the credit operations, the credit unions provide savings account services. The average number of share and savings accounts per staff member was 228.

**Vietnam - The Central Credit Fund and the People's Credit Funds**

131 CCF and the PCFs operate under the Law on Banking, Co-operatives, and Finance Companies of 1990. They were established in 1993 by a Decision of the Prime Minister (No. 390/TTG) and have been operating on a pilot basis for six years up to 1999. The Government understands the importance of a conducive policy environment for PCF development, and to this end has made progress towards the adoption of a market-oriented system with progressive interest rate deregulation, minimising state intervention to address perceived market failures, creation of an enabling legal framework, development of close central bank supervision and inspection, and adoption of appropriate accounting and auditing systems.

132 Being autonomous business entities in about 1,000 or 11 percent of the total communes in the country, PCFs are compelled to make their own business decisions and are accountable for the results. The results of the six-year pilot program (from a national evaluation of the PCF network by the Government in December 1999) show that PCFs have performed creditably, been conservative in their lending operations, and have generally made sound lending decisions. The results also show that the Government has not intervened to save PCFs that have failed to operate profitably. Indeed, 17 out of 988 PCFs have been closed by the SBV for failing to meet the standards set for them, even though the Government had placed a heavy burden on
them by taxing them at the rate of 45 percent. The 971 PCFs that have passed show an average profit of D51 million and recovery performance of more than 95 percent.

133 From an initial 49 PCFs in 49 provinces in October 1994, the network expanded rapidly to 988 PCFs, 21 Regional Credit Funds operating in the poorest 53 out of 61 provinces of the country, and a CCF in Hanoi by 31 December 1999. Outreach has also grown significantly from 46,000 members in 1994 to 700,000 members and 746,000 borrowers in December 1999. Their combined total assets at 31 December 1999 were D2,300 billion having grown 30 times from D83 billion in 1994. The combined equity capital at 31 December 1999 was about D300 billion or US$ 21 million, of which domestically mobilised savings accounted for D1,532 billion and the rest (D 440 billion) came from external assistance. Total disbursements since inception have exceeded US$ 1 billion or D 14,000 billion. By end 1999, the PCF network accounted for five percent of the market for rural credit and they are a potential competitive source of financial services to the poor and rural households.

134 Although the PCF network has grown significantly and its operations have been successful there is still substantial potential for improving their services and meeting the demand of the people for credit and savings, estimated at more than five times the level provided at present. Based on the recent evaluation, supplemented by field studies, the network has developed a cautious operational plan for the next four years. By December 2003, it intends to establish another 360 PCFs, increase membership by 723,000 or by 100 percent, increase equity of members by D170 billion (about $12 million), increase mobilised funds by D1,350 billion (about $95 million) or 90 percent, and increase other borrowings by D 500 billion (about $40 million). The network aims to double the number of loans, make larger and longer term loans, and increase the outstanding loans by B2,580 billion or more than 2.3 times the current amount by 2003.

Village Banks

135 The village banking model enables poor communities to establish their own credit and saving associations in village banks. These are intermediaries between the sponsoring agency, which makes one loan to the village bank, and the member/borrowers. The village bank relies on peer pressure and support among members to ensure repayment of its loans. Borrowers start with an extremely small loan and work their way up to an established ceiling. Credit is linked to savings and loan sizes to the amount saved by each borrower. Members' savings are held by the village bank as an internal account and forms one source of capital the bank can lend or otherwise invest to increase its resource base.

136 Village banking is now being implemented in over 25 countries in Latin America, Africa and Asia. Over 3,000 banks serve close to 84,000 members, 92 percent of which are women. The active collective portfolio stands at about USD 8.5 million with an average loan size of USD 80 and a 97 percent repayment rate.82

137 Most implementing agencies have had to strike a balance between empowering village borrowers to create their own village bank management systems and providing sufficient oversight to assure accountability. These implementing

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82 Crafts News Spring/Summer 1995 Vol. 6, Issue 24, “Micro Credit Lending Experiences”.
agencies’ programs make great investments in accounting training to improve banks management. This is often supplemented with literacy training.

138 Some village banks have changed from simple financial service providers to integrated providers of credit and savings together with education, health, nutrition, environment, and general community development. Village banks originally projecting three years to autonomy sometimes in practice find their capital accumulation slowed by member demands for greater access to savings, lower rates on loans and fluctuating membership.

139 Evaluation of village banking programs indicates that their benefits are both economic and social, with positive impact on the members and their communities. Borrowers increase incomes, diversify and expand activities, and participate in the group and its democratic process. Some members have increased their knowledge and improved practices in management, literacy, nutrition, and health.

**Indonesia - Badan Kredit Desas (BKD)**  

140 Indonesia had a population of 203.7 million in mid-year 1998, with a population growth rate of 1.6 percent. About 62 percent of these live in rural areas. Average GNP per capita is US$ 680. Eighty-five percent of the adult population is literate. With an average growth rate of 7.1 percent between 1985 and 1995, a real GDP growth rate of 7.8 percent in 1996, a poverty reduction from 60 percent of the population to 11 percent, and an overall improvement in general living standards, Indonesia was seen as a "model of development". In the two years since the crisis hit East Asia, Indonesia has been subjected to unprecedented economic, social and political pressures. Over the past six months, the trend has been for the better, with signs of economic stabilisation, the success of the parliamentary elections in June and significant progress made on the broad economic reform program.

141 The recession has caused a substantial increase in the number of people living in poverty in Indonesia. The tremendous social gains made over the past thirty years are at risk of being reversed. Latest estimates show that the number of poor as a share of the population roughly doubled from about 11 percent in 1996 to 18-20 percent in 1998. The recession has reduced opportunities for employment in the formal sector, forcing more people into the informal sector. Combined with higher poverty, this has increased the number of potential microfinance clients. Simultaneously, the profitability of micro-enterprises has fallen, reflecting increased competition and reduced demand.

142 The BKD is a system of village-owned financial institutions in Indonesia, first established in 1898, and have existed in their present form since 1952. The concept is based on a Dutch system of village banks. Each BKD unit is owned by an individual village and operated by three residents of the village. Units general transact business only one day per week, operating from a village public building or

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the house of one of the village leaders. There are 5,345 BKD units in Indonesia, of which 4,806 were active in 1996.

143 BKD units are established with small grants from provincial governments. Their loan capital is derived mainly from this initial grant, retained earnings and required and voluntary savings. BKD units also borrow from BRI or other sources, but in practice they often have substantial savings and no need to borrow. Their bookkeeping, cash handling and portfolio quality are supervised by BRI staff or contract workers, who arrange for excess cash to be deposited in BRI, arrange BRI loans and organise lending between BKD units. The BKD unit pays a fee for this service, which is related to their volume of lending. Supervisors can dismiss BKD unit staff.

144 Loans of 10 to 12 weeks make up about 65 percent of total lending. Payments are made weekly: the first week’s payment is interest, the second is forced savings and the loan principal is amortised over the remaining 8 to 10 weeks. Seasonal/agricultural loans account for 20 percent of lending and 35 day loans for 15 percent. Loan sizes range from approximately US$ 10 to US$ 430.

145 Loans are small with flexible terms, to suit individual borrowers’ needs. Interest rates cover the cost of funds and cost of operations including loan losses, but because the village bank is located in the borrower’s village, the total transaction cost is reasonable. Borrowers are known to BKD unit staff and, because they live in the village, their character and ability to repay are well known. Repayment performance is good. Default rates range from 2 to 6 percent per year.

146 Withdrawal rights to the forced savings are determined by the local unit; some units retain the forced savings as a fee. Interest rates on loans are about 7.2 percent per month on a declining balance basis (not including any retained forced savings), in an environment of about 9 percent inflation per year. Voluntary savings services are also offered, and interest rates are comparable to those offered by BRI.

**Government and Donor Microfinance Programmes**

147 Government and donor programmes for provision of financial services to the poor or the marginalised are operated in many countries. These can be operated by government ministries, government controlled agencies or independent project management units. These may evolve into government-owned microfinance banks, or independent organisations of a variety of types. Provision of financial services by way of project-based programmes has largely been discredited in recent years, however such programmes are still sometimes operated in countries or regions that have experienced severe disruption to financial and other infrastructure due to war, civil disturbance or natural disaster.

148 These types of programmes still tend to suffer all the problems attributed to government-operated subsidised credit programmes, including high default rates, lack of sustainability and the suppression of development of a viable rural financial infrastructure. Such programmes depend on continuous subvention, at the same time as they price potentially sustainable financial services out of the market. However, while the lack of sustainability built into such programmes is of concern in
the medium- to long-term, they may be appropriate in specific emergency situations on humanitarian grounds.

**The Albanian Development Fund (ADF)**

149 Albania showed an impressive record in the early years of its transition. The recovery of economic growth started in 1993 and lasted uninterrupted through 1996. During these four years of 9 percent real annual growth, structural reforms advanced well while reforms in the public administration and financial sectors advanced at a much slower pace. In 1997, Albania descended into near anarchy following the collapse of the pyramid schemes, which led to a virtual collapse of the State. Total liabilities of these schemes, which mushroomed to enormous dimensions in the course of 1996, are estimated at almost 50 percent of GDP. This precipitated a deep social and State crisis with widespread rioting and looting, killing of 1,500 people, and major damage to buildings and infrastructure.

150 The economic fall-out from the crisis was severe. The loss of wealth in the failed financial schemes depressed domestic demand. Supply-side disruptions reduced output in construction and industry, although agriculture was little affected. International trade slowed markedly, remittances from abroad dropped sharply, project implementation was paralysed, and foreign aid flows came to a halt. The crisis impoverished many households and the number of registered unemployed increased by 15 percent in the first six months of 1997.

151 The 1999 Kosovo conflict also had a serious negative impact on the country, with the sudden arrival of hundreds of thousands of refugees in Albania and neighbouring countries. The Government was forced to postpone or limit previously-approved budgetary expenditures, thus affecting public investments, civil service wage adjustments and operations expenditures of almost all ministries. In addition, the marked deterioration of conditions in the neighbouring frontline countries has affected general economic activity in the region through adverse impact on trade and domestic and foreign investment. With the end of the Kosovo conflict in June 1999, and the initial exodus of refugees from Albania back to Kosovo, reconstruction efforts are now underway.

152 Albania is the poorest country in Europe with a 1998 per capita GDP of US$ 610 (down from an estimated 1996 GDP per-capita of US$ 829). Its population in 1998 was 3.4 million with a density of 115 people per square kilometre, making it one of the most densely populated countries in the Balkans. The population growth rate is only 0.8 percent. Approximately 60 percent of Albanians live in the rural areas and agriculture accounts for 55 percent of GDP.

153 Between 1991 and 1993, all co-operatives and state farms were privatised, leading to the creation of over 400,000 small family farms (average 1.3 hectares per family). The result of land reform has been a regression toward subsistence farming, as 85 percent of farm output is consumed. In addition, much of the infrastructure in Albania was destroyed in the early 1990s, while that which remained has

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deteriorated due to lack of maintenance and upkeep. The poorest people live in the upland and mountainous areas on incomes of less than US$ 70 per year.

154 Since the end of World War II, Albania suffered from low levels of production and high levels of poverty, relying on substantial support from the USSR and PRC. Formerly, Albania was one of the most extreme regimes in Eastern Europe and was largely sealed off from the rest of the world until it began making moderate reforms in 1990. During the period between mid-1992 to 1996, Albania seemed to be on its way to completing a successful transition to a market-based economy. However, the collapse of pyramid investment schemes in 1997 resulted in massive civil unrest. Inflation reached 33.2 percent in 1997\(^89\).

155 Prior to 1990, 84 percent of Albanians of working age were employed by the state. After 1990, total employment in the public and co-operative sectors decreased from 1.4 million in 1990 to 265,000 in 1995, leaving over 1 million former state employees without jobs. Forty-five years of isolation and collective production had left most Albanians without the skills required to successfully engage in market activities.

156 While restructuring efforts have been in place since 1992, the formal financial sector remains limited (a central bank and three state-owned banks), and characterised by large loan losses and ineffective management. The weak legal system inhibits foreclosure on collateral. Most limiting to banking reform is a culture of non-payment of loans. There is general opposition to foreclosing on collateral as the concept of private property remains rather new. In addition, depositors lack the confidence in the banking system to make long-term deposits, resulting in potential liquidity problems.

157 The lack of a properly-functioning banking system coupled with no enforcement of the legal framework is a key reason for the emergence of informal financial markets. Loans made through informal markets have short terms and high rates (1 percent per day to 10 percent per month). Beyond the informal sector, the only provider of microfinance services is the ADF.

158 The Albanian government developed a programme in 1992 to rebuild the rural economy on a free-market basis with an emphasis on poverty alleviation. The Rural Development Fund, subsequently transformed into the ADF, was created as a transition institution that would establish and direct infrastructure development and provide small loans to the rural poor. The ADF is supported by the World Bank among other donors.

159 ADF is organised into six different departments: Infrastructure Works; Rural Credit; Microenterprise Support and Rural Activities; Urban Credit; Monitoring, Evaluation and Studies; and Finance and Administration. Policies and objectives are defined and overseen by a Board of Trustees (made up of Government representatives) in conjunction with the various donors, primarily the World Bank. Overall management is performed by an Executive Committee consisting of the heads of departments and the Executive Director, a government appointee.

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160 ADF’s rural credit programme aims to establish Village Credit Funds (VCFs) to finance small loans to farmers and other rural residents for all types of income-generating activities. VCFs are revolving accounts managed by the villages themselves through an elected Village Credit Committee with the assistance of an ADF credit officer. At the end of 1996, ADF was active in 170 villages in 10 districts with close to 7,000 outstanding loans totalling more than US$ 2.4 million. The average loan size in 1996 was US$ 460. The average loan term is 30 months, interest must be paid a minimum of once per year, and principal payments are made on a semi-annual or annual basis. Eighty to 90 percent of villages chosen are in the mountain regions as these are the areas predominantly inhabited by the poor.

161 The amount of funds made available to each village is based on the objective of reaching one-third of the adult population. The average amount of funds provided to each village is about US$ 20,000, typically delivered in two or three tranches. Loans are made on an individual basis with a maximum loan duration of three years. For existing VCFs, the maximum loan size is US$1,000 equivalent. For new VCFs, the maximum loan size is US$500 and is increased to US$1,000 once the VCF has developed a good repayment history. A borrower can only have one loan outstanding at any time. Loans are disbursed by a representative of the local branch of the Rural Commercial Bank during a public meeting held in the village. Loan payments are collected the same day, providing peer pressure for repayment since new borrowers can only receive loans once others have repaid. The interest rate is currently 10 percent per annum.

162 Physical collateral such as animals, land or housing is generally required in addition to pledging the asset purchased with the loan funds. However, the poorest borrowers usually have no existing animals or minimal land. Most often, a VCC member guarantees repayment of the loan. Because loan approval is made at the village level by neighbours who know the borrower, the most important collateral substitute is village peer pressure. Additional security is provided by the threat of VCF closure if 100 percent of the loans are not repaid on time. ADF strictly enforces this rule, and at the time of writing only one village had ever failed to repay the loans and was subsequently closed. Most villages have greater demand for credit than there are funds, resulting in significant pressure for on-time repayment in order for others to receive loans.

163 The rural credit program was not designed with financial sustainability in mind because: most of the target population are subsistence farmers who do not have easy access to markets; there was substantial macroeconomic uncertainty (in 1992, inflation was over 200 percent); and the program is run with substantial participation of the farmers themselves (making the whole system more complicated than a top-down approach). In addition, as a government programme ADF has resisted imposing market interest rates and the financial discipline needed for reaching sustainability. Operating costs range between 10 percent and 15 percent as a percentage of average outstanding portfolio. If ADF plans to achieve financial self-sufficiency, the rate of interest will have to be increased substantially, given the high rate of inflation, market rates for commercial funds (20 percent), and the need for some provisioning for loan losses.

164 In 1996, the Albanian government passed a "Savings and Credit Association Law" and a "Mutual Collaboration Association Law" (a framework co-operative law).
This established a legal framework for the transformation of VCFs into Village Savings and Credit Associations (VCSAs), and for the creation of a national microfinance apex institution.

The Policy Environment

Financial Sector Reform

Challenges to be overcome by microfinance institutions in order to mobilise savings include:

- **a hostile macroeconomic and financial sector environment.** Political turmoil and high inflation make savings mobilisation difficult. When there is uncertainty about the future, people prefer non-financial assets as hedges against instability. Extensive government interference through interest rate controls and subsidised credit make savings mobilisation unproductive.

- **absence of a regulatory framework tailored to the special characteristics of microfinance institutions.** In the absence of specific prudential regulation for micro-finance institutions, a microfinance institution would have to become a formal institution, with the concomitant obligations to meet high minimum capital requirements, requirements for full loan documentation and collateral requirements. In addition, these legal stipulations are not adjusted to the specific risk exposure of microfinance institutions, such as high turnover of loans due to short maturities or use of collateral substitutes.

Governments can address these issues through financial system reform and establishment of a legislative, regulatory and supervisory framework that takes account of the special needs and unique nature of microfinance institutions.

MFI Regulation and Supervision

Achieving significant outreach to micro enterprises requires financial resources far beyond what governments and donors have available. Thus, it is necessary to mobilise resources from commercial sources, including deposits to satisfy the existing demand. Given the higher risk of microloan portfolios, it is also necessary to institute supervision and regulation of microfinance institutions if commercial sources, especially public deposits, are to be mobilised. However, some traditional banking rules cannot be applied to microfinance institutions.

The key issues include:

- **interest rate limits.** Legal limits on microloan interest rates will usually make commercial viable microfinance impossible, given the higher operational and loan loss costs of most microfinance operations.

- **regulation of microfinance institutions.** In most countries, microfinance institutions that are lenders only and do not take deposits are not considered

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90 Source: A conference in November 1995 sponsored by ACCION International, reported in CGAP Focus Note No 4, August 1996.
financial intermediaries and therefore do not fall under commercial bank legislation. Deposits required under group microloan programmes and those raised by credit unions from their members could be considered as different from deposits raised from the general public.

- **financial standards.** The financial standards required of microfinance institutions should be different from those required of commercial banks, because of the different nature of their operations. In some areas, standards should be stricter; in other areas, more flexible.

- **asset quality.** Repayment rates of microloan portfolios are often better than those of normal commercial bank loan portfolios. However, microenterprises tend to have more volatile performance and lack the resources of larger enterprises to sustain them through downturns. Asset quality tracking systems are critical to microfinance institutions. While microfinance institutions need to be more aggressive in their loan loss provisioning than commercial banks, their provisioning criteria will naturally be different, given the different types of loan portfolios (largely without collateral support). Additionally, it would be inappropriate to require elaborate loan documentation or involved credit approval procedures for very small loans; or case-by-case loan reviews. Reliance on historical performance, statistical sampling methods and management and systems reviews are likely to be the primary methods of supervision.

- **minimum capital requirements.** Small capitalisation is the norm with microfinance institutions. The social value of microfinance and the need for vastly expended coverage argues for lower capital requirements for this type of institution.

- **capital adequacy.** Most countries have had only brief experience with microfinance, and this mandates caution when fixing leverage ratios. Also, because microfinance institutions operate with higher costs and lending rates than commercial banks, a given percentage of the portfolio as non-performing will have a more drastic effect on microfinance institutions. Taking the higher risk of microfinance loan portfolios into account, these issues suggest an initial capital/asset ratio no lower than about 20 percent for microfinance institutions.

- **financial performance.** When analysing financial performance, supervisors need to make adjustments that account for the direct and indirect subsidies received by most microfinance institutions at present.

- **liquidity requirements.** Seasonal factors influence many (especially rural) microfinance institutions and some microfinance institutions rely on unpredictable donor funding. Non-donor liabilities tend to be short term in nature. This means that microfinance institutions are exposed to high levels of liquidity risk and regulators should set relatively high liquidity standards for microfinance institutions.
• **fraud prevention.** Supervisory bodies should be able to review internal audit and internal control procedures in microfinance institutions, perhaps through random client-level monitoring of loans.

• **insolvency.** Regulators must have the authority and will to protect the system by imposing sanctions on insolvent institutions. Having several microfinance institutions reduces the pressure to bail out insolvent institutions.

• **internal superintendent structures.** As the microfinance industry develops, some countries have established separate microfinance institution departments within their central banks. Donor support may be required to ensure supervision authorities have the capacity to carry out their mandate. In the longer term, low-cost methodologies for microfinance institution supervision need to be developed, such as:

  • reviews could be contracted out to specialists familiar with microfinance institution operations;

  • self-regulating mechanisms could provide microfinance institution managers with guidelines and incentives to monitor themselves; and

• entry standards, such as loan portfolio management track record, profitability and capacity for long-term planning.

169 Even when regulatory policies are reasonably appropriate for the financial system as a whole, there are some areas that may hide a differential policy bias against microfinance. The areas where this is most likely to occur, and impose a differential cost on microfinance institutions over traditional banks, include: prudential controls (loan documentation, provisioning and capital adequacy; protective controls (interest rate ceilings); and structural controls (entry requirements and limits on the activities of financial institutions).

**Pro-active Support for Microfinance Institutions**

170 The recommendations of the Women’s World Banking Global Policy Forum are designed to build actions that would open local and global financial systems to low income entrepreneurs. The objective is to provide access to sound, responsive, market-based financial services to these people. The Forum recommends that governments support institutions that meet the following standards:

• Financial Performance: excellent repayments with arrears under 10 percent of principal due and bad debts less than 4 percent; interest rates and fees that are high enough to cover finance and operating costs of an efficient microlender; substantial progress and credible plans to cover operating and finance costs from internal revenues in a three to seven year period from the outset of operations; diversity in portfolio by size and sector, to spread risk; a growing capital structure that can be used to generate investment income, can be loaned and can be used to leverage domestic resources;

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• Client Outreach: market penetration for significant outreach to low income entrepreneurs; strong savings mobilisation directly or through other institutions;

• Business Practices: sound governance and accountability structure, freedom from political interference; competent staff, responsive loan systems; and sound institutional operations, effective management information systems and financial accountability.

171 The Policy Forum encourages governments not to provide subsidies to micro-entrepreneurs or microfinance providers, on the grounds that micro-entrepreneurs require rapid and continued access to financial services, not subsidies. The Policy Forum also encourages all actors to find effective means to support the build-up of local intermediaries that have a commitment to and competence in provision of microfinance services, rather than approach the problems of micro-entrepreneurs on an ad-hoc, project-oriented basis. This does not mean that, in their start-up phase, microfinance institutions do not require investment on a non-repayable basis, generally for a period of five to seven years.

172 The Policy Forum concludes that governments and external funders need to adopt new funding approaches that provide and promote:

• small amounts of grant funds for promising new entrants to finance start-up operating costs and loan portfolios over a short period;

• capitalisation for institutions that meet performance standards;

• access to refinance from development banks and other second-tier intermediaries;

• in order to encourage the build-up of leveraged credit lines by local banks to specialise in financial intermediaries, provision of loan guarantees that are partial and time-bound, on the basis that once an institution has reached the scale and efficiency to cover costs and manage fully commercial sources, it will be able to access international commercial funds directly and through networks;

• where appropriate, use second-tier institutions (including development banks and practitioner networks) to provide financial and institutional support services to retail intermediaries to: build an agreed set of standards as the eligibility criteria for accessing support services; organise performance benchmarking systems; encourage exchange of experience among participating retail institutions; serve as a wholesaler or broker of seed funding, capitalisation funds, refinancing facilities and institutional development support; encourage mutually advantageous linkages between commercial banks and specialised financial intermediaries; and help ensure that the appropriate legal, regulatory and supervisory structures and incentives are in place;

• build a favourable policy, regulatory and incentive framework for financial institutions that serve the poor, including: encouraging a range of institutions
to enter the microfinance market and expand; allowing microfinance institutions that meet performance standards to operate as recognised financial intermediaries; keeping entry thresholds, such as minimum capital requirements and statutory deposits, low enough so that specialised institutions can become part of the formal financial system; maintaining simple supervisory and reporting requirements, with a focus on key performance indicators; freeing institutions lending to micro and small enterprises to set their own lending rates; and providing attractive incentives to these intermediaries.

173 Top priority in the policy framework is interest rate deregulation.\(^{92}\)

The Lessons

174 Regarding the different types of microfinance institution that have proven successful there are specific lessons that are useful for PRC policy makers in determining the future of microfinance in PRC.

175 Success of an agricultural development bank in providing microfinance depends on a list of strong preconditions, including: a dynamic agricultural sector; at least moderate macroeconomic equilibrium and a sound fiscal system committed to reform; an existing or developing legislative, regulatory and supervisory framework, including access to the courts to enforce contracts; and an autonomous and healthy institution demonstrating a good quality loan portfolio with low arrears, independent programme design and implementation by competent staff and management and an information system capable of providing quality information on the loan portfolio.

176 While the first two requirements generally can be met in the PRC context, the government owned agricultural development bank, Agricultural Bank of China (ABC) may not be an ideal candidate for the role of microfinance provider. This is because of its poor quality portfolio, staff and management who have little expertise in lending to very small borrowers and an information system that is not capable of providing the kind of detailed information required for management of a large portfolio of small loans. In particular, ABC’s lack of autonomy with respect to its existing poverty reduction lending programme is of concern. The corporate culture of ABC is inappropriate for microfinance operations: branches in rural areas prefer to make larger loans backed by collateral that are repayable in one lump sum at maturity, rather than microfinance loans that are small, have no collateral and are paid in frequent instalments.\(^{93}\)

177 In PRC, there are no existing specialist microfinance banks. The lessons from international experience on the difficulties of programme expansion and of making the transition from non-bank to bank, and in particular the time and expense required to make such a transformation, should be noted. In the PRC context, the paucity of large rural financial institutions with a firm commitment to microfinance coupled with extensive experience in microfinance operations makes selection of a candidate for such a transformation difficult.


\(^{93}\) Author’s field notes, interview with President and Vice-President of ABC Ankang County Branch, Shaanxi Province, 29 July 1999.
In the commercial banking sector the useful lessons from those who have pioneered it are: starting and sustaining a microfinance programme requires committed and visionary leadership; commitment is most likely to be found in small banks or in specialised units of larger banks; profit must be the principal motivation, not social image enhancement; there must be a strategic fit between the commercial bank and the new market (perhaps caused by commercial pressure in its traditional markets); successful microfinance operations require a different set of operating procedures, extensive investments in appropriate information technology, training, staff incentives, a wide network of bank branch offices and a schedule of hours of operation that are convenient for microfinance clients; careful consideration must be given as to how to structure and organise a microfinance programme within a commercial bank (for example, as a fully integrated product, a division or a subsidiary); and managers need to focus on operational efficiency and delinquency control, not solely on profits, because profits can mask problems in a non-competitive environment.

The model of the commercial bank that establishes a new microfinance subsidiary is of interest in the PRC context because of the lack of a good fit between microfinance operations and the existing corporate culture of PRC commercial banks, plus the lack of existing microfinance institutions large enough to be capable of moving into this role.

The feasibility of using NGOs as a major component of broad-based provision of microfinance services on even a regional basis in PRC is problematic, because of the quasi-legal status of existing microfinance project in the country and because of the small relative size of all existing pilot microfinance projects. However, because NGOs make up the bulk of microfinance providers internationally, and they collectively have vast experience with microfinance, their experiences particularly in the areas of operations and credit methodology particularly must be taken into account when designing any microfinance programme.

Recognition that microfinance organisations have special organisational and operational characteristics that flow from the unique nature of their loan portfolios is important in the PRC context, as elsewhere. It is necessary that microfinance institutions be classified as a unique kind of financial institution, so that they can be made subject to appropriate laws, regulations and supervisory requirements that may be substantially different from those that apply to other financial institutions.

Two lessons from international experience are important to take into the PRC context. The first is that self-help groups, independently established, can be operated in a financially prudent, self-sustaining manner without the imposition of regulation from outside. The members of the credit union manage their own affairs to their own benefit. Secondly, it is important to note that such institutions serve a valid financial intermediary role in rural areas. Although credit unions may not specifically target the poor, they can serve low-income clients successfully with a broad range of financial services. This helps to stimulate economic well being and the accumulation of physical, social and human capital in rural areas. The model development of People’s Credit Funds in Vietnam over the past six years is illustrative of a

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successful partnership between the State Bank of Vietnam and the Central Credit Fund and donors including ADB and can be considered for the development of RCCs.

183 The village bank model is of interest in the PRC context because it offers a way to link a larger organisation, such as a commercial bank, with a specialised microfinance institution based at the local level, controlled and operated by its members. The question of charging interest rates sufficient to ensure self-sustainability are cast in a new light when the interest accrues to the poor themselves. The supervising financial institution serves as the conduit for funds, so the poverty reduction benefits are not limited due to lack of local resources. Other benefits include low administrative and transaction costs and sustainability, while prudent financial operation is maintained by the supervising financial institution.
PRC Rural and Microfinance Approaches and Experience

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Summary

The introductory section of this paper provides an overview of the rural financial system in the People's Republic of China (PRC) covering the formal and informal sectors including the microfinance sector. It then reviews the evolution and current situation of each of the major rural financial institutions in the formal sector: the Agricultural Bank of China (ABC), the Agricultural Development Bank of China (ADBC), Rural Credit Co-operative (RCCs); and the informal sector including Rural Credit Foundations (RCFs), various kind of ‘Hui’s (Rotational Savings and Credit Associations or ROSCAs), farmers’ mutual lending and the different microfinance schemes sponsored by non-government organisations (NGOs), government, the formal financial sector and donors. The paper considers the historical context of each type of organisation, its outreach and client base, and interest rate and financial management issues as a basis for examining the effectiveness and demonstrating the issues facing the rural financial sector and policy makers in the context of poverty reduction. It then analyses the policy needs and the alternative strategies for the development of sustainable microfinance.

ABC was set-up and disbanded three times before the rural reform in 1978. Prior to this it was government's agricultural policy instrument rather than commercial bank. Since 1978 it has been a state-owned bank with branch outreach to all counties and most townships nation-wide. ABC's clients are mainly township and village enterprises (TVEs), state-owned enterprises (SOEs) and other collective enterprises. It also serves individual farmers and private enterprises. ABC was been associated with poverty lending through its earlier involvement in the directed credit of various types. Much of this was transferred to ADBC following its establishment in 1995, but in 1998 lending under the government's subsidised lending programme for poverty reduction was transferred back to ABC. Initially officials from local Poor Area Development Offices (PADOs) continued to control the lending, but in 1999 control was essentially passed to ABC. The persistence of historically poor credit discipline in the programme and subsidised interest rates has led to problems for ABC management and staff because of ABC’s commercial orientation and strong internal accountability for lending performance. As a result, the general trend has been a disinclination to lend to the rural poor, this being reflected in ABC’s loan portfolio generally.

ADBC is a policy bank, established in 1994 to deliver the government's subsidised poverty lending programme, other subsidised credit schemes, and for financing SOEs for the purchase and storage of grain, cotton, and edible oil. The subsidised credit operations were transferred back to ABC in 1998. ADBC's operations are now primarily confined to acting as a conduit for government lending to agriculturally related SOEs. It does not take deposits from the public and lends under terms determined by government.

In the 1950s, at their establishment, RCCs were real co-operative organisations. Later they became subordinated to the People's Bank of China (PBC) and then ABC. In 1996, RCCs again separated from ABC and put under PBC supervision. RCCs cover most townships and have outreach to villages through agents (usually the village accountant or village head) who are engaged to deliver financial services. With their separation from ABC, PBC has required RCCs to create apex organisations at the county level to supervise lower level RCCs. RCCs clients are
farmers, TVEs and rural private enterprises including individuals. RCCs have been mandated by the State Council to allocate more than 50 percent of credit to farmers, but in practice this has proved hard to realise because non-financial transaction costs for farmers are high and RCCs prefer to make larger loans to better-off farmers and enterprises. RCCs are exploring new ways to deliver service to farmers both through experimental linkages with microfinance projects and new lending mechanisms such as the use of joint liability groups. However, RCCs interest rates remain state controlled, management is weak, and the use of joint liability groups for production lending to relatively better-off farmers will not bring them closer to the poor.

Informal finance developed rapidly after the reform in 1979. RCFs, 'Hui's and other forms of informal lending developed rapidly after reform especially in areas where there were economic opportunities and formal financial institution's services were unable to meet the demand or did not have outreach. RCFs grew rapidly in the 1980s and 1990s, financed by collectives and farmers, and it is estimated that that in 1998 their loan portfolios were more than four times that of the formal financial sector. RCF's clients were mainly farmers. RCFs were ordered to close or merge with RCCs by PBC in 1999 for reasons of financial prudence and ceased operation almost immediately. The extent of 'Hui's is not possible to estimate with accuracy because they are illegal. They are reported to be widespread in rural areas, meeting demands for credit with relatively low total transaction costs for borrowers. Members of 'Hui's are typically small business people or those with spare capital to invest at higher risk for higher return. Interest rates are generally two to three times the official rates charged on a flat rate basis making the effective rates significantly higher. Two percent per month flat rate is reported is normal.

Microfinance schemes are of four types comprising those sponsored by: NGOs, government, formal financial institutions and donors. The schemes are diverse and although loan sizes are generally small (less than RMB 2,000) and in line with the expected size for "microfinance", scheme operation varies greatly and few, if any schemes, operate in accordance with international best practice, though some are striving to do so. There are more than 200 pilot microfinance schemes in PRC. Other than the few that are operated through formal financial institutions (ABC or RCCs) they are illegal, but the government has tolerated their development because there is genuine interest in developing microfinance in PRC, and based on the initial success of some pilot microfinance projects, “microfinance” has come to be regarded in PRC as a potentially effective tool for poverty reduction.

The analysis finds that although the formal financial system is characterised by its legality and good outreach throughout PRC, in some cases down to village level and its ability to offer a range of services to its clients including the legal taking of deposits, microfinance is not well suited to ABC’s business strategies, as ABC is now undergoing a transformation into a regular commercial bank; microfinance is not at all suited to ADBC, as ADBC has now been assigned very different policy lending responsibilities by government; RCCs may be the most appropriate existing player in the formal rural financial sector to undertake microfinance operations, but are not yet ready because their internal policies, procedures, systems and corporate culture are not appropriate; and it is not politically possible for RCFs to undertake microfinance operations because of the recent government moves to close them or merge them
with RCCs. PBC is actively addressing the constraints in the RCC system to improve their potential for microfinance delivery.

Pilot microfinance schemes sponsored by NGOs, formal financial institutions and donors have demonstrated: the relevance and viability of microfinance in PRC and that outreach of microfinance can be extended to the poorest areas and to poor farmers. However, these projects have no legal status and there is an acute lack of microfinance policy, legislative, regulatory and supervisory frameworks. Most NGOs, formal financial institutions and donor microfinance programmes charge the maximum loan interest rates permitted under law, these are insufficient to achieve full financial self-sustainability, but most government poverty reduction projects rely on highly subsidised government funds and charge interest rates on loans far below the level at which these projects can be made self-sustainable.

Examination of operational issues demonstrates that; a focus should be put on training microfinance management and field staff in microfinance international best practice; accounting and information systems need to be upgraded; a variety of microfinance methodologies should be encouraged, not restricted to group lending, in order to provide competition and consumer choice and to continue to evaluate the best methods for various regions and groups; loan and savings products and service delivery methods need to be perfected in order to respond to the demands of the potential market in an efficient way; and additional sources of funds for microfinance need to be developed. These matters can be readily addressed through technical assistance and training.

The principal issues are about how to role out successes in the context of finite NGO and donor funding, PBC’s understandable reluctance to create new formal microfinance institutions, and the limitations of the existing formal financial sector to take on this role effectively. These are the core issues that affect microfinance and effective poverty reduction lending in PRC. To develop microfinance as a tool for poverty reduction, and to let formal financial institutions be involved in microfinance, the following three conditions are critical: the legal status of microfinance institutions should be regularised and a framework of policy, regulation and supervision concerning microfinance should be established including depositor protection; the interest rate ceiling should be abolished to allow microfinance institutions to attain financial self-sustainability; and a grassroots network appropriate for microfinance needs to be developed regardless of whether it is attached to an existing formal financial institution to allow organisational and methodological flexibility to suit different areas and to assist to break up the financial monopoly that currently exists in rural areas.
Introduction

Trends in the Formal Sector

1. Formal rural financial organisations in PRC are ABC, ADBC, and the RCCs.

2. From 1990 to 1997, deposits in the formal rural financial system ranged from 27 percent to 29 percent of total domestic deposits. In 1990, total deposits in financial organisations nation-wide were about RMB 1,164 billion while the total deposits in the formal financial system in rural areas were about RMB 338 billion. In 1997 the total deposits in all financial organisations nation-wide were about RMB 8,239 billion, and total deposits in the formal financial system in the rural areas were about RMB 2,225 billion. From 1990 to 1997, the annual increase of deposits in formal financial organisations in rural areas was 30.9 percent on average.

3. From 1990 to 1997, the outstanding loan portfolios of formal rural financial system ranged from 29 percent to 33 percent of total loans. In 1990, the total balance of loans from formal financial organisations nation-wide was about RMB 1,517 billion and the total balance of loans from the formal rural financial system was about RMB 440 billion. In 1997, the total balance of loans from the whole rural formal sector was about RMB 7,491 billion and the total balance of loans in rural areas was about RMB 2,322 billion. From 1990 to 1997, the annual increase in lending from formal financial organisations in rural areas was 26.8 percent on average.

4. If marketing loans made by ADBC to SOEs are included, rural loans consistently exceed rural deposits in PRC’s formal rural financial organisations. However, if these loans to SOEs are deducted, loans have been consistently less than deposits and the gap has been widening. Because the capital for loans made by ADBC comes from government and not the public, the capital of PRC’s rural areas has been increasingly transferred to the urban areas through formal financial channels. In 1998, about RMB 270 billion flowed from PRC’s rural areas.

5. The deposit and loan structure of the formal financial organisations in PRC’s rural areas in 1997 was as shown in Table 1.

Table 1 Deposit and Loan Structure of Formal Rural Finance Organisations in 1997

<table>
<thead>
<tr>
<th></th>
<th>ABC</th>
<th>ADBC</th>
<th>RCC</th>
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<tbody>
<tr>
<td>Deposits (% of total)</td>
<td>50.4</td>
<td>1.6</td>
<td>48.0</td>
</tr>
<tr>
<td>Loans (% of total)</td>
<td>37.9</td>
<td>33.4</td>
<td>28.7</td>
</tr>
</tbody>
</table>


4. See End Table 1.

Trends in the Informal Sector

6 Informal financial organisations include RCFs, ROSCAs and microcredit projects targeted at poverty reduction that have developed in recent years.

7 After liberation, the government began to crack down on usury. By 1978, informal lending had almost disappeared from the countryside, with only mutual borrowing between production brigades and commune members or their relatives or friends remaining. Because individuals did not to finance collective production, such borrowings were mainly for the purpose of consumption, without interest or with low interest, and they were typically small and short-term loans.

8 Various forms of informal rural finance emerged soon after the 1978 reform. The amount of informal borrowing by farmers between 1980 and 1998 can be deduced from the sample survey data of the state agricultural inspection team\(^6\): From 1980 to 1996, farmers' informal sector borrowing increased at an average annual rate of 20 percent. In 1997 the rate of increase dropped to 1 percent, and in 1998 the amount of borrowing declined by 9 percent. In comparison, farmers' loans from formal institutions increased by an average annual rate of only 7 percent between 1980 and 1997 and also dropped, by 7.7 percent, in 1998.

9 Table 2 shows that since 1990 farmers' loans from informal sources (not including township and village enterprises) have been over four times that from formal credit institutions. Thus, from the farmers' perspective, the informal credit market is far more important than the formal market.

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</thead>
<tbody>
<tr>
<td>Number of farmers nation-wide (000)</td>
<td>176,730</td>
<td>190,770</td>
<td>222,370</td>
<td>231,650</td>
<td>232,820</td>
<td>234,376</td>
<td>234,062</td>
<td>N/A</td>
</tr>
<tr>
<td>Number of persons in villages nation-wide (000)</td>
<td>810,960</td>
<td>844,197</td>
<td>895,903</td>
<td>915,282</td>
<td>916,746</td>
<td>919,410</td>
<td>915,247</td>
<td>915,240</td>
</tr>
<tr>
<td>Net income per farmer (RMB)</td>
<td>191.33</td>
<td>397.6</td>
<td>686.31</td>
<td>1220.98</td>
<td>1577.74</td>
<td>1926.07</td>
<td>2090.13</td>
<td>2161.98</td>
</tr>
<tr>
<td>Informal loans to farmers (RMB billion)</td>
<td>8.247</td>
<td>28.078</td>
<td>55.788</td>
<td>95.096</td>
<td>125.064</td>
<td>158.028</td>
<td>160.37</td>
<td>146.072</td>
</tr>
<tr>
<td>Formal loans to farmers (RMB billion)</td>
<td>12.992</td>
<td>13.761</td>
<td>18.049</td>
<td>26.256</td>
<td>35.213</td>
<td>37.379</td>
<td>34.777</td>
<td></td>
</tr>
<tr>
<td>Informal loans / formal loans (times)</td>
<td>2.16</td>
<td>4.05</td>
<td>5.26</td>
<td>4.78</td>
<td>4.48</td>
<td>4.29</td>
<td>4.23</td>
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</tr>
</tbody>
</table>

10 Survey data on income and expenditures\(^7\) shows that borrowing by farmers has been on a downward trend in recent years while savings have been on an upward trend. Based on the actual sub-regional results, in 1996 farmers in eastern PRC had average borrowings of RMB 17.79 per person from formal credit institutions and total borrowings of RMB 201.39 per person; in central PRC, RMB 44.20 and RMB 209.57 respectively; and in western PRC, RMB 61.26 and RMB 106.37 respectively. The farmers in the poor areas of central and western PRC rely on formal credit institutions to a greater degree than those in eastern PRC.

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\(^6\) See End Table 6 for the survey data.

\(^7\) See End Table 7 for the survey data on income and expenditures.
Trends in Microfinance

11 Based on the initial success of some pilot microfinance projects, “microfinance” has come to be regarded in PRC as a potentially effective tool for poverty reduction. For this reason, “microfinance” has been eagerly seized on by hard-pressed poverty reduction officials as a solution to their problems of poor repayment rates and inadequate outreach in the government's subsidised credit programme for poverty reduction.

12 “Microfinance” projects at present in PRC can be divided into two types:

- pilot projects depending mainly on international sources for capital, operated by non-governmental organisations to test the feasibility, sustainability, policies and operational methodologies for microfinance service provision in the PRC context and which to varying degrees have characteristics of international best practice; and

- projects to fund the poor using methods commonly described as “microfinance”, implemented mainly by government or government owned or founded organisations that are focused on achievement of “policy” poverty reduction funding targets, use government subsidised credit at negative real interest rates as the primary source of funds, and have few if any of the characteristics of international best practice.

13 Development of microfinance in PRC can also be divided into two phases in accordance with changes in the poverty reduction policies and measures of the government. The first period of development was from the beginning of 1994 to October 1996. In this period, the most significant work explored the feasibility of using Grameen Bank (GB) Model replicators in PRC. Implementation was by NGOs without policy interference or capital involvement from government.

14 The second period from October 1996 to the present is most significantly characterised by government action to realise its poverty reduction targets using "microfinance" projects dependent on government capital, human resources and organisations for implementation; and the development of many other externally funded projects with varying charitable and financial services objectives.

15 From the beginning of the 1990’s, small-scale microfinance pilot projects began to be implemented in some poor regions. Examples include the "Funding of the Poor Co-operatives" (FPC) pilot projects implemented by the Chinese Academy of Social Sciences (CASS) with LGOP. This developed four GB replicator projects in Yixian County of Hebei Province, Yucheng and Nanzhao counties of Henan province, Danfeng County of Shaanxi Province, similar UNDP projects were started in Yilong County of Sichuan Province, Malipo and Jinping Counties of Yunnan Province, four counties in the natural reserve area of Tibetan Everest. Similar projects were sponsored by local governments using national and international fund in the Shanxi Lulliang area, Sichuan Luangzhong County and Shaanxi Ankang.
According to statistics\(^8\), total capital in microfinance pilot projects reached about RMB 90 million by the end of 1996.

16 These microfinance pilot projects have attracted the attention of the highest levels of government and society in general. In September 1996, the central government and the State Council held a poverty reduction conference\(^9\). At the conference, it was stressed that Party Councils and local governments at each level in poor areas should make solving the food and clothing problems of poor families their primary objective. Conference delegates were told that this was the primary objective, and that the objective was coincident with that of microfinance projects. In this regard the government did not appear to draw a distinction between the bankable poor and the poor that need welfare assistance and did not give recognition to the fact that the poorest are not generally the beneficiaries of successful microfinance schemes.

17 In February 1998, the Leading Group Office for Poverty Alleviation and Development (LGOP) of the State Council held a national conference on poverty reduction funding. At the meeting, Chen Junsheng, a member of the State Committee and then Head LGOP, pointed out that microfinance was an effective tool for poverty reduction and should be steadily tested and rolled-out in PRC. It was emphasised that microfinance should be implemented in PRC with reference to the international experience, and echoing the 1996 conference stressed that important characteristics were to ensure funds go to the poorest families and to ensure that the repayment was good. It was recommended that provinces that had not yet carried out microfinance pilot projects should immediately start, while those that had achieved success should move steadily to a large scale.

18 In May 1998, Wen Jiabao, member of the Political Bureau, Vice Premier of the State Council and Head of LGOP of the State Council, pointed out at the first plenary session of the new Poverty Reduction Leading Group that three aspects of work should be carried out, of which the second was to “pay special attention to the work of poverty reduction for families, especially that of microfinance pilot and replication projects”\(^10\).

19 In June 1998, the delivery of poverty reduction subsidised loans was transferred from ADBC to ABC and in the second half of 1998, government subsidised "microfinance" projects expanded very quickly using poverty reduction funds lent at an interest rate of 2.88 percent. In this, ABC effectively acted as a funding channel for the government, with local Poor Area Development Offices (PADOs) selecting the borrowers.

20 In September 1998, relevant departments of CCCP and the State Council released guidelines for microfinance poverty reduction work in the notice “Get Well with Agriculture and Rural Work”: which required the active start-up of pilot projects, careful development of regulations and gradually roll-out. The guidelines stated that

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\(^8\) Liu Wenpu and X Du, 1997, “Microfinance to the Poor”, First Issue


the findings of the LGOP February conference with regard to microfinance should be put into effect.\footnote{Liu Wengpu, 1998, “Microfinance to the Poor”, Third Issue.}

21 The “Decision of Several Important Problems about Agriculture and Rural Work of the CCCP” made at the third plenary session of the fifteenth Central Committee held on 14 October, 1998, restated that the food and clothing problem of the poor is an urgent and intractable one, and that an effective method of providing microfinance for families should be formulated and disseminated. This continued to place primary importance on poverty reduction through distribution of subsidised loans rather than the development of sustainable financial services.

22 At the end of 1998 PBC and ABC cast doubt on the lawfulness of the set-up under which PADO's managed poverty reduction subsidised loans. It was stated that PADOs had no right to act as intermediaries and handle microfinance activities. As a result, since 1999, poverty reduction subsidised loans have been directly issued to rural families by ABC, with PADOs introducing borrowers to ABC, but with ABC taking the credit decision. This has led to friction between the two because of ABCs commercial outlook and internal accountability culture that has made credit officers disinclined to lend to the poorest.

23 During 1999 various roundtables and conferences (for example by UNDP and CIDA) have highlighted the difficulties ABC faces in delivering the subsidised loan programme, the non-sustainability of the subsidised credit and its distortive effects on the rural economy, its crowding out effects, and the frustration of roll-out of many existing pilots because of their illegality. These issues are well understood in PBC, whose current position on the immediate future of microfinance is that RCCs, including those that will absorb the closed-down RCFs, will be the providers of microfinance and that other new institutions will not be established. This continues to pose problems for the roll-out of the majority of successful pilots that are not linked to RCCs. Although they are tolerated by the government in view of their utility in experimenting with microfinance as a tool in poverty reduction, the position of PBC is that it is not imperative to develop a legal basis for such microfinance institutions, and as a consequence roll-out other than through RCCs is an unlikely option at present.\footnote{Interview with Li Jun Feng, Chief System Reformer, PBC, 26 October 1999.}

The Evolution of the Rural Financial Sector

Agricultural Bank of China

\textit{Before the Reform}

24 From the start of the new republic to 1977, ABC was founded and abolished three times. In August 1951, the State Affairs Council founded the Agricultural Co-operative Bank to handle fiscal appropriations for agriculture, provide long-term\footnote{Defined as loans with terms of one year or more.} loans in accordance with state plans, and support the development of RCCs. Branches were not immediately established after its founding, and in 1952, the
Agricultural Co-operative Bank was abolished as part of an effort to rationalise administrative structures.

25 In order for the state to support the credit requirements of the agricultural co-operatives, and following the approval of the State Council, ABC was officially founded in March 1955. A four-level system was established, with a headquarters, provincial branches, main branches in special regions, and sub-branches in counties. ABC was placed under the supervision of PBC and was made responsible for managing the RCCs. In April 1957, ABC was again abolished and its personnel and organisational structures were merged into PBC.

26 In November 1963, following a resolution of the Standing Committee of NPC, ABC was re-established. In November 1965, due to retrenchment, ABC and PBC were re-merged on the approval of the CPC Central Committee.

27 Prior to 1978, PBC did not function as a central bank and in fact was itself involved in financial businesses. Whenever the government emphasised the importance of agriculture, ABC was founded: whenever retrenchment was promoted, ABC was abolished.

After the Reform

28 In February 1979, the State Council issued a Circular regarding ABC, emphasising that “ABC shall establish organisations at various levels from top to bottom”, “rural business offices and RCCs are all placed under the leadership of ABC” and stipulating the business scope of ABC. Thus ABC became responsible not only for rural savings and agricultural loans, but also for rural industrial loans, loans to SOEs for purchasing agricultural products and by-products and loans for the cooperative supply and distribution system. It also developed foreign financial co-operation and managed the RCCs.

29 From 1979 to 1994, the financial reforms of ABC were mainly focused on increasing profit retention, introducing and implementing contract management systems, resuming mass participation, instituting improvements in organisation and methods and increasing the scope of its business.

30 Following a Resolution of the State Council on Financial System Reform in 1993, ADBC was founded in November 1994. Agricultural policy finance was separated off to ADBC, while commercial finance was retained by ABC. By 1997 the separation of the operations of ADBC were largely complete.

31 In 1996, following a Resolution of the State Council regarding Rural Financial System Reform, the RCCs were separated from ABC and their management systems reformed. By the end of 1996, the separation of ABC and the RCCs nationwide was almost complete.

32 In 1998 the state adjusted the business scope of ADBC, transferring subsidised poverty lending and other policy lending back to ABC. The performance of subsidised lending has been consistently poor.
Poverty Reduction Funds through Financial Channels: Subsidised Loan Programme

Based on the assumption that farmers’ access to the formal credit market is limited due to shortage of funds and the inability of the poor to afford to pay full market interest rates, the subsidised loan programme for the poor has played a key role in the government’s poverty reduction programmes since 1986. When LGOP was established in 1986, the major new poverty programme it initiated was a subsidised poverty loan programme for nationally designated poor counties administered by ABC. Over time, this programme became the largest and most important loan programme targeted at poor areas. In 1988, two additional programmes were set up, one targeted at pastoral areas, the other to support the development of county-run enterprises in national poor counties. After 1994, all these subsidised loan poverty programmes were combined together and formed the only poverty loan programme. They were gradually shifted to ADBC after 1994, but all returned to ABC from 1998. The amount of the subsidised poverty loan programme has changed over time. In the 1980s, the amount increased slightly in nominal terms but declined in real terms. In recent years, the amount has increased substantially, reaching RMB 10 billion in 1998. The interest rate on the main subsidised poverty loans has been about 3% annually.

The national LGOP approves the subsidised loan allocations to different provinces each year. The national PADO is the implementing office, which makes recommendations to LGOP oversees fund allocation. Leading Groups and PADOs at the provincial and county levels perform similar functions in approving loan allocations to counties and townships. At the county level (and the provincial level for large projects), loans are allocated for approved projects. These projects also must be approved by ABC (ADBC from 1994 to 1998), which disburses the loans and has the right to reject loans that it feels are poor credit risks. ABC provides the loans at the low interest rate and collects a subsidy payment from the central government. Loans are typically for a period of three to five years. In the first phase of the subsidised loan programme from 1986, priority was given to poor households to develop cropping, animal husbandry, and agricultural processing. An official survey at the end of 1987 showed that in the first year of the program, 92% of subsidised loans were distributed directly or indirectly to farm households, rather than to TVEs. This pattern of loan distribution ended by 1989 when LGOP adopted a policy to encourage the development of economic entities.

Repayment rates in the subsidised loan programmes have been very low. It was these low repayment rates, especially the extremely low repayment of subsidised loans TVEs and other entities that have caused LGOP to switch priority again to the individual farmers and to copy models of international microfinance in recent years. A report from China’s Science and Technology Commission (1995) showed that repayment rates for the three years 1991 to 1993 for subsidised loan programme administered through ABC averaged just 54 percent. Statistical data from ADBC showed the repayment rate of subsidised loans has increased in recent years, but it is still very low. It reported the rate of 61.93% in 1997.

Organisation

33 In 1997, there were 31 provinces, 332 regional level administrations (including 222 cities at regional level), 2,135 county level administrations (including 442 cities at county level), 44,689 township administrations and 739,447 village committees in PRC.

34 At the end of 1997, ABC had: a head office with 733 staff members; 31 branches at provincial level with a total of 6,276 staff; 16 branches at subprovincial level with 2,480 staff; 319 branches at regional city level with 23,174 staff; 2,448 branches at county city level with 97,064 staff; 1,179 offices in city suburbs with 38,428 staff; 563 business department with 21,531 staff; 33,096 subofices and business offices with 288,025 staff; 25,350 savings offices with 44,658 staff; and 673 other organisational units with 14,447 staff. In total it had 63,676 organisational units with 536,816 staff members. ABC is the largest bank in PRC in terms of its

Field visits, 29th July to 4th August 1999, Shaanxi Province and Henan Province, PRC.
organisational outreach and second only to Industrial and Commercial Bank of China (ICBC) in terms of staff numbers. Its network covers all of the counties and most of towns in the country but it has limited outreach at village level. ABC’s sub-offices, business offices and savings offices in some towns and villages below county level compete with RCCs to some degree.

**Clients**

35 ABC is the state commercial bank, the credit business of which is meant to promote economic development by supporting:

- enterprises, enterprise groups and large-scale agricultural production bases engaged in primary agricultural production;
- profit-earning enterprises engaged in primary agricultural production; and
- development of the social service system.

36 ABC’s lending clients are mainly township and village enterprises (TVEs), supply and distribution co-operatives, commercial organisations and private businessmen or individuals.

37 ABC’s Loan Management Policies (August 14, 1997) stipulate that:

- borrowers shall be legal persons or enterprises, other economic entities, individual businessmen or natural persons with complete civil competence and of PRC nationality registered by the industrial and commercial administration (or competent organisations);
- borrowers shall be required to open a current account or general savings account with ABC and maintain savings not less than 10% of their loan balance as a guarantee;
- generally, any external investment of the enterprise shall not exceed 50% of its total net assets;
- those unable to comply with savings deposit conditions shall provide a guarantor, mortgage or other collateral to comply with the guarantee conditions;
- when applying for a short-term loan, an applicant shall have an asset liability ratio of not less than 70 percent;
- when applying for a medium or long-term project loan, the applicant shall produce project approval documents issued by the state relevant organisations and shall have capital complying with the proportion stipulated by the State Council.

38 ABC has more and more taken on the nature of a commercial bank and appears to be increasingly uncomfortable with policy lending. In 1998, ABC’s policy
lending amounted to RMB 156 billion, representing 28.2 percent of the year’s total loans of RMB 553.8 billion.\textsuperscript{16}

\begin{table}[h]
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\begin{tabular}{|l|}
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\textbf{New Developments and Related Issues} \\
\hline
ABC is now defined as a commercial bank, seeking profits in its business operations, while the subsidised loan programme is policy oriented. We found in Shaanxi and Henan provinces that county level ABC branches were instructed to themselves fund the required amount for the subsidised loan programme, with their upper level providing the subsidies. This means the flow of capital may have changed compared with previous ADBC’s management. In the case of ADBC, PBC provided the amount of the subsidised loans prior to disbursement, and because ADBC had no deposit business with the public, the subsidised loan programme meant capital flowed from outside into the poor areas. However, with ABC’s new management procedure, this will no longer be the case and local funds will be used.

ABC’s separation from the RCCs leaves it no grass-roots network at the village level, especially in poor areas. ABC has no capability to provide individual lending directly to the farmers because of the extremely high cost of doing so. In Ankang county of Shaanxi province, ABC planned to hire 50 new staff (one for each village) to do the work, but it seemed too difficult and 1999’s subsidised loans to farmers were postponed.

Subsidised loan funds have often used as matching funds for international funded programmes by local governments for their experimental micro-finance programmes. This has been the case for most international multilateral and bilateral funded microfinance programmes in PRC. China International Centre for Economic and Technical Exchange (CICETE), which is responsible for implementing UNDP projects, negotiated with ABC to sustain UNDP’s existing microfinance programmes when ABC became responsible for the funding. However, domestic microfinance programmes stopped, and while LGOP offices at each local level have actively negotiated with ABC to find ways to resume their programmes, ABC has not always been supportive. \\
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39 In 1997, the loan portfolio of ABC amounted to RMB 1,018.2 billion (including short-term loans of RMB 918.3 billion), an increase of 13.3 percent over RMB 898.5 billion in 1996. At year end 1997, ABC had a loan of RMB 205.6 billion from the central bank, representing 13 percent of its liabilities and owner’s equity of RMB 1,573.9 billion; RMB 81.6 billion was deposited by and lent from its counterparts, representing 5 percent of its liabilities and owner’s equity. Before 1994 the loans of ABC were more than its deposits.\textsuperscript{16}

\begin{table}[h]
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\hline
\textbf{Governance} \\
\hline
40 ABC is an official commercial bank and is supervised by PBC. It complies with the interest rates stipulated by PBC for savings and loans. Different interest rates are specified for various purposes. The interest rate for subsidised poverty relief loans, normal poverty relief loans and agricultural comprehensive development loans are lower than those of ordinary commercial loans.

41 The Banking Laws of PRC, Banking Laws for Commercial Banks of PRC, Insurance Laws of PRC and Billing Laws of PRC were promulgated for implementation in 1995. In 1994, Management Regulations of Financial Institutions were published. ABC is subject to these. On 14 August 1997, ABC published its ABC Loan Management Regulations, ABC Savings Management Regulations, ABC

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\textsuperscript{17} See End Table 3 for the balance sheet of ABC.

\textsuperscript{18} See End Table 4 for the source and application of funds statement for ABC.
Agency Management Regulations and ABC Basic System of Accounting, which stipulates that the accounting system of ABC is accrual based.

42 ABC is allowed to participate in the interbank market, however after 1996, in order to control financial risks, new regulations were issued for interbank borrowing that require that borrowing be conducted through the head office\(^\text{19}\). Beginning in 1998, PBC abolished loan quota control over state-owned commercial banks, and instituted asset liability and management procedures for control of risk.

43 Officials of ABC head office stated that the “classified\(^\text{20}\)” loan rate of ABC was 38 percent in 1998. In 1996, the official loan collection rate of ABC was 89.11 percent\(^\text{21}\), the business income of ABC in 1997 was RMB 122.458 billion and net profit was RMB 527 million, a significant drop over 1996\(^\text{22}\).

**Agricultural Development Bank of China**

44 In December 1993, a Resolution of the State Council on Financial System Reform suggested that ADBC be founded and that agricultural policy finance and commercial finance be separated. In November 1994, ADBC announced its official foundation. In April 1995, ADBC completed the establishment of organisations at the provincial level and by 1997 the separation of its operations from those of ABC was largely complete. Recently, the state adjusted the business scope of ADBC, transferring poverty relief loans and comprehensive development loans back to ABC and focusing ADBC on the disbursement and management of loans for purchasing grain, cotton and oil and for storage of these products.

**Organisation**

45 On 31 December, 1997, ADBC had: a head office with 260 staff; a head office business department with 23 staff; 35 branches at provincial level with 2,553 staff; 35 branch business departments at provincial level with 1,148 staff; 294 branches at regional level with 8,153 staff; 258 branch business departments at regional city level with 3,730 staff; and 1,617 sub-branches at county level with 33,981 staff. In total it had 2,241 organisational units with 49,848 staff\(^\text{23}\). ADBC covers most of the counties nation-wide for lending business but has no saving-offices resource mobilisation.

**Clients**

46 Since poverty relief and other policy lending have been re-assigned to ABC, ADBC is mainly engaged in lending to SOEs for agricultural product and by-products


\(^{20}\) “Classified” loans consist of those classified as overdue (arrears up to two years), in default (arrears over two years) and bad.


\(^{22}\) Refer to End Table 9 for the Income Statement of ABC for 1997.

purchasing. In 1998 the balance of ADBC’s agricultural product and by-product purchasing loan portfolio was RMB 626.2 billion, a 9 percent decrease over 1997\(^{24}\).

47 The capital of ADBC mainly comes from the central government. Its loan of RMB 816.8 billion from the central government in 1997 represented 88.5 percent of its liabilities and owner’s equity of RMB 923.3 billion.\(^{25}\)

**Governance**

48 ADBC is a policy bank, supervised by PBC. On 20 Oct 1996, Regulations on Supply and Management of Grain, Cotton and Oil Policy Purchase Capitals (Yin Fa [1996] No. 392) were published.

49 The loan interest rates of ADBC comply with state policy. ADBC’s collection rate in 1997 was 70.58\%, among which the collection rate for subsidised poverty loans was 61.93\% and that for poverty relief was 29.91\%.\(^{26}\)

**Rural Credit Co-operatives**

**Before the Reform**

50 In 1950 and 1951 farmers established RCCs on a trial basis, mainly for the purpose of organising and regulating funds and cracking down on usury. The network developed rapidly and by the end of 1955 there were 159,000 RCCs throughout the country, covering 85 percent of counties. 76 million farming households participated in these co-operatives, representing 65 percent of all farming households. In 1956, there were nearly 100 million farming households participating in RCCs. After 1958, with the founding of rural people’s communes, the businesses and management of RCCs were transferred to the production brigades. The profits and losses of the RCCs were accounted by the production brigades on a unified basis, credit relationships became non-transparent, and RCCs lost their original co-operative nature.

51 By the end of 1962, the savings in RCCs nation-wide had dropped to RMB 970 million from RMB 2 billion in 1958. From 1962 to 1978, PBC increased its control over the RCCs. For example, RCC leaders were appointed by PBC and their business, finances and salaries were closely supervised. They became “government controlled”.

**After the Reform**

52 In February 1979, the State Council Circular regarding ABC placed RCCs under the leadership of ABC. In August 1996, the Resolution of the State Council regarding Rural Financial System Reform (State Council [1996] No. 33) suggested that the establishment and perfection of the rural financial system should be based on co-operative finance and that commercial finance and policy finance should be


\(^{25}\) See End Table 5 for the balance sheet of ADBC.

separated. It recommended reform of the management system of the RCCs and reorganisation of the RCFs, saying “the focus of the rural financial system reform is the reform of the management system of the RCCs, and the core of the reform is to gradually change the RCCs into co-operative financial organisations from which the farmers buy shares and which are managed democratically by the farmers and mainly serve the farmers.” The first step of the reform was to separate the RCCs from ABC. PBC instructed RCCs to establish county level apex organisations that would be directly supervised by PBC. A co-operative model was adopted to re-standardise the RCCs.

53 By the end of 1996, the separation of RCCs from ABC nation-wide was almost complete. In 1997 the work of the RCCs was standardised according to the co-operative system model outlined in the State Council Resolution: “clarify and expand shareholding”, establish co-operative management systems and reorientate service direction”. Approximately 60 to 80 percent of county level RCCs instituted the model co-operative system after the preliminary reform27.

Organisation

54 By the end of 1995, there were 50,129 independently accounting RCCs, including 47,117 township credit co-operatives, 675 united village credit co-operatives, 185 village credit co-operatives and 2,242 united business departments. There were 57,906 non-independent accounting organisations, including 41,091 credit sub co-operatives, 16,815 savings offices, 257,367 credit stations and 2,409 county (city) united co-operative organisations.

55 Staff members of the RCCs totalled 634,245, including 266,160 permanent employees and 368,085 contract employees. Divided by organisations, 563,665 worked in credit co-operatives, 30,324 in united co-operative business departments and 40,256 in united co-operatives28. RCCs cover almost all villages nation-wide. At grassroots level, such as an administrative or natural village, RCCs usually hire the village accountant or village head as their agent to deliver financial services.

Clients

56 The main clients of the RCCs are farmers and TVEs. Although the State Council Resolution regarding Rural Financial System Reform (State Council (1996) No.33) required the RCCs to allocate more than 50 percent of total loans to farmers, this will only be realised gradually. At the end of 1998, the balance of RCC lending to farmers was about RMB 184 billion, representing only 25 percent of the total RCC loan portfolio balance of about RMB 727 billion. From 1985 to 1990, the average annual number of farmers obtaining credit from formal credit organisations


represented 32 percent of all farmers; that is, only one third of farmers obtained credit through formal organisations\(^{29}\). Loans that are granted are often small.

**RCC Credit: Quotas and Credit Rationing**

Although RCCs are defined as rural community based credit co-operatives and should be run independently, they are controlled by the RCC apex organisation, which often assigns loan quotas to specific RCCs to channel funds flow to meet PBC’s requirements or further the apex’s own profit objectives.

In our field visits, most RCC funds in the poor areas were controlled in this way. The apex usually gives a ratio of credit to deposits mobilised to each RCC. In Luanping county, these ratios were around 60% to 70% for most RCCs, meaning that for every RMB 1.00 that the RCCs mobilises from farmers (not including the reserves required by PBC), only RMB 0.60 to RMB 0.70 can be used for credit.

Loans to TVEs and larger loans to the better-off farm households make up the lion’s share of the RCC’s loan portfolios. Small loans to large numbers of farm households are usually assigned by quota for no more than several hundred RMB per household. Less than one third of households can access this small preferential lending for which no hard collateral is required, but guarantors must be obtained. For larger loans, usually deposits or guarantors with deposits are required as collateral.

Because PBC did not previously provide RCCs with interest subsidies for long-term deposits under inflationary conditions, RCCs have the right to increase their loan interest by up to 50 percent above PBC’s benchmark lending interest rate\(^{30}\).

57 According to officials of the Supervision and Management Department of Co-operative Financial Organisations of PBC, currently there are 80 percent of farmers depositing in RCCs and nearly 50 percent of these have at some time been granted a loan from an RCC. At the end of 1997, deposits in RCCs amounted to about RMB 1,056 billion, including about RMB 913 billion belonging to farmers (86.5 percent of the total) and about RMB 142 billion from collective agriculture and TVEs (13.5 percent of the total). Outstanding loans amounted to about RMB 727 billion, including about RMB 184 billion to collective agriculture (25.3 percent of the total), about RMB 369 billion to TVEs (50.7 percent) and about RMB 174 billion to farmers (24.0 percent). The capital of RCCs comes mainly came from farmer short-term deposits while lending transfers the majority of these funds to collectives and TVEs. Deposits in RCCs have always exceeded loans, and before 1996, RCCs did not have recourse to PBC. By 1997, they owed RMB 1.64 billion to PBC\(^{31}\).

58 Generally, loans require mortgage security, however a mortgage is not required for loans below a specified amount. Large loans may require both mortgage and other collateral security. At present, RCCs in some regions are testing joint liability group security for small loans on a trial basis. In 1999, the RCCs suggested starting granting consumption loans to farmers, mainly for house building, education and medical treatment\(^{32}\).


\(^{30}\) Source: Notes from field visits, 29th July to 4th August 1999, Shaanxi province and He Nan province, PRC; Note from field visit, 8th to 9th, September 1999, Luanping county, Hebei province.

\(^{31}\) See End Table 2 for the balance sheets of RCCs.

\(^{32}\) Abstracted from the interviews of officials of Supervision and Management Department of Co-operative Financial Organisation of PBC.
High Transaction Cost for RCC Credit

In Yeping village of An Kang county in Shaanxi province, farmers from administrative villages need to go to the RCC office, located 1 to 10 km away, in order to apply for a loan. A farmer needs to have three guarantors (these guarantors cannot apply for loans before the guaranteed loan is repaid), who must go with him to the office to make the application. The time taken in this increases the transaction cost for farmers (and guarantors). Repayments also have to be made at the RCC office and because of distance, farmers will usually opt for a lump-sum repayment at maturity rather than installment payments.

Governance

59 RCCs are required to comply with state policy with respect to interest rates on deposits, but they are permitted to vary their interest on loans by up to 50% from the state-set base interest rate. Currently, the base interest rate on loans is 5.85 percent per annum. The permitted degree of deviation of loan interest rates from the state base rate differs according to the purpose of the loan and its priority under state policy.

60 RCCs are now supervised by Co-operative Finance Organisation Management Department of PBC at all levels. RCCs in all areas are required to have county-level apex institutions to manage the lower level RCCs. The apex institution provides a central fund allocation or clearing house service for the local RCCs. The apex institution collects management fees from its affiliates. Some apex institutions also handle financial businesses directly. Some areas have also set up regional-level apex institutions on a trial basis.

61 Beginning in 1985, RCCs have implemented accrual accounting systems. In 1997, the loan collection rate of the RCCs was 88.7 percent\(^{34}\). The loan collection rate for farmers was higher than the average\(^{35}\).\(^{36}\).

62 Although RCCs are defined as rural co-operative economic organisations, a Law on Credit Co-operatives has not yet appeared. PBC has published Management Regulations for RCCs, Management Regulations for County-level Apex Institutions of RCCs and printed and issued Ten Opinions regarding RCCs to Improve and Strengthen Farmer Assistance Services.

RCCs Exploring New Ways

Recently, PBC has striven hard to make RCCs closer to the farmers, and PBC has set a goal of at least 50 percent of RCC’s lending portfolio to farm households.

In August 1999, new regulations for RCC’s small loans to farmers were promulgated. They aim at RCC’s lending to farmers without collateral. Although this is still within the scope of credit rationing and will not change RCC’s credit behaviour, it is a step forward in rural financial reform.

In addition, under the supervision of central PBC and with the help of the Development

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Source: Notes from field visits, 29th July to 4th August 1999, Shaanxi province and Henan province, PRC.


Abstracted from interviews with officials of the Supervision and Management Department of Co-operative Financial Organisations of PBC.

Refer to End Table 2 for the aggregate Balance Sheet of RCCs.
Rural Credit Foundations

63 RCFs were local quasi-governmental financing organisations. Their funds mainly originated from the collective assets and share capital contributed by farmers. Similar organisations by different names include Agricultural Economic Service Companies, Agricultural Economic Service Stations and Rural Mutual-Aid Funds. Rural Mutual-Aid Funds were established by the Ministry of Civil Affairs after the reform to adapt systems to the difficult task of distributing relief funds to scattered farmers. From 1986 to 1988, all these types of funds experienced dramatic growth.

64 In 1986 and 1987, the central government issued documents allowing and encouraging internal financing of RCFs. Although the RCFs adopted a co-operative shareholding system, in fact they had close administrative relations with the local villages. Although they competed with the formal financial organisations in their operational business, they had no proper legal status. Some co-operative funds violated regulations and operated in a way that lead to deterioration in their financial risk.

65 In 1994 there were 128,400 informal financial organisations of which RCFs were the main forms. These covered 38 percent of the villages and towns throughout the country, financing RMB 25.5 billion. They were financed with collective share capital (72 percent) and farmers share capital (28 percent). Officials of the Supervision and Management Department for Co-operative Financial Organisations of PBC estimated that in 1998 RCFs had total financing of RMB 160 billion and a total loan portfolio of RMB 130 billion.

66 From the end of 1988, RCFs were continuously under threat of re-organisation or closure. PBC and formal financial organisations regarded them as illegal, but the Ministry of Agriculture (MOA) and local governments gave them positive support. Re-organisation was staved-off until 1999, when in the face of the Asian financial crisis, the national government placed particular emphasis on controlling financial risks and required RCF re-organisation and closure. Currently, all RCFs have ceased operation nation-wide. They will either be absorbed into RCCs or closed.

RCFs: Closed Down

Nan Zhao county is a national designated poverty county in Henan province, a less developed region in central PRC. There are 16 townships and 337 administrative villages with 590,000 people in this


Source: Notes from field visits, 29th July to 4th August 1999, Shaanxi province and Henan province, PRC.
county. The average net income per capita of farmers in 1998 was only RMB 1,360, compared to the national average of RMB 2,162 for the same year.

Until September 1998, there were 380 RCFs or RCF-like institutions. In 1998, the funds mobilised reached more than RMB 150 million, about 15% of the total deposits of formal financial organisations in this county, and the RCFs made net profits of more than RMB 50,000.

Under the government's RCF closure programme, all 380 organisations ceased business operations. They will be closed down or merged into RCC's, but they will not be allowed to change into independent RCCs though this was a supposed alternative under the policy.

**Governance**

67 Interest rates on deposits with RCFs were required to comply with the state-set interest rates, but in practice this was not always the case.

**Informal Credit Mechanisms**

68 Various forms of informal rural credit, such as private money shops, moneylenders, ROSCAs of various forms (usually called "hui" in PRC, which means "meeting"), fund raising, pawnbroking and borrowing between farmers developed rapidly following reform. Government action forced the disappearance of private money shops and moneylenders or their removal to the hidden economy. However, various forms of "Hui" and mutual lending have continued to develop. Farmers' credit has mainly relied on the informal market.40

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40 See Table 2 for reference.
“Hui” in Rural PRC

Hui have a long history in the coastal areas of PRC. They were not eradicated under the new republic but survived underground in small numbers after PRC was established and following the reform in the late 1970's.

In essence, Hui are a kind of rotational savings and credit activity. A number of people (usually familiar with each other) form a group. The group meets at regular intervals, pooling a sum of money for one member at each meeting. The number of members in the Hui may vary (but are fixed in one Hui), the interval between meetings may be long or short (but are regular in one Hui), and the sum pooled may be large or small, depending on need.

Hui are classified by the ways that the members use to determine which of them gets the pool of funds, and by how much each member donates to the pool every meeting. There are many forms of Hui. Examples are “Lun Hui” (“Lun” means by scheduled order), “Biao Hui” (“Biao” means by bidding) and “Yao Hui” (“Yao” means by throwing dice).

For “Lun Hui”, the order in which each member uses the pool is predetermined, the sum of the pool is fixed, but those who use the pool earlier contribute more money at each meeting. So members using the pool early behave like borrowers while those using the pool later behave like lenders. Members can choose their order according to their borrowing or lending demand. For “Yao Hui”, the lending order is determined by throwing dice. For “Biao Hui”, a fixed basic contribution is the same for each member at each meeting, but the member that bids the highest price wins the pool at any individual meeting. That member then contributes the basic contribution plus their bid price in the following meeting. Each “Hui” has a head responsible for meeting discipline. He/she usually takes the first pool and pays no interest.

The interest rate is usually around 20% annually for these "Hui". In general, those "Hui" with relatively fewer members and moderate interest rates operate on a more stable basis with better security.

Characteristics of these "Hui" include:
- varieties in form, duration, members, amount of funds and ways in which the order of use of funds are determined to meet various financial demands;
- members within the same "Hui" are usually familiar with each other;
- "Hui" with large funds and high interest rates usually have higher financial risks.

In mid and late 80's, Some "Hui" in Wen Zhou of Zhejiang province changed into pyramid schemes and caused social unrest. As a result, PBC promulgated regulations to curb informal rural finance activities, but with only marginal success for a relatively short time.41

It is difficult to determine the number of informal rural financial organisations. "Hui" predominate but usually operate in secret in those rural areas where there are more business opportunities, especially in the coastal areas in southern PRC. It is difficult, if not impossible, for the government to monitor and regulate the "Hui"s if they are not legitimate, but for as long as the formal financial institutions can not meet the non-state-owned enterprises' financial demands, these kinds of informal finance will act as substitutes.

Clients

The credit mode, clients and purpose of rural informal loans in PRC are varied. Enterprises mainly obtain short-term working capital from the informal credit market that cannot be met by the formal credit market, or collect funds from the

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informal credit market by various means. Individuals and households participating in business activities or seeking higher returns on capital participate in different forms of “Hui”. Women hold a higher proportion of informal loans. Among informal loans, those for non-production purposes represent 60 percent.42

Governance

Informal credit by definition is self-governing. The interest rate on informal loans varies greatly. Borrowing between friends and relatives can be interest free. The interest rate on loans for production and commercial purposes is generally one to two times higher than that of formal financial institutions, although the nominal interest rate in the loan contracts may not exceed the upper limit set by local judicial departments. Compound interest is generally not used: interest rates are flat rates based on the initial principal amount. In the coastal regions where informal lending is popular, normal loan interest rates are generally 2 fen (a monthly flat rate of 2 percent).

Microfinance Implementing Organisations

There are four basic types of microfinance implementing organisations in PRC:

- NGOs (non-government organisations), implementing pilot microfinance projects such as the "Funding Poor Co-operatives" FPC project of the China Academy of Social Sciences (CASS);
- government poverty reduction organisations that manage and operate subsidised interest microfinance loan projects, the size and influence of which are greatest in Shanxi and Yunnan provinces and Guangxi autonomous region;
- formal financial institutions operating microfinance projects, such as the RCC project in Luanping County, Hebei Province and the AusAID Qinghai project, which was transferred to Microcredit Office (MCO) of ABC in Haidong Prefecture when donor project funding ceased; and
- donor funded projects, often managed by special governmental organisations that operate according to the requirements and regulations of the donor organisations. Donors have included multilateral organisations such as UNDP or UNICEF, and bilateral donors from Canada (the Xinjiang project) and Australia (the AusAID Qinghai project, now transferred to the control of ABC).

It is estimated that there are currently in excess of 260 microfinance pilot projects in PRC. Projects of different organisations have their own characteristics: projects of NGOs and donors place emphasis on sustainable social development; government poverty projects focus on the speed and scale of development; while projects of formal rural finance organisations place importance on continuity,

supervision and risk control. The sections below review each of these four types of project.

**NGO Microfinance Pilot Projects**

74 Pilot microfinance started in PRC with the pilot microfinance project of the Rural Development Institute of CASS, which took as its model the Grameen Bank of Bangladesh (the GB Model). The CASS pilot project has the dual objectives of exploring the use of the GB Model for poverty reduction. At present, it is still in the pilot phase. Its emphasis is on providing productive loans to poor families. As a production-oriented microfinance project, its basic target is to explore effective methods of funding the poor. It is still focused on its “customer level” strategy, and is not yet a fully self-sustaining, replicable operation.

75 Others NGOs have also operated experimental pilots, often with international support. Most of these pilot projects also use liability group methods emphasising peer co-operation and supervision. However, direct loans to individuals also exist. In the joint liability group projects a typical group is formed voluntarily by five borrowers (blood relatives cannot be in the same group). Six to eight groups will form a "centre". Heads of groups and directors of centres are elected. Group members help and supervise each other and they guarantee each other’s loans. The director of the centre and staff call meetings periodically (weekly, ten days, half a month or monthly) to check on the progress of individual business activities and the usage of capital, to handle procedures of loan issue, repayment and savings, and to exchange experiences. Therefore, the majority of these projects are also similar to the GB Model. Table 3 provides a synopsis of the main NGO projects.
Table 3  Basic Microfinance Portfolio Data for NGO Microfinance Projects

<table>
<thead>
<tr>
<th>Funding (F), Implementing (I), PRC partner agencies (P)</th>
<th>Project Area</th>
<th>Time Scale</th>
<th>Source of Start-up Loan Capital</th>
<th>Total value of Loans (in last accounting period)</th>
<th>Typical Loan Size</th>
<th>Interest Rate</th>
<th>Repayment Schedule</th>
<th>Outline of Savings or other Component</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ford Foundation, Grameen Trust, Canada Fund (F, I) Rural Development Institute CASS (I)</td>
<td>Hebei, Hemen, Shaanxi</td>
<td>Start: 04/94 05/96</td>
<td>International Donors</td>
<td>USD 2,260,000 (4/94-12/96)</td>
<td>1st year RMB 1,000, 2nd year 1,500, 3rd year 2,000</td>
<td>6% or 10% flat</td>
<td>Every week from third week of loan period</td>
<td>Savings deposit interest rates same as Commercial Bank</td>
</tr>
<tr>
<td>Ford Foundation, Asia Foundation, Oxfam HK (F) Rural Women Knowing All and Women's Federation (I)</td>
<td>Hebei, Huabei, Guizhou Heilongjiang, Gansu</td>
<td>Start 11/96</td>
<td>Initial funding donated by Chinese individual</td>
<td>RMB 400,000</td>
<td>RMB 500-2,000</td>
<td>8%</td>
<td>Loan Period: 1 year, monthly repayments begin from 3rd month</td>
<td>5 farmer co-ordinators facilitate/monitor user groups; 5 Caohai Reserve staff approve formation of groups</td>
</tr>
<tr>
<td>Intl. Crane Foundation, Trickle-up Program (F), Caohai Nature Reserve, Guizhou Env. Prot. Bureau (I)</td>
<td>Guizhou, Weining county</td>
<td>Start 06/1995</td>
<td>ICF &amp; T-Up 60%, Local govt. 25-30%, farmers 10-15%</td>
<td>RMB 400,000</td>
<td>RMB 200-2,000</td>
<td>Mostly 3% per month</td>
<td>Repayment in full after 3 months</td>
<td>microfinance programmes are part of integrated development projects</td>
</tr>
<tr>
<td>Jian Hua Foundation (F, I) county &amp; township govt. (P)</td>
<td>Hebei, Inner Mongolia</td>
<td>Start 02/99</td>
<td>Private int'l. Donors through Jian Hua Foundation</td>
<td>RMB 501,600</td>
<td>RMB 300; 43 large loans 3,000-4,200</td>
<td>11% pa</td>
<td>8 month loans repaid at end or 22 months with 2 instalments</td>
<td>2 farmer co-ordinators facilitate/monitor user groups</td>
</tr>
<tr>
<td>Oxfam HK (F, I) Yunnan PAO, KFETCC; Guizhou Agri. Dept.; Guangxi Minority Affairs Comm. (P)</td>
<td>Guizhou, Guangxi Yunnan</td>
<td>1992-2000 (different start dates)</td>
<td>90% from Oxfam HK</td>
<td>RMB 1,200,000</td>
<td>RMB 150-1,000</td>
<td>Variable 3.00%-12% pa</td>
<td>Repayment period varies from 3 months to 3 years</td>
<td>microfinance programmes are part of integrated development projects</td>
</tr>
<tr>
<td>DORS (Development Organisation of Rural Sichuan) (F, I) Poverty Alleviation Bureau (P)</td>
<td>Sichuan Hanyuan County</td>
<td>Start 1997</td>
<td>DORS</td>
<td>RMB 293,500</td>
<td>RMB 600-1,000</td>
<td>No interest: RMB 40-50 mangement fee</td>
<td>Two six-month instalments</td>
<td></td>
</tr>
<tr>
<td>Salvation Army (F, I) local Women's Federation (P, I)</td>
<td>Yunnan Luxi County</td>
<td>03/98 - 02/2000</td>
<td>Sa 48%, Local govt. 52%</td>
<td>RMB 262,500 (first 6 months)</td>
<td>RMB 800-2,500</td>
<td>5.04%-5.76%</td>
<td>Loan period is 1 year, monthly repayments</td>
<td></td>
</tr>
</tbody>
</table>

Development Scale

76 The most significant NGO project is the CASS FPC project, aided by Grameen Trust of Bangladesh and the Ford Foundation and Yang Lin, a businessman, with funding of RMB 8 million.

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1999, "China Brief Volume II Number 2".
Most NGO and civil organisations emphasise women as the main target group. Table 4 shows the eligibility criteria of two sample NGO microfinance pilot projects and the percentage of clients that are women.

Table 4  Eligibility Criteria and Women's Participation for NGO Microfinance Projects

<table>
<thead>
<tr>
<th>Projects</th>
<th>Eligibility Criteria</th>
<th>% of Women Borrowers</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASS FPC Project</td>
<td>Per capita income below national poverty and total property &lt; RMB 8,000</td>
<td>90%</td>
</tr>
<tr>
<td>Oxfam HK Yunnan, Guangxi and Guizhou Project</td>
<td>Loans are made to individuals, groups and communities; criteria: Poor and motivated</td>
<td>70%</td>
</tr>
</tbody>
</table>

**Loan Products**

The first cycle loan of NGO sponsored microfinance projects is generally in the range RMB 400 to RMB 1,000. The term ranges from 3 to 12 months. The loan is repaid either in lump sum on maturity or by instalments every one to four weeks. The loan interest ranges from 12 to 20 percent per annum. Most projects use the liability group guarantee system, while some provide individual loans. Repayment rates are generally good, above 90 percent. If the borrowers can repay on time, they can get a subsequent loan with a larger amount, based on the prior loan. The retention rate of clients is high.

**Deposit Products**

At present, almost all NGO microfinance projects in PRC require a security deposit as a substitute for collateral. This is not to be confused with savings deposit requirements, although interest is usually paid. Some projects require that a certain proportion of loan value (for example: 1 percent) be deposited when repaying, according to the frequency of repayment. For example, the CASS FPC project requires that each borrower deposit 5 percent of the loan value in the group fund on disbursement, and in addition deposit RMB 1.00 or 0.1 percent of the loan value in the fund with each weekly repayment.

**Financial Management**

Accounting and financial management systems of NGO projects in PRC are still formative. Before 1997, most projects focused their attention on identifying and mobilising poor families, disbursing loans and ensuring high repayment rates. Most projects had imperfect accounting and financial reporting systems, no integrated or uniform tracking of income and expenses or loans and no uniform loan quality and business progress reporting. At the start, most staff of microfinance pilot projects had knowledge of social development issues but lacked finance and business knowledge.

Since 1997, projects have obtained advisory assistance from consultants or PRC formal financial institutions (local branches of ABC or RCCs) and have made some progress with accounting and financial management systems. The CASS FCP project, for example, has set up accounting and financing management systems to
produce uniform financial reports (balance sheets and income statements) each month as well as financial ratio analysis based on the standard established by the Small Enterprise Educational Promotion (SEEP) project. Table 5 sets out the financial results from this analysis for the three CASS FCP projects as at the end of 1998.

Table 5  Financial Ratios for the CASS FCP Project 1998

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Yixian</th>
<th>Yucheng</th>
<th>Nanzhao</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial Sustainability Ratios</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Return on Assets (%)</td>
<td>6.9</td>
<td>12</td>
<td>12.4</td>
</tr>
<tr>
<td>Financial Cost Ratio (%)</td>
<td>0.7</td>
<td>1.4</td>
<td>1.5</td>
</tr>
<tr>
<td>Gross Financial Margin (%)</td>
<td>6.3</td>
<td>10.6</td>
<td>10.9</td>
</tr>
<tr>
<td>Loan Loss Provision (%)</td>
<td>0</td>
<td>0.2</td>
<td>0.9</td>
</tr>
<tr>
<td>Net Financial Margin (%)</td>
<td>6.3</td>
<td>10.4</td>
<td>10</td>
</tr>
<tr>
<td>Operating Cost Ratio (%)</td>
<td>3.4</td>
<td>6.4</td>
<td>5.8</td>
</tr>
<tr>
<td>Operating Margin (%)</td>
<td>2.9</td>
<td>4</td>
<td>4.2</td>
</tr>
<tr>
<td>Imputed Cost of Capital Ratio (%)</td>
<td>4.1</td>
<td>3.9</td>
<td>4.6</td>
</tr>
<tr>
<td>Net Margin (%)</td>
<td>-1.2</td>
<td>0.1</td>
<td>-0.4</td>
</tr>
<tr>
<td>Operating Grants Ratio (%)</td>
<td>36.2</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Net Result (%)</td>
<td>35</td>
<td>0.1</td>
<td>-0.4</td>
</tr>
<tr>
<td>Operating Self-sufficiency (%)</td>
<td>173.6</td>
<td>156</td>
<td>152</td>
</tr>
<tr>
<td>Financial Self-sufficiency (%)</td>
<td>85.5</td>
<td>101.6</td>
<td>97</td>
</tr>
<tr>
<td><strong>Operating Efficiency Ratios</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost per Unit of Money</td>
<td>0.04</td>
<td>0.03</td>
<td>0.03</td>
</tr>
<tr>
<td>Cost per Loan Made</td>
<td>51.4</td>
<td>55.1</td>
<td>42.77</td>
</tr>
<tr>
<td>Average No. of Loans per Credit Officer</td>
<td>248</td>
<td>285</td>
<td>278</td>
</tr>
<tr>
<td>Average Value of Loans per Credit Officer (RMB)</td>
<td>248,119</td>
<td>159,905</td>
<td>194,008</td>
</tr>
<tr>
<td><strong>Portfolio Quality Ratios</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Portfolio in Arrears</td>
<td>0.03</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Portfolio at Risk</td>
<td>0.4</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

82  The financial system of the Ankang World Bank project was set up on the basis of CGAP standards, and improved in practice. It has also used the SEEP format financial report from 1999.

**Sustainability**

83  The government interest rate ceiling on loans means that microfinance projects are not able to openly follow the international principle of charging interest rates sufficient to cover the high cost of delivering microfinance. This does not mean, however, that sustainability is not an objective of microfinance projects in PRC. Despite the interest rate restrictions, after some five years of operation some
Microfinance pilot projects have achieved operational self-sustainability. For example, the CASS FCP pilot projects in three counties have been operationally self-sustaining since the end of 1997 and by the end of 1998 all FCP pilot projects had achieved 120 to 150 percent operational self-sustainability.

**Funding the Poor Co-operatives**

The microfinance projects of the Funding the Poor Co-operatives (FPC) is an “action-research plan” of the Rural Development Institute of CASS initiated in 1993. The project was prepared in the period 1993-1994 and was formally launched in May 1994. FPC introduced and used the concept of microfinance in PRC for the first time and operated in accordance with international models. Out of many microfinance models, the FPC chose the GB Model to test it for use in poverty reduction work in PRC (using poverty reduction funds as capital). Three problem areas were to be researched: difficulties that poor families have in obtaining loans, difficulties they experience in loan repayment and difficulties related to the survival of microfinance organisations.

From the beginning of 1994 to November 1995 (from the first loan issued in Yixian County by the first FPC to the start-up in Nanzhao of the third FPC), the central task of the FPC projects was to achieve effective and efficient operation under the regime of fixed funding supply and standard technology. At this stage, the focus was on how to make loans effectively to poor families and assure high loan repayment rate; that is, achieve success at the customer level.

From the end of 1995 to 1996, on the basis of the pilot projects’ successful experience in lending to poor families, FPC projects began to address problems at the organisational level. On the one hand, importance was placed on organisation development, formulation of regulations and management development. On the other hand, financial independence and self-sustainability were also emphasised.

Since 1997, FPC projects have entered the third phase, to achieve self-sustainability, explore approaches for the extension of projects and strengthen organisation capacity and effective management methods. Importance was placed on operations planning and the enhancement of organisational capacities. By June 1999, FPCs had nearly 10,000 loan members. The total loan portfolio is RMB seven million and the loan repayment rate exceeds 95 percent. A uniform interest rate policy has been adopted with the nominal interest rate being 8 to 10 percent (flat rate) per annum. Compulsory deposit and liability group guarantee systems are used.

Microfinance projects of FPC are mainly operated by civil organisations. FPC takes an independent corporate form registered in the civil administration departments of the project counties. Leaders of the project counties serve as directors of Board of FPC. FPC employs special officials as managers and employs full-time staff. FPC has set up a two-level hierarchy, at county and township levels. Responsible people from counties are directors of FPC branches. They work under the leadership of the board and head office, and are responsible for the co-operative’s business in the local area. FPC sub-branch at township are responsible for setting up member groups and centres and participate in the weekly meetings of the centres, supervising implementation, repayment and collection of loans and penalties. The FPC Beijing Head Office has been set up and is responsible for leading and supervising the work of FPC in each of the project counties. County governments provide support and assistance in managing the projects, such as helping to establish the board of the local FPC and choosing project principals. They help the FPCs to develop, but do not intervene in concrete matters.

**Government Poverty Reduction Projects**

Based on some early success of the pilot projects, government-operated poverty reduction projects adopted some aspects of the GB Model. The main goal of...
government is to help poor farmers in poor areas directly, and the impact and scale in the short term are emphasised, instead of the programme’s long term sustainability.

**Development Scale**

According to the statistics of the Leading Group on Poverty Reduction, government poverty reduction projects have issued RMB 600 million in loans in 605 counties and 22 provinces by August 1998. At the end of 1998, provinces with large-scale governmental projects include Shaanxi, Yunnan and Sichuan provinces and Guangxi Autonomous Region. Table 6 provides some basic portfolio data for two major government poverty reduction projects.

### Table 6 Basic Microfinance Portfolio Data for Government Poverty Reduction Projects

<table>
<thead>
<tr>
<th>Funding(F), Implementing (I), PRC partner agencies (P)</th>
<th>Project Area</th>
<th>Time Scale</th>
<th>Source of Start-up Loan Capital</th>
<th>Total value of Loans (in last accounting period)</th>
<th>Typical Loan Size</th>
<th>Interest Rate</th>
<th>Repayment Schedule</th>
<th>Outline of Savings or other Component</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guangxi, Government, ABC</td>
<td>28 poverty counties in Autonomous Region</td>
<td>Start 1997</td>
<td>Government subsidised loan</td>
<td>RMB 90,000,000</td>
<td>RMB 1,000</td>
<td>Interest 3.00% flat and 2% management fee</td>
<td>Monthly instalments</td>
<td></td>
</tr>
<tr>
<td>Rural Development Association of Poor Areas in Sichuan Province</td>
<td>12 poverty counties in Sichuan province</td>
<td>Since 1997</td>
<td>Government fiscal fund and subsidised loan</td>
<td>RMB 20,040,000</td>
<td>RMB 1,000</td>
<td>Interest 6%-8% flat</td>
<td>Monthly instalments</td>
<td></td>
</tr>
</tbody>
</table>

### Characteristics of the Target Group

The main target group of government poverty reduction projects is poor families in designated poor counties. Governmental microfinance poverty reduction projects aiming at funding the poor using subsidised loans and emphasise inclusion of the poorest families in the target group. These programmes do not emphasise inclusion of women. For example, the poverty reduction project promoted by the government of Shaanxi Province takes all poor families registered by the Poverty Alleviation Development Office (PADO) as its target. Table 7 provides the eligibility criteria of examples of government poverty reduction projects and the percentage of clients that are women.

### Table 7 Eligibility Criteria and Women Participation for Government Poverty Reduction Projects

<table>
<thead>
<tr>
<th>Projects</th>
<th>Eligibility Criteria</th>
<th>% of Women Borrowers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guangxi, Government, ABC</td>
<td>Registered Poor Households in local PAO office</td>
<td>Does not emphasise gender</td>
</tr>
</tbody>
</table>

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46 Sun Ruomei, 1999, “Microfinance to the Poor”, Number 1.
Rural Development Association of Poor Areas in Sichuan Province | Registered Poor Households in local PAO office | Does not emphasise gender

**Loan Products**

87 The first round loan of most government poverty reduction projects is generally up to RMB 1,000 with a term of one year. The loan is sometimes repaid by instalments (monthly) and sometimes by lump sum at maturity. Subsidised loan interest rates have ranged from 2.88 to 7.2 percent per annum (though as of September 1999 all poverty reduction subsidised loans bear a rate of 3.0 percent). These projects use the joint liability group guarantee system. There are no provisions for a larger subsequent loan to motivate good repayment. Generally, the repayment rate for government schemes is lower than that for NGO projects. The official recovery rate in 1998 was 62 percent.

**Deposit Products**

88 At the beginning, some government projects had compulsory savings, however, now almost all government poverty reduction projects in PRC have no requirement of any deposit as a substitute for collateral now.

**Financial Management**

89 The Government subsidised loan scheme emphasises client needs, and the financial management of the scheme is weak. With the subsidised lending transferred to ABC, financial management should strengthen, but poverty orientation may weaken.

**Sustainability**

90 With a mandated interest rate of 2.88 percent per annum (3.0 percent starting in September 1999), government poverty reduction lending is non-sustainable by design. Poor repayment rates around 60 percent or less contribute to the non-sustainability of these programmes. Without the continued injection of government grant funds, these programmes cannot continue. However, the political mission of the government for short-term poverty reduction is perceived by some to be satisfied by the subsidised loan poverty reduction programme because of the large disbursements achieved under the scheme (RMB 10 billion in 1998). The perspective is short-term (3 to 5 years) rather than long term based on programme sustainability.

**Formal Financial Institution Microfinance Projects**

91 The main projects of formal financial institutions include the AusAID Qinghai Haidong project with funding of RMB 12 million (now operated by ABC), and the RCC project of Luanping County, Hebei Province.

**Development Scale**

92 Table 8 provides basic portfolio data for some formal financial institution microfinance projects, including for comparison the AusAID project.
Table 8 Basic Microfinance Portfolio Data for Formal Financial Institution Microfinance Projects

<table>
<thead>
<tr>
<th>Funding(F), Implementing (I), PRC partner agencies (P)</th>
<th>Project Area</th>
<th>Time Scale</th>
<th>Source of Start-up Loan Capital</th>
<th>Total value of Loans (in last accounting period)</th>
<th>Typical Loan Size</th>
<th>Interest Rate</th>
<th>Repayment Schedule</th>
<th>Outline of Savings or other Component</th>
</tr>
</thead>
<tbody>
<tr>
<td>AusAID (F), Qinghai, COFTEC (P), ABC (I)</td>
<td>Qinghai Haidong Prefecture</td>
<td>08/96-06/2003</td>
<td>Govt. Of Australia</td>
<td>RMB 17.02 million</td>
<td>RMB 400-1,000</td>
<td>12% pa</td>
<td>6-12 months</td>
<td>Savings component, but not compulsory</td>
</tr>
<tr>
<td>DID (Development International Desjardins) (F, I), RCCs (I, P)</td>
<td>Hebei, Luanping County</td>
<td>01/98-12/2000</td>
<td>PRC sources, incl. RCC savings</td>
<td>RMB 740,000</td>
<td>RMB 1,000 typical; range 500-1,000</td>
<td>Nominal 8.88% pa</td>
<td>Every two weeks, starting from fifth week</td>
<td>Includes savings element. Note: DID’s contribution is entirely focused on training</td>
</tr>
<tr>
<td>IFAD (I) RCC (I) Ministries of Finance, Agriculture (P)</td>
<td>Sichuan, Anhui, Qinghai, Guizhou</td>
<td>1996-2004</td>
<td>IFAD loan to govt., orient to RCCs</td>
<td>USD 20 million</td>
<td>RMB 100-3,000</td>
<td>Commercial rates used by RCCs</td>
<td>Repayment periods vary from 1 to 6 years</td>
<td>Savings deposit rates determined by RCCs</td>
</tr>
</tbody>
</table>

Characteristics of the Target Group

93 The microfinance projects of formal financial organisations are sited in poor regions, but do not specifically emphasise poor families or poor women. Table 9 shows the eligibility criteria of the main formal financial institution microfinance projects and the percentage of clients that are women.

Table 9 Eligibility Criteria and Women’s Participation of Some Formal Financial Institution Microfinance Projects

<table>
<thead>
<tr>
<th>Projects</th>
<th>Eligibility Criteria</th>
<th>% of Women Borrowers</th>
</tr>
</thead>
<tbody>
<tr>
<td>AusAID Qinghai Project</td>
<td>Poor household without collateral but with labour capacity</td>
<td>47.2%</td>
</tr>
<tr>
<td>by Developpement Internationale Desjardins (DID) /RCC Luanping Project</td>
<td>Poor without collateral or access to financial services; participation in savings</td>
<td>45.8%</td>
</tr>
<tr>
<td>IFAD/RCC Project</td>
<td>Beneficiary to undertake viable activity and must have undergone technical training</td>
<td>30%</td>
</tr>
</tbody>
</table>

Loan Products

94 The size of first loans ranges from RMB 400 to RMB 1,000, and loan terms are 3 to 12 months. The loan principal is repaid either as a lump sum on maturity or by instalments monthly. Interest is repaid by instalments monthly. Loan interest ranges from 8 to 12 percent on a nominal basis per annum. Most projects use the joint liability group guarantee system, while some provide individual loans. If borrowers repay on time, they can get a larger subsequent loan.

Deposit Products

95 At present, some formal financial institution microfinance projects in PRC require a security deposit as a substitute for collateral. This is not to be confused with...
savings deposit requirements, although interest is usually paid. Formal financial institutions have the advantage over other microfinance project implementation agencies in that they are able to offer a full range (in the context of the PRC market) of deposit products to their clients.

Financial Management

96 Financial organisations (ABC and RCCs) have the advantage of established accounting and financial management systems, which are better than those of government projects. However, the financial management systems in use require further improvement, especially on producing regular financial statements.

Sustainability

97 The AusAID Qinghai project run by ABC has achieved operational self-sustainability. This has been achieved through the implementation of a suitable interest rate policy, strict control over costs, enhancement of efficiency and assurance of loan quality.

98 The internal control ability of formal financial institutions is generally stronger than NGOs and government projects, and they have the legal status necessary to undertake microfinance business. If they could charge interest rates sufficient to cover costs, they could potentially achieve long term financial self-sustainability.

Development International Desjardins (DID) Luanping RCC Project

A microfinance project operated by formal financial institutions was launched by Developpement Internationale Desjardins and PBC, and implemented in Luanping, Hebei Province at the beginning of 1998. DID provides technical assistance and RCC/Luanping provides all loan funds from their savings deposits. At the same time, the FPC/CASS working group was requested to provide advice.

All the loan principal of the project comes from savings deposits mobilised by RCC Luanping. Twenty percent of the previous year’s total savings deposits in all the RCCs in Luanping is available as loan principal. This ratio can be adjusted according to requirements. The loan principal is saved in a special project account in the RCC. The account is cleared once each year and all the money is transferred to the normal account of RCC. The new loan principal is then transferred to the special account in accordance with the conditions for the next year.

The microfinance business is managed and operated together with the regular financial business of the Luanping RCCs. The director of the credit department of Luanping RCC apex office and the director of every RCC are responsible for the operation of microfinance business. Assistant credit officers in every village covered by the RCCs evaluate the borrowers, identify groups, disburse loans and collect repayments. There are no full-time dedicated microfinance staff at field level. Instead of a fixed monthly salary, the income of assistants comes from half of the administration fee (RMB 5 for each loan) and part of the interest (10 percent of the interest collected).

The operations of Luanping project can be summarised as follows:

- loan term ranges from 6 to 10 months;
- loan size is from RMB 500 to RMB 2,000, and on average of each loan is RMB 850;
- interest is charged on the declining balance; the interest rate at the beginning of operations was 12 percent per annum, and from 1999 it decreased to 8 percent; loan capital and interest are repaid monthly;
- RMB 10 is collected for each loan as administration fee;

According to the CGAP definition. See footnote 45.
group lending methodology is used;

- each borrower deposits 5 percent of the loan up-front in the RCC as security deposit: this cannot be withdrawn before repaying the loan in full;

- up to the end of August 1999, there were 2,619 loans disbursed for a total amount of RMB 2.23 million, the outstanding loan balance was RMB 1.67 million, and the accumulated repayment rate in the first cycle was 100 percent.

The advantages of the project are:

- because it is operated by formal financial organisations, the problem of the legal status of the operation does not exist as in the case of other microfinance projects that are operated by purpose-established institutions;

- the source of loan principal is assured;

- the cost of setting up effective financial and accounting systems is low; and

- the delivery system is the RCC is network, and at the village level it can be operated by credit officer assistants, decreasing costs.

However, microfinance projects operated by formal financial institutions have to face problems of high operating costs and strict limitations in interest rates and the activities allowed of finance organisations. Microfinance projects in PRC take poverty reduction as their main target. For commercial banks, adjustment in their management systems is a problem yet to be resolved.49

Donor Microfinance Projects

Development Scale

At the end of 1998, UN executed projects (including UNDP, UNICEF, IFAD, WFP, ILO, and UNFPA) and World Bank projects had been developed in 150 counties and 22 provinces and regions. The total funding reached RMB 160 million. Table 10 provides a synopsis of the main donor funded projects (and includes for comparison the Qinghai project started as an AusAID project but now under the control of ABC).

Table 10 Basic Microfinance Portfolio Data for Some Donor Microfinance Projects50

<table>
<thead>
<tr>
<th>Funding (F), Implementing (I), PRC partner agencies (P)</th>
<th>Project Area</th>
<th>Time Scale</th>
<th>Source of Start-up Loan Capital</th>
<th>Total value of Loans (in last accounting period)</th>
<th>Typical Loan Size</th>
<th>Interest Rate</th>
<th>Repayment Schedule</th>
<th>Outline of Savings or other Component</th>
</tr>
</thead>
<tbody>
<tr>
<td>AusAID (F), Qinghai COFTEC (P), ABC (I) (now fully transferred to ABC)</td>
<td>Qinghai Haidong Prefecture</td>
<td>08/96-06/2003</td>
<td>Govt. Of Australia RMB 17.02 million</td>
<td>RMB 400-1,000</td>
<td>12% pa</td>
<td>6-12 months</td>
<td>Savings component, but not compulsory</td>
<td></td>
</tr>
<tr>
<td>Caritas Germany (F), CIDA (I), CICETE &amp; IDAZ (P)</td>
<td>Sichuan Yilong County</td>
<td>1998-2000</td>
<td>Caritas RMB 270,900</td>
<td>Average RMB 865 ; Range 200-1,500</td>
<td>Nominal 8%</td>
<td>Every 10 days; repayments begin after 20 days</td>
<td>Project includes technical training - no savings component</td>
<td></td>
</tr>
</tbody>
</table>


Characteristics of the Target Group

The main target groups of donor microfinance pilot projects are poor families, especially poor women in poor regions. Most external donor funded projects emphasise women as the main target group. However, depending on the priorities of the donor and implementing organisation of a project, the participation of poor and women differs. Table 11 provides the eligibility criteria of some donor projects and the percentage of clients that are women.

Table 11 Eligibility Criteria and Women’s Participation for Some Donor Microfinance Projects

<table>
<thead>
<tr>
<th>Projects</th>
<th>Eligibility Criteria</th>
<th>% of Women Borrowers</th>
</tr>
</thead>
<tbody>
<tr>
<td>AusAID Qinghai Project (now fully transferred to ABC)</td>
<td>Poor household without collateral but with labour capacity</td>
<td>47.2%</td>
</tr>
<tr>
<td>CIDA Xinjiang Project</td>
<td>Women with income &lt; RMB 600 pa, must have savings of at least 10% of loan</td>
<td>100%</td>
</tr>
<tr>
<td>GTZ/Jiangxi MRL Project</td>
<td>Low and middle income rural households and farmer organisations</td>
<td>30%</td>
</tr>
<tr>
<td>World Bank/Sichuan and Shaanxi Project</td>
<td>Household per capita income &lt; RMB 500, grain consumption &lt; 300kg, living in mud or straw houses, priority given to married women, must attend related meetings</td>
<td>38.4%</td>
</tr>
<tr>
<td>UNICEF/MOFTEC Project</td>
<td>Women below local poverty line; priority given to mothers of children age &lt; 5, or whose children have dropped out of schooling, and to female headed households</td>
<td>100%</td>
</tr>
</tbody>
</table>
Loan Products

101 The first round loan of donor microfinance projects is generally in the range RMB 400 to RMB 1,000 and the term ranges from 3 to 12 months. The loan is repaid either in lump sum on maturity or by instalments every one to four weeks. Interest ranges from 12 to 20 percent per annum. Most projects use the joint liability group guarantee system, while some provide individual loans.

Deposit Products

102 At present, almost all donor microfinance projects in PRC require a security deposit, as a substitute for collateral. This is not to be confused with savings deposit requirements, although interest is usually paid. If the borrowers repay on time, they can get a subsequent loan with a larger amount than the prior loan.

Financial Management

103 Accounting and financial management systems of most early donor microfinance projects in PRC were generally poor. These are in the process of improvement at present. Before the end of 1996, almost all projects focused their attentions on project activities, including identifying and mobilising poor families, disbursing loans and ensuring high repayment rates. Most projects had imperfect accounting and financial reporting systems, no integrated or uniform tracking of income and expenses or loans and no uniform loan quality and business progress reporting. At the start, most staff of microfinance projects had knowledge of social development issues but lacked finance and business knowledge. This has progressively improved since 1997. The following three case studies are illustrative of donor projects.

### AusAID Qinghai Community Development Projects

This project is a poverty reduction aid project of Australia agreed between the PRC and Australian governments in 1992. In the launching period in April 1994, Australian specialists came to Haidong Prefecture of Qinghai Province to undertake an investigation in three project counties of Huangzhong, Pingan and Ledu for one year, in order to understand government organisations and service systems in the project area. Then they co-operated with PRC project officers and staff members to compile a project implementation plan. After approval of the two governments, the implementation period of the project extended from July 1995 to July 1998.

The general target of the project is to continuously increase the income of poor families in three counties of Huangzhong, Pingan and Ledu and to improve the people’s living standard. The project includes construction (road and water projects) and training components, in addition to credit and project management components. A further objective is to enhance farmers’ abilities in economic analysis and self-development, through training.

The organisation of the project is in two parts. One part is to set up a project management office in the project area, to function as a supervision and consulting office. The microfinance sub-project including credit and deposit mobilisation is a important part of Qinghai Community development project. Australia provided RMB 12 million as credit capital. After 13 month’s preparation, the microfinance sub-project was launched in August 1996. In the preparation period for the microfinance sub-project, the project management office provided a design framework and necessary technology support, including training of ABC staff members assigned to the project. Other tasks of the project office included drawing up credit rules to assure high loan repayment, and supervising staff. All the actual financial business is undertaken by ABC branch offices in the Haidong Area. ABC enjoys the benefits
from the interest spread: the project office issues loans to ABC at an interest rate of 1 percent per annum, and ABC issues loans to farmers in an interest rate of 12 percent per annum. ABC offices at the Prefecture level recruit village credit officers for the microfinance project.

When the project was completed in March 1998, the management function was smoothly transferred from the former project office to the local branches of ABC. By the end of March 1999, the project had 14,000 customers in 112 villages of 17 townships of 3 counties in Haidong area. The actual interest rate is 12 percent per annum. A microcredit office (MCO) is set up in the local area. There are seven staff members in the MCO: one director, one accountant, two drivers and three credit officers. The credit officers go to villages 20 days in each month to directly manage and supervise the work of the credit officers in the branch offices of ABC and Credit Extension Intermediaries. A subsidy is provided according to ABC offices' work results. The Credit Extension Intermediaries are responsible for the centre meetings each month and collects repayments. Loans have terms of 3, 6 or 12 months and are in amounts of RMB 400, 600, 800 or 1,000. The principal of the loan is returned in one lump sum on maturity. The loan repayment rate is 98 percent. As the end of September 1999, there are 15,165 clients, and the outstanding loan balance is RMB 8.85 million.
Ankang of Shaanxi SSCOP/World Bank Rural Microfinance Project

SSCOP (The Supporting Service Co-operative to the Microenterprises of the Poor) microfinance project is a sub-programme of Qinba Mountain Area Poverty Reduction programme. SSCOP was designed and monitored by the Human Resources Development Centre for Western PRC, of the Leading Group of Economic Development in Poor Areas. The methodology of SSCOP was adapted from the Grameen model to some degree. For example, the project uses liability groups of 5 borrowers, each centre with 30 members, weekly centre meetings and repayments (changed to every 10 days from 1999) and use of group funds. Some rules and methods of the GB Model have been changed in accordance with the local situation. SSCOP is registered as an association in the civil administration department of the county, under the supervision of the PAO of Ankang county and the Human Resources Development Centre for Western PRC.

There are 30 full time staff, consisting of the director, 3 administration staff and 26 field staff. The project was started in October 1995, and the first loan was disbursed in January 1997. Up to the end of June 1999, 4,892 loans were disbursed for a total amount of RMB 4.48 million, and the balance of loans outstanding was RMB 2.7 million.

Table 12  Progress of Ankang / World Bank Microfinance Project

<table>
<thead>
<tr>
<th></th>
<th>As at the end of 1997</th>
<th>As at the end of 1998</th>
<th>As at the end of June, 1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coverage of Townships</td>
<td>2</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Coverage of Villages</td>
<td></td>
<td>79</td>
<td>79</td>
</tr>
<tr>
<td>Number of Centres</td>
<td>12</td>
<td>225</td>
<td>235</td>
</tr>
<tr>
<td>Number of Groups</td>
<td>62</td>
<td>1,277</td>
<td>1,346</td>
</tr>
<tr>
<td>Number of Borrowers</td>
<td>314</td>
<td>4,132</td>
<td>4,892</td>
</tr>
<tr>
<td>Total amount of loans</td>
<td>228,500</td>
<td>3,681,400</td>
<td>4,480,800</td>
</tr>
<tr>
<td>disbursed</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amount of loan outstanding</td>
<td>136,961</td>
<td>2,863,241</td>
<td>2,705,800</td>
</tr>
<tr>
<td>Amount of repayment</td>
<td>91,539</td>
<td>818,159</td>
<td>1,775,000</td>
</tr>
<tr>
<td>Repayment rate</td>
<td>100</td>
<td>99.0</td>
<td></td>
</tr>
<tr>
<td>Amount of Group funds</td>
<td>8,893</td>
<td>173,100</td>
<td>223,120</td>
</tr>
</tbody>
</table>

The SSCOP target group is the poor farmers located in the Qinba mountains, an area with scarce population and a lack of transport and market infrastructure. The major business activities of borrowers are agriculture and animal husbandry. Weekly meeting and repayment are a challenge in the SSCOP project because the target group live spread out in a highly mountainous area. Transaction costs of borrowers are therefore high and the average number of loans per Credit Officer is lower than projects operating in flat areas.

Table 13  Loan Size, Loan Term and Business Activities of Borrowers

<table>
<thead>
<tr>
<th>Business activities</th>
<th>Activities</th>
<th>Average Loan Term (mths)</th>
<th>Average loan size (RMB)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1997</td>
<td>1st half of 1998</td>
<td>2nd half of 1998</td>
</tr>
<tr>
<td>Agriculture</td>
<td>21.5%</td>
<td>4.9%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Livestock</td>
<td>38.6%</td>
<td>73.7%</td>
<td>88.1%</td>
</tr>
<tr>
<td>Produce</td>
<td>5.4%</td>
<td>8.0%</td>
<td>2.7%</td>
</tr>
<tr>
<td>Service</td>
<td>4.0%</td>
<td>4.3%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Small trade</td>
<td>6.7%</td>
<td>1.8%</td>
<td>1.4%</td>
</tr>
<tr>
<td>Transport</td>
<td>23.8%</td>
<td>6.7%</td>
<td>1.3%</td>
</tr>
</tbody>
</table>

In 1997, the first cycle loans are from RMB 100 to 3,500, the average being RMB 1,016. The interest rate was 8 percent flat in 1997 and 7 percent flat in 1998. Frequency of instalments was weekly in 1997 and every 10 days in 1998.

Table 14 Income Statement of Ankang / World Bank Project

<table>
<thead>
<tr>
<th></th>
<th>1997</th>
<th>1998</th>
<th>Jan to July 1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from interest</td>
<td>24,444</td>
<td>179,460</td>
<td>82,682</td>
</tr>
<tr>
<td>Income from investment</td>
<td>0</td>
<td>29,904</td>
<td>7,707</td>
</tr>
<tr>
<td>Income from fee</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total financial income</strong></td>
<td><strong>24,444</strong></td>
<td><strong>209,364</strong></td>
<td><strong>90,389</strong></td>
</tr>
<tr>
<td>Interest on debt</td>
<td>17,216</td>
<td>78,441</td>
<td>22,448</td>
</tr>
<tr>
<td><strong>Total cost of fund</strong></td>
<td><strong>17,216</strong></td>
<td><strong>78,441</strong></td>
<td><strong>22,448</strong></td>
</tr>
<tr>
<td>Loan loss provision</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Net financial margin</strong></td>
<td><strong>7,228</strong></td>
<td><strong>130,923</strong></td>
<td><strong>67,941</strong></td>
</tr>
<tr>
<td>Salary and benefit</td>
<td>48,724</td>
<td>80,120</td>
<td>32,857</td>
</tr>
<tr>
<td>Cost of management</td>
<td>6,227</td>
<td>51,268</td>
<td>19,825</td>
</tr>
<tr>
<td>Cost of training</td>
<td>22,962</td>
<td>62,074</td>
<td>58,049</td>
</tr>
<tr>
<td>Other cost of operation</td>
<td>3,780</td>
<td>12,150</td>
<td></td>
</tr>
<tr>
<td><strong>Total cost of operation</strong></td>
<td><strong>81,693</strong></td>
<td><strong>74,689</strong></td>
<td><strong>110,731</strong></td>
</tr>
<tr>
<td>Net income from operation</td>
<td>(74,465)</td>
<td>(74,689)</td>
<td>(42,790)</td>
</tr>
<tr>
<td>Grants for operation</td>
<td>0</td>
<td>4,000</td>
<td>25,000</td>
</tr>
<tr>
<td><strong>Profit/Loss</strong></td>
<td><strong>-74,465</strong></td>
<td><strong>-70,689</strong></td>
<td><strong>-17,790</strong></td>
</tr>
</tbody>
</table>

The financial system was set up based on the CGAP system, with modifications gradually made in practice. The SEEP financial report format is used at present. The Western Centre emphasises the MIS of SSCOP. Monitoring and evaluation in Ankang have been carried out twice a year by the consultants of World Bank and officials of Western Centre. In general, the SSCOP microfinance project in Ankang has covered the poorest of the poor in mountainous areas with a relatively large scale. The capital loan funds are concessional loans.

CIDA/Canadian Co-operative Association

A Canadian government funded project implemented by the Canadian Co-operative Association (CCA) in Xijiang aims to develop permanent, village level institutions to finance income generation activities in member owned and operated micro-enterprises. The women’s credit and savings cooperatives require savings as a condition for obtaining loans and mutual loan guarantees from members. The project began in 1997 and will continue until 2001 with CAD 2 million devoting to start-up loan funds and operated in 4 counties. The Canada Co-operative Association is the executive co-operative body for Canada, and county-level PAO are the local executive organisations.

The methodology of Xinjiang/CCA project is based on the solidarity group. The targeted group are women. The eligibility criteria are a per capita income below RMB 650 per year and an ability to engage in business activities. Compulsory savings are required and the loan sizes are related to the size of deposit.

Table 15 Relationship Between Deposit Size and Loan Size

<table>
<thead>
<tr>
<th>Loan size (RMB)</th>
<th>Deposit size (RMB)</th>
<th>Deposit: loan ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>600</td>
<td>60</td>
<td>1:10</td>
</tr>
<tr>
<td>1,000</td>
<td>125</td>
<td>1:8</td>
</tr>
<tr>
<td>1,500</td>
<td>250</td>
<td>1:6</td>
</tr>
<tr>
<td>2,000</td>
<td>500</td>
<td>1:4</td>
</tr>
</tbody>
</table>

To date, all borrowers have taken out the maximum loan amount and there has been no default on repayments. The 1,120 women who took out loans in the first year of the project have recently begun the fourth loan cycle. By the end of this year it is expected that some 5,000 women will have taken out at least one loan. The loan term is 6 month and the interest rate is 20 percent. Originally it was intended to schedule repayments at monthly intervals, but in light of the difficulty women had in making repayments before realising the return on their investment, repayments are now made at six monthly intervals and monthly savings are encouraged.
The Effectiveness of Rural Finance and Microfinance in Poverty Reduction

The Formal and Informal Financial System

104 The formal financial system is characterised by its legality and good outreach throughout PRC, in some cases down to village level and its ability to offer a range of services to its clients including the legal taking of deposits. As a channel for funding to enterprises and wealthier individuals it has provided an effective means of supporting PRC's rapid economic growth. However, average loan sizes are relatively large and the attitudinal culture is not geared to poverty reduction lending. For the most part, with a few pilot project exceptions, poverty lending has been linked with the government's subsidised loan programme that is unsustainable and tainted by poor credit discipline. The degree to which microfinance would be consistent with the business strategies of the various players in the formal rural finance system is can be summarised as follows:

**ABC**

105 Microfinance is not well suited to ABC's business strategies, as ABC is now undergoing a transformation into a regular commercial bank: becoming a microfinance bank for the poor would be a distracting move in an opposite direction at this time. There is some evidence that ABC lacks enthusiasm for implementing the subsidised poverty reduction loan programmes that has been assigned to it by the central government. However, ABC has the advantage that it already has built up a commercial orientation that is conducive to self-sustainability in its operations, and has existing internal infrastructure in place such as savings services and information systems (although these may require adjustment to suit poor clients).

**ADBC**

106 Microfinance is not at all suited to ADBC, as ADBC has now been assigned very different policy lending responsibilities by government. Assigning microfinance to ADBC would be politically impossible at present because responsibility for the poverty reduction programme lending was only recently removed from ADBC in the face of very high arrears levels. Until ADBC achieves good performance in its financing of state-owned agro-products purchase and sale enterprises (which seems unlikely in the foreseeable future) its role is unlikely to expand.

**RCCs**

107 RCCs may be the most appropriate existing player in the formal rural financial sector to undertake microfinance operations. However, RCCs are currently not yet ready; their internal policies, procedures, systems and corporate culture are not appropriate (RCCs historically have served TVEs and still prefer to make large loans to better-off farmers and TVEs). PBC is actively addressing these issues through the strengthening of the RCC structure, piloting of new lending and management practices, and increased supervision and administration at all levels.
RCFs

108 It is not politically possible for RCFs to undertake microfinance operations because of recent strong government moves (in the face of some public opposition) to close them or merge them with RCCs.

Microfinance Schemes in PRC

109 Pilot microfinance schemes sponsored by NGOs, formal financial institutions and donors have demonstrated:

- the relevance and viability of microfinance in PRC, as well as the prudence of the microfinance methodology according to international best practice;
- that outreach of microfinance can be extended to the poorest areas and to poor farmers and some pilot projects have achieved a reasonable scale in rural PRC;
- the lending and savings operations of most pilot microfinance projects are not approved or authorised by PBC; these projects have no legal status;
- there is an acute lack of microfinance policy, legislative, regulatory and supervisory frameworks;
- while most civil organisation, formal financial institution and donor microfinance programmes charge the maximum loan interest rates permitted under law, these are insufficient to achieve full financial self-sustainability; most government poverty reduction projects rely on highly subsidised government funds and charge interest rates on loans far below the level at which these projects can be made self-sustainable;
- all microfinance projects rely on foreign technical assistance for advice;
- all microfinance projects are faced with challenges of financial management, accounting, risk control and capacity building;
- information on loan portfolio quality and programme performance and impact is lacking in most programmes;
- a proven methodology in PRC is based on group lending; use of other methods is still relatively rare;
- the capital funds of almost all microfinance programmes in PRC are grants or concessional loans from government, international donors and the private sector; the cost of funds for microfinance projects in PRC is quite low;
- some pilot microfinance projects achieve quite high levels of on-time repayments; this depends on the project's mission and the quality of its trained full-time staff at field level; and
in areas where little technical support or appropriate investment opportunities exist for the poor, microfinance services by themselves may be insufficient for poverty reduction.

110 These findings imply that on an operational basis:

• a focus should be put on training microfinance management and field staff in microfinance international best practice; training should be provided in financial management, accounting, risk control and capacity building;

• accounting and information systems need to be upgraded;

• a variety of microfinance methodologies should be encouraged in the market, not restricted to group lending, in order to provide competition and consumer choice and to continue to evaluate the best methods for various regions and groups;

• loan and savings products and service delivery methods need to be perfected in order to respond to the demands of the potential market in an efficient way; and

• additional sources of funds for microfinance need to be developed; microfinance projects using commercial interest rate funds may be practicable in rural areas where other forms of technical support are available and borrowers have suitable investment opportunities.

111 These matters can be readily addressed through technical assistance and training. The principal issues are about how to role out successes in the context of finite NGO and donor funding, PBC's understandable reluctance to create new formal microfinance institutions, and the limitations of the existing formal financial sector to take on this role effectively. These are the three core issues that most affect the future of microfinance and effective poverty reduction lending in PRC.

**Future Developments**

**The Policy Environment**

112 The current policy environment is not conducive to the expansion of microfinance activities, specifically because there is:

• no legal and regulatory framework for microfinance.

While microfinance has good potential as a tool for poverty reduction in rural areas in PRC, in order to develop a healthy environment for the expansion of microfinance it is essential that an appropriate microfinance policy, legislative, regulatory and supervisory framework is developed and implemented. At present there is no law on credit co-operatives to clarify the operations of the RCCs, and the legal status crisis of pilot microfinance projects negatively impacts on their expansion.

• a restrictive interest rate policy.
The inability of microfinance institutions to set interest rates that permit financial self-sustainability inhibits the expansion of microfinance in the financial systems context. The interest rate policy should be liberated for qualified microfinance programmes at the earliest possible time, in order to allow the development of self-sustainable microfinance programmes.

- a negative attitude of PBC toward independent microfinance institutions.
- At present the government requires a monopoly over the rural financial sector. This is not conducive to development of a financially self-sustainable and dynamic microfinance sector.
- a lack of long-term planning and inability to maintain one strategy for any length of time.

This is illustrated by the examples of: the three foundings and three abolitions of ABC; the transfer of policy lending from ABC to ADBC and then back again; exertion of control over RCCs and then a policy of making RCCs more democratic; making ABC a commercial bank and then assigning directed lending poverty reduction programme implementation responsibilities to ABC. Such swings in policy impede the development of the rural financial sector in general, and particularly microfinance.

- weaknesses in the effectiveness of the government poverty reduction strategy and a possible lack of long-term commitment to microfinance.

This is demonstrated by the switch of subsidised poverty reduction lending targets from households, to enterprises, to individuals through microfinance; and by the interruption to government microfinance programmes caused by transferring their implementation back to the commercialised ABC. These problems also impede the development of microfinance.

Implementation Issues

113 From the perspective of the ability of the main players in the financial system to implement microfinance, the strengths and weaknesses of the different institutions can be compared as follows.

- ABC lacks a branch network to the lowest level necessary for microfinance operations; and the cost of installing such a network may be prohibitive because of ABC’s commercial bank like cost structure.
- ADBC has no capability to run microfinance even though it is defined as a policy oriented bank; it has no deposit-taking capacity; and it lacks a branch network in the rural areas.
- RCCs may be the best option although they lack a full village level branch network; usually have only one staff member or agent in an administrative village or natural village, serving several hundred farm households, and the farm household to staff ratio is especially high in poor areas; a grassroots network would need to be build in order to deliver real microfinance services;
and it will be difficult for PBC to work with RCCs without a strong apex organisation at the provincial and national levels.

- RCFs are not a possible choice, as they have been closed down or merged with RCCs.

114 In order to develop microfinance as a useful tool for poverty reduction in PRC, and in particular to let formal financial institutions become involved in microfinance, the following three conditions are critical:

- the legal status of microfinance institutions should be regularised and a framework of policy, regulation and supervision concerning microfinance should be established.

- the interest rate ceiling should be abolished to allow microfinance institutions to attain financial self-sustainability.

- a grassroots network appropriate for microfinance needs to be developed regardless of whether it is attached to an existing formal financial institution to allow organisational and methodological flexibility to suit different areas and to assist to break up the financial monopoly that currently exists in rural areas.

Financial Sustainability of Microfinance Activities in PRC

115 Microfinance operations capable of becoming financially self-sustainable must be of high standard in their portfolio quality, productivity and scale. A few such projects may exist on a pilot basis in PRC at present, but they lack the national scope required for a significant impact on poverty reduction.

116 There is a long way to go before financially self-sustainable microfinance operations can be undertaken on a widespread basis in PRC. In order to speed progress, increased efforts need to be made at the policy level as well as on capacity building of microfinance organisations. The key to turning subsidised microfinance projects into sustainable projects in PRC is a change in objectives and operation strategy. An objective led by politics has to become an objective led by the market. Government activity has to change into market activity. There is a big difference in the policies and functions of the Government required for these two phases: to fulfil political tasks requires large sums of capital invested by the Government, while to realise economic and financial sector targets needs relevant market policies.

117 As an instrument of financial intermediation, microfinance must ensure its own economic viability as well as reduce poverty. This means that the potential for economic viability of microfinance institutions under the existing policy, legislative, regulatory and supervisory frameworks is a precondition for successful poverty reduction through the use of microfinance methodologies.
### End Table 1 Deposit and Loan Balances

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total country deposits</strong></td>
<td>803.9</td>
<td>1,010.0</td>
<td>1,239.2</td>
<td>1,464.0</td>
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<td><strong>Deposits at Agricultural Bank of China</strong></td>
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<td>292.7</td>
<td>355.8</td>
<td>408.4</td>
<td>479.4</td>
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<td>Agricultural deposit</td>
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<td>23.9</td>
<td>26.4</td>
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<td>Deposit by town and township enterprise</td>
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<td>37.6</td>
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<tr>
<td>Deposit by farmers</td>
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<td>237.7</td>
<td>293.4</td>
<td>341.8</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Deposits at Rural Credit Cooperatives</strong></td>
<td>568.1</td>
<td>717.3</td>
<td>879.4</td>
<td>1,055.6</td>
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<td>Collective agricultural deposit</td>
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<td>89.2</td>
<td>112.3</td>
<td>142.4</td>
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<td>Deposit by town and township enterprises</td>
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<td>8.5</td>
<td>-</td>
<td>-</td>
<td>N/A</td>
</tr>
<tr>
<td>Deposit by farmers</td>
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<td>767.0</td>
<td>913.2</td>
<td>N/A</td>
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<tr>
<td><strong>Total country loans</strong></td>
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<td>827.6</td>
<td>1,019.5</td>
<td>1,206.5</td>
<td>1,382.4</td>
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<tr>
<td><strong>Loans by Agricultural Bank of China</strong></td>
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<td>340.2</td>
<td>384.0</td>
<td>473.9</td>
<td>553.8</td>
</tr>
<tr>
<td>Agricultural loans</td>
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<td>112.1</td>
<td>142.5</td>
<td>175.0</td>
<td>209.3</td>
</tr>
<tr>
<td>Loans to town and township enterprise</td>
<td>93.8</td>
<td>110.5</td>
<td>142.8</td>
<td>163.7</td>
<td>188.5</td>
</tr>
<tr>
<td>Agricultural overall development loans</td>
<td>71.2</td>
<td>81.6</td>
<td>98.7</td>
<td>135.2</td>
<td>156.0</td>
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<tr>
<td><strong>Loan by Rural Credit Cooperatives</strong></td>
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<td>523.4</td>
<td>629.0</td>
<td>727.3</td>
<td>828.6</td>
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<td>Collective agricultural loan</td>
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<td>109.5</td>
<td>148.7</td>
<td>184.4</td>
<td>N/A</td>
</tr>
<tr>
<td>Loans to town and township enterprise</td>
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<td>277.9</td>
<td>326.5</td>
<td>368.7</td>
<td>N/A</td>
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<tr>
<td>Loans to farmers</td>
<td>108.1</td>
<td>136.0</td>
<td>153.9</td>
<td>174.3</td>
<td>N/A</td>
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<tr>
<td><strong>Loan deposit difference</strong></td>
<td>134.3</td>
<td>182.4</td>
<td>219.7</td>
<td>257.5</td>
<td>308.5</td>
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Data sources:


Notes: Agricultural overall development loans includes development loans and relief loans by Agricultural Development Bank of China before 1998.
### End Table 2 RCC Balance Sheet

<table>
<thead>
<tr>
<th>At year end:</th>
<th>1995</th>
<th>1996</th>
<th>1997</th>
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</thead>
<tbody>
<tr>
<td>Reserve assets</td>
<td>121.83</td>
<td>193.56</td>
<td>224.27</td>
</tr>
<tr>
<td>Reserve</td>
<td>85.74</td>
<td>71.20</td>
<td>124.67</td>
</tr>
<tr>
<td>Deposit at central bank</td>
<td>18.78</td>
<td>106.67</td>
<td>80.08</td>
</tr>
<tr>
<td>Cash on hand</td>
<td>15.51</td>
<td>15.69</td>
<td>19.52</td>
</tr>
<tr>
<td>Bonds of central bank</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Creditor's rights to central government</td>
<td>33.85</td>
<td>40.63</td>
<td>18.64</td>
</tr>
<tr>
<td>Creditor's rights to other departments</td>
<td>523.42</td>
<td>636.47</td>
<td>766.15</td>
</tr>
<tr>
<td>Creditor's rights to nonmonetary institutions</td>
<td>0.00</td>
<td>0.00</td>
<td>3.14</td>
</tr>
<tr>
<td>Debts to nonfinancial departments</td>
<td>717.29</td>
<td>879.35</td>
<td>1,060.92</td>
</tr>
<tr>
<td>Current deposit</td>
<td>89.20</td>
<td>100.74</td>
<td>126.48</td>
</tr>
<tr>
<td>Fixed deposit</td>
<td>8.53</td>
<td>11.55</td>
<td>15.88</td>
</tr>
<tr>
<td>Savings deposit</td>
<td>619.56</td>
<td>767.06</td>
<td>913.22</td>
</tr>
<tr>
<td>Other deposits</td>
<td>0.00</td>
<td>0.00</td>
<td>5.34</td>
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<tr>
<td>Debts to central bank</td>
<td>0.00</td>
<td>0.00</td>
<td>1.64</td>
</tr>
<tr>
<td>Debts to nonmonetary institutions</td>
<td>0.00</td>
<td>0.00</td>
<td>0.29</td>
</tr>
<tr>
<td>Bonds</td>
<td>0.00</td>
<td>0.00</td>
<td>0.04</td>
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<tr>
<td>Owner’s equity</td>
<td>63.19</td>
<td>54.77</td>
<td>31.00</td>
</tr>
<tr>
<td>Paid-in capital</td>
<td>37.77</td>
<td>40.11</td>
<td>63.05</td>
</tr>
<tr>
<td>Others (net)</td>
<td>(101.38)</td>
<td>(36.46)</td>
<td>(81.69)</td>
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</table>

**Data sources:**


**Notes:** This form is the content of the balance sheet of a deposit currency bank.
## End Table 3 ABC Balance Sheet

<table>
<thead>
<tr>
<th></th>
<th>1996</th>
<th>1997</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and deposit</td>
<td>13.54</td>
<td>15.49</td>
</tr>
<tr>
<td>Deposit with central bank</td>
<td>241.16</td>
<td>251.84</td>
</tr>
<tr>
<td>Deposit with peer banks</td>
<td>61.14</td>
<td>39.06</td>
</tr>
<tr>
<td>Loans to peer banks</td>
<td>57.71</td>
<td>41.17</td>
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<tr>
<td>Short-term loans</td>
<td>802.19</td>
<td>918.27</td>
</tr>
<tr>
<td>Short-term investment</td>
<td>19.29</td>
<td>12.82</td>
</tr>
<tr>
<td>Other current assets</td>
<td>74.94</td>
<td>96.26</td>
</tr>
<tr>
<td>Middle-term and long-term loans</td>
<td>96.32</td>
<td>99.95</td>
</tr>
<tr>
<td>Less: Allowance for bad debts</td>
<td>4.19</td>
<td>3.99</td>
</tr>
<tr>
<td>Long-term investment</td>
<td>43.52</td>
<td>40.12</td>
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<tr>
<td>Net value of fixed assets</td>
<td>40.35</td>
<td>42.00</td>
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<tr>
<td>Other long-term assets</td>
<td>20.99</td>
<td>20.98</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>1,466.95</td>
<td>1,573.95</td>
</tr>
</tbody>
</table>

|                      |          |          |
| **Liabilities and Equity** |          |          |
| Short-term deposit    | 299.90   | 320.91   |
| Short-term savings deposit | 298.78  | 436.76   |
| Borrowing from central bank | 267.51  | 205.59   |
| Interbank deposits    | 75.43    | 72.08    |
| Interbank borrowing   | 20.55    | 9.50     |
| Other current debts   | 96.01    | 101.74   |
| Long-term deposit     | 22.32    | 30.21    |
| Long-term savings deposit | 330.46  | 346.77   |
| Long-term borrowing   | 10.88    | 9.17     |
| Including: foreign long-term capital | 9.16 | 8.36     |
| Other long-term debts | 2.95     | 1.47     |
| **Total debts**       | 1,424.79 | 1,534.19 |
| Paid-in capital       | 36.21    | 36.17    |
| Paid-in surplus       | 3.63     | 2.87     |
| Earned surplus        | 0.21     | 0.19     |
| Undistributed profit  | 2.11     | 0.53     |
| **Total owner's equity** | 42.16   | 39.76    |
| **Total liabilities and equity** | 1,466.95 | 1,573.95 |

Data source:

### End Table 4 Sources of Credit Funds for ABC

<table>
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<tr>
<th></th>
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<th></th>
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</thead>
<tbody>
<tr>
<td><strong>Total sources of funds</strong></td>
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<td>578.62</td>
<td>706.18</td>
<td>915.00</td>
<td>1,224.39</td>
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<td><strong>Totals of various deposits</strong></td>
<td>192.11</td>
<td>245.28</td>
<td>313.82</td>
<td>384.27</td>
<td>518.56</td>
<td>693.94</td>
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<tr>
<td>Deposit by enterprises</td>
<td>43.83</td>
<td>54.65</td>
<td>76.52</td>
<td>109.83</td>
<td>141.44</td>
<td>190.93</td>
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<td>Industrial enterprises</td>
<td>3.46</td>
<td>4.42</td>
<td>6.19</td>
<td>7.26</td>
<td>9.15</td>
<td>11.11</td>
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<tr>
<td>Commercial enterprises</td>
<td>31.02</td>
<td>38.04</td>
<td>53.03</td>
<td>5.97</td>
<td>8.27</td>
<td>13.08</td>
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<tr>
<td>TVEs</td>
<td>6.63</td>
<td>8.64</td>
<td>13.25</td>
<td>27.23</td>
<td>31.51</td>
<td>33.19</td>
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<td>4.45</td>
<td>5.44</td>
<td>10.43</td>
<td>19.75</td>
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<td><strong>Others</strong></td>
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<td>-</td>
<td>-</td>
<td>63.94</td>
<td>82.08</td>
<td>113.80</td>
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<td>Agricultural deposit</td>
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<td>19.06</td>
<td>17.60</td>
<td>19.45</td>
<td>21.68</td>
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<td>Savings deposit</td>
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<td>157.76</td>
<td>197.24</td>
<td>253.30</td>
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<td>481.34</td>
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<td>Current savings deposit</td>
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<td>24.29</td>
<td>36.89</td>
<td>51.18</td>
<td>72.69</td>
<td>97.56</td>
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<tr>
<td>Fixed savings deposit</td>
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<td>133.47</td>
<td>160.36</td>
<td>202.13</td>
<td>283.77</td>
<td>383.78</td>
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<tr>
<td><strong>Others</strong></td>
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<td>16.78</td>
<td>20.59</td>
<td>3.54</td>
<td>1.21</td>
<td>-</td>
</tr>
<tr>
<td>Fiscal deposit</td>
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<td>7.16</td>
<td>7.24</td>
<td>8.09</td>
<td>9.84</td>
<td>10.28</td>
</tr>
<tr>
<td>Borrowing from central bank</td>
<td>143.89</td>
<td>174.99</td>
<td>208.11</td>
<td>271.88</td>
<td>355.46</td>
<td>86.12</td>
</tr>
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<td>Of which: temporary borrowing</td>
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<td>80.62</td>
<td>88.55</td>
<td>90.89</td>
<td>5.24</td>
<td>5.66</td>
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<td>Interbank deposits and loans</td>
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<td>149.29</td>
<td>193.46</td>
<td>211.61</td>
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<td><strong>Others</strong></td>
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<td>4.87</td>
<td>1.86</td>
<td>61.73</td>
<td>102.27</td>
<td>69.20</td>
</tr>
<tr>
<td>Owner’s equity</td>
<td>27.96</td>
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<td>30.13</td>
<td>39.74</td>
<td>44.80</td>
<td>40.78</td>
</tr>
<tr>
<td>Of which: paid-in capital</td>
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<td>-</td>
<td>-</td>
<td>36.73</td>
<td>42.69</td>
<td>35.93</td>
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<td><strong>Usage of funds</strong></td>
<td>473.63</td>
<td>578.62</td>
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<td>546.81</td>
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<td>304.24</td>
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<td>430.01</td>
<td>470.43</td>
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<td>Industrial loans</td>
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<td>181.83</td>
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<td>93.84</td>
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<td>18.19</td>
<td>85.00</td>
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<td>82.01</td>
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<td>34.02</td>
<td>43.13</td>
<td>51.81</td>
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<td>93.37</td>
<td>116.82</td>
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<td>42.78</td>
<td>34.06</td>
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<td>57.34</td>
<td>58.12</td>
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<tr>
<td>Deposit at peer banks</td>
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<td>57.81</td>
<td>29.69</td>
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<tr>
<td>Cash</td>
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<td>7.07</td>
<td>8.76</td>
<td>13.55</td>
<td>14.18</td>
<td>14.78</td>
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<tr>
<td>Others</td>
<td>-</td>
<td>-</td>
<td>6.94</td>
<td>95.03</td>
<td>438.87</td>
<td>199.11</td>
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<td>0.17</td>
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Data source:

**End Table 5 ADBC Balance Sheet**

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<td>Current assets</td>
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<td>571.16</td>
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<td>Cash</td>
<td>0.15</td>
<td>0.31</td>
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<tr>
<td>Deposit at central bank</td>
<td>33.71</td>
<td>26.22</td>
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<tr>
<td>Reserve handed in to central bank</td>
<td>2.13</td>
<td>3.45</td>
</tr>
<tr>
<td>Deposit at peer banks</td>
<td>11.60</td>
<td>2.86</td>
</tr>
<tr>
<td>Short-term loans</td>
<td>404.22</td>
<td>508.86</td>
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<td>Other current assets</td>
<td>42.61</td>
<td>29.46</td>
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<td><strong>Long-term assets</strong></td>
<td>217.99</td>
<td>352.06</td>
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<tr>
<td>Middle-term and long-term loans</td>
<td>220.58</td>
<td>354.95</td>
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<tr>
<td>Less: Allowance for bad debts</td>
<td>4.69</td>
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<td>Net value of fixed assets</td>
<td>0.47</td>
<td>0.75</td>
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<td>Other long-term assets</td>
<td>1.62</td>
<td>2.73</td>
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<td>Intangible, deferred and other assets</td>
<td>0.04</td>
<td>0.08</td>
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<td><strong>Total assets</strong></td>
<td>712.45</td>
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<td><strong>Debts and owner’s equity</strong></td>
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<td>0.00</td>
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<td>Current debts</td>
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<td>883.55</td>
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<td>Short-term debt</td>
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<td>Borrowing from central bank</td>
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<td>816.78</td>
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<td>Deposit by peer banks</td>
<td>11.49</td>
<td>0.80</td>
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<td>Other current debts</td>
<td>29.10</td>
<td>20.49</td>
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<td><strong>Long-term debts</strong></td>
<td>10.76</td>
<td>27.57</td>
</tr>
<tr>
<td><strong>Long-term bond</strong></td>
<td>10.75</td>
<td>27.53</td>
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<tr>
<td><strong>Owner’s equity</strong></td>
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<td>12.18</td>
</tr>
<tr>
<td>Including: paid-in capital</td>
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<td>14.00</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td>712.45</td>
<td>923.30</td>
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Data source:

## End Table 6 Cash Flow and Expenditure of Rural Residents

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</thead>
<tbody>
<tr>
<td><strong>Aggregate cash inflow</strong></td>
<td>128.76</td>
<td>429.49</td>
<td>796.11</td>
<td>1,442.07</td>
<td>1,882.49</td>
<td>2,309.39</td>
<td>2,516.37</td>
<td>2,528.32</td>
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<tr>
<td>Basic income</td>
<td>97.61</td>
<td>320.57</td>
<td>617.62</td>
<td>1,129.74</td>
<td>1,469.60</td>
<td>1,770.03</td>
<td>1,959.25</td>
<td>1,967.02</td>
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<td>Cash inflow from savings and loans</td>
<td>15.64</td>
<td>72.10</td>
<td>119.44</td>
<td>209.39</td>
<td>286.83</td>
<td>382.38</td>
<td>385.16</td>
<td>364.71</td>
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<tr>
<td>Loans received from banks and credit cooperatives</td>
<td>N/A</td>
<td>15.39</td>
<td>15.36</td>
<td>19.72</td>
<td>28.64</td>
<td>38.30</td>
<td>40.84</td>
<td>37.67</td>
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<tr>
<td>Borrowing</td>
<td>10.17</td>
<td>33.26</td>
<td>62.27</td>
<td>103.90</td>
<td>137.06</td>
<td>171.88</td>
<td>175.22</td>
<td>159.60</td>
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<td>Loans withdrawals</td>
<td>1.74</td>
<td>9.76</td>
<td>20.39</td>
<td>42.90</td>
<td>59.72</td>
<td>76.38</td>
<td>72.88</td>
<td>68.42</td>
</tr>
<tr>
<td>Deposit withdrawals from banks and credit cooperatives</td>
<td>3.73</td>
<td>13.14</td>
<td>20.48</td>
<td>40.55</td>
<td>59.21</td>
<td>92.15</td>
<td>93.76</td>
<td>95.61</td>
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<tr>
<td>Gains from stock transfers</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>0.07</td>
<td>0.03</td>
<td>0.15</td>
<td>0.11</td>
<td>0.04</td>
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<tr>
<td>Investment funds withdrawals</td>
<td>N/A</td>
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<td>0.94</td>
<td>2.25</td>
<td>2.28</td>
<td>3.52</td>
<td>2.35</td>
<td>3.37</td>
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<tr>
<td><strong>Aggregate cash expenditure</strong></td>
<td>122.93</td>
<td>389.19</td>
<td>741.17</td>
<td>1,330.40</td>
<td>1,766.67</td>
<td>2,137.39</td>
<td>2,297.30</td>
<td>2,316.35</td>
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<td>Cash expenditure on production expenses</td>
<td>14.05</td>
<td>98.93</td>
<td>183.35</td>
<td>373.87</td>
<td>517.06</td>
<td>587.76</td>
<td>599.91</td>
<td>565.67</td>
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<td>Cash expenditure on living consumption</td>
<td>83.83</td>
<td>194.68</td>
<td>374.74</td>
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<td>859.43</td>
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<td>1,126.28</td>
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<td>Cash expenditure on savings and loans</td>
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<td>102.11</td>
<td>174.40</td>
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<td>249.90</td>
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<td>385.37</td>
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<td>Retirement of loans from banks and credit cooperatives</td>
<td>10.82</td>
<td>11.80</td>
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<td>14.83</td>
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<td>24.09</td>
<td>22.96</td>
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<td>Loans</td>
<td>2.21</td>
<td>7.03</td>
<td>13.21</td>
<td>18.08</td>
<td>19.99</td>
<td>23.27</td>
<td>31.73</td>
<td>42.84</td>
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<td>Retirement of borrowings</td>
<td>6.97</td>
<td>21.04</td>
<td>38.85</td>
<td>53.04</td>
<td>65.41</td>
<td>80.07</td>
<td>92.89</td>
<td>94.98</td>
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<td>Deposit at banks and credit cooperatives</td>
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<td>37.12</td>
<td>85.53</td>
<td>117.88</td>
<td>122.73</td>
<td>184.24</td>
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<td>Investment expenditure</td>
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<td>1.13</td>
<td>3.86</td>
<td>2.70</td>
<td>3.19</td>
<td>4.28</td>
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Data source:

## End Table 7 Inflow and Expenditure of Various Districts

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<td>Middle</td>
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<tr>
<td><strong>District:</strong></td>
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<tr>
<td><strong>Aggregate inflow</strong></td>
<td>3,489.91</td>
<td>2,658.56</td>
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<td><strong>Net income</strong></td>
<td>2,548.91</td>
<td>1,763.40</td>
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<td><strong>Cash inflow</strong></td>
<td>2,616.12</td>
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<td><strong>Cash inflow from savings and loans</strong></td>
<td>472.30</td>
<td>378.47</td>
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<td><strong>Cash inflow from savings and loans/Cash income</strong></td>
<td>18.05%</td>
<td>22.15%</td>
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<td><strong>Aggregate expenditure</strong></td>
<td>3,007.63</td>
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<tr>
<td><strong>Production expenses</strong></td>
<td>832.56</td>
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<tr>
<td><strong>Family operating expenses</strong></td>
<td>771.39</td>
<td>693.40</td>
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<td><strong>Productive fixed assets purchase</strong></td>
<td>61.17</td>
<td>66.27</td>
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<td><strong>Living consumption</strong></td>
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<td><strong>Cash expenditure</strong></td>
<td>2,410.42</td>
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<td><strong>Cash expenditure in savings and loans</strong></td>
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<td><strong>Cash expenditure in savings and loans/Cash expenditure</strong></td>
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## End Table 8 ABC Income Statement

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<td>Operating revenue</td>
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<td>Other operating revenues</td>
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<td>Operating expenditure</td>
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<tr>
<td>Interest expenditure</td>
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<td>86.21</td>
</tr>
<tr>
<td>Commission expenditure</td>
<td>3.68</td>
<td>4.53</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>19.09</td>
<td>21.05</td>
</tr>
<tr>
<td>Other operating expenses</td>
<td>7.12</td>
<td>8.99</td>
</tr>
<tr>
<td>Sales tax and additions</td>
<td>5.16</td>
<td>5.33</td>
</tr>
<tr>
<td>Operating profit</td>
<td>1.79</td>
<td>(3.66)</td>
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<td>Investment income</td>
<td>4.52</td>
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<td>Non-operating revenues</td>
<td>0.23</td>
<td>0.24</td>
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<tr>
<td>Adjustment to profits of previous years</td>
<td>(0.55)</td>
<td>(0.24)</td>
</tr>
<tr>
<td>Non-operating expenditure</td>
<td>1.30</td>
<td>1.13</td>
</tr>
<tr>
<td>Aggregate profit</td>
<td>4.68</td>
<td>0.79</td>
</tr>
<tr>
<td>Income tax</td>
<td>2.58</td>
<td>0.26</td>
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<td>Net profit</td>
<td>2.11</td>
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### End Table 9 ADBC Income Statement

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<td>Operating revenue</td>
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<td>Interbank loan revenue</td>
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<td>Commission revenue</td>
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<td>Exchange gain</td>
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<td>Other operating revenues</td>
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<td>Operating expenditure</td>
<td>77,175.9</td>
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<td>Interest expenditure</td>
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<td>Commission expenditure</td>
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<td>Exchange loss</td>
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<td>Other operating expenses</td>
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<td>Sales tax and additions</td>
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<td>Operating profit</td>
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<td>Subsidy</td>
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<td>Non-operating revenues</td>
<td>5.1</td>
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<td>Adjustment to profits of previous years</td>
<td>(1.5)</td>
</tr>
<tr>
<td>Non-operating expenditure</td>
<td>36.1</td>
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<tr>
<td>Aggregate profit</td>
<td>(2,421.6)</td>
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<tr>
<td>Income tax</td>
<td>108.9</td>
</tr>
<tr>
<td>Net profit</td>
<td>(2,530.5)</td>
</tr>
</tbody>
</table>

International Voluntary Rural Mobility Approaches and Experience

Summary

Introduction

The Evolution of Resettlement Programmes
Africa
Latin America
Asia
Organisation of Resettlement Projects

The Effectiveness of Voluntary Resettlement Projects
A Basic Evaluation
The Multiplier Effect
Success Factors
Financing Resettlement
Cost Recovery

The Lessons

Tables in the Text

Table 1 Economic Rates of Return of Selected Settlement Projects
End Table 1 Description of Selected Voluntary Resettlement Projects
Summary

This report discusses motivations and objectives of international resettlement programmes, noting that the purposes of the programmes have lasting impacts on the outcome of the programmes. It then examines the organisational characteristics of resettlement, followed by an assessment of the effectiveness of these programmes and factors determining their performance. Since resettlements are a costly investment, all governments have sought to contain costs and recoup at least part of the costs, it then examines cost reduction and cost recovery practices. In conclusion, it considers some of the guidelines that should be followed in voluntary resettlement programmes as useful lessons for the People’s Republic of China (PRC) policy makers.

Rural mobility is defined as the movement of people to areas of under-utilised agricultural potential. This has also been called “settlement”, “resettlement” and “land colonisation”. The analysis focuses on government assisted or supported projects for rural mobility on a voluntary basis. Spontaneous resettlement has been the dominant form of resettlement where people have moved because of exhaustion of natural resources (as in shifting cultivation) or because of the availability of new land. In some resettlement the mobility process is often initially spontaneous with government later supporting it. Even where government is the initiator, spontaneous settlement has always taken place in parallel.

Government assistance has involved providing access to credit to finance migration, resettlement and the start-up of new activities; the provision of infrastructure in settlement areas; and protection for the rights of settlers to land use and use of other assets. Government support can be in all three areas or can be selective, but normally infrastructure is provided.

Most government sponsored or supported schemes have been carried out with the economic objective of improving agricultural productivity and thus generating better incomes for the rural poor. But there have also been political objectives, often dominant ones. In Africa for example, much resettlement has focused on giving back colonially occupied land to farmers. In Latin America, the underlying concern has often been about territorial sovereignty or providing plantation labour, and more recently about stemming civil unrest from the landless. In Asia, in Indonesia the transmigration programmes relieved population pressure but also asserted sovereignty over outer islands. The Malaysian Federal Land Development Authority (FELDA) programme had the parallel objective of increasing export revenues from industrial crops while in Sri Lanka settlement has been primarily about developing newly irrigated land to stem the tide of rising unemployment and unrest.

The areas in which sponsored or supported settlement has been made have generally been previously uninhabited or sparsely inhabited because of inaccessibility or because for some reason they were not suitable for habitation, for example, disease infestation or lack of water. Settlers have usually been recruited on a family by family basis from different communities where there is unemployment or poverty. It has been unusual for whole communities to be relocated in voluntary resettlement. (This is not of course the case in involuntary resettlement where the normal cause is the loss of land to a community as a result of large-scale physical infrastructure development such as dams). Voluntary resettlers face a range of...
problems: particularly lack of familiarity with local agronomic practices, lack of access to credit, and lack of community leadership and social infrastructure. While natural resources and physical capital are normally available, there are significant weaknesses in human, financial and social capital that need addressing following settlement if poverty reduction is to be effective.

Voluntary resettlement is complex and international experience shows that the overall phasing of the programmes will involve: planning and site selection; infrastructure construction and settler recruitment; a transition period of three to five years while new agricultural systems are established requiring human capital development and financial support; the development of mature social capital in the settler community; and the phasing out of special government support.

Ex post estimates of economic rates of return for settlement projects show mixed results. Low rates of return have been encountered where plot sizes for settlers have been too small and where annual crops (with low value added) have been the basis of their new livelihood. There is very little available analysis of actual with and without project income for settlers and this appears to have been generally overlooked in the research. The environmental impact of settlement projects has only recently received attention, but early projects involved much deforestation.

Overall benefits are also difficult to assess because there are multiplier effects. Settlement catalyses regional development and growth in non-farm activity. The research shows that there are economies of scale. For example, in Malaysia, a settlement of 2,500 families at full development could provide employment for the whole labour force while a settlement of 400 families could provide employment for only about 70 percent of the labour force. The development of market infrastructure and non-farm employment opportunities has also been shown to increase multiplier effects.

Demonstrated factors of success in resettlement are good project management whether parastatal or otherwise; a flexible production system with crop diversification opportunities, good natural resources and good extension services; the creation of supplementary employment opportunities during the initial stages, for example through food for work programmes, to help with infrastructure construction; secure title for settlers; and access to credit for production and consumption.

Costs to government for resettlement are high and have ranged from USD 5,000 to USD 20,000 per family. Evidence shows that some cost reduction can be achieved by private sector involvement in infrastructure development because of greater efficiency. Allowing spontaneous settlement also reduces costs for government as can site selection if there is proximity to existing communications or market infrastructure. Careful planning and phasing can minimise cost overruns while access to credit for settler housing can reduce infrastructure costs.

Cost recovery has been a challenge for resettlement projects as it is for many infrastructure projects. The evidence shows that short-term lending has a better repayment rate than long-term lending and that repayment capacity is improved if annual crops are not the main source of settler income and opportunities for non-farm employment are fostered. A major cause of default has also been from settlers leaving the settlement area emphasising the importance not only of income but the
development of other assets necessary for a stable community to evolve. Some argue that settlers need to receive grant support, but other more innovative mechanisms have also been successful in developing settler resources. In Indonesia for example, transmigrants were given the opportunity to work as wage labourers to accrue resources prior to settlement. Unwillingness to repay has also been found in some settlement schemes. Using land title as collateral or making repayment a condition of acquiring land title have both been found to be effective means of encouraging good repayment rates. Centralised marketing and marketing co-operatives have also proved to be useful means of deducting repayments at source.

A review of the Asian Development Bank (ADB) Guidelines for Involuntary Resettlement shows that many of the guidelines are also applicable for successful voluntary resettlement and can be useful to PRC policy makers. Specifically, it is concluded that: resettlement should only be carried out when there is no other option; displaced people should be at least as well off after resettlement as before; resettlers must be fully informed about all aspects of resettlement and compensation; appropriate patterns of social organisation must be promoted, particularly existing social institutions of resettlers; and the full costs of resettlement including compensation should be included in the analysis so that the overall net benefits can be assessed. Additionally to the guidelines: settlers should be informed about the resource potential of the area they are moving to; the selection process should be free from political favouritism; host populations should be adequately compensated for loss to new settlers; and spontaneous settlement and private sector involvement should be encouraged.
Introduction

1 Rural mobility is defined as the movement of people to areas of under-utilised agricultural potential. The movement may be involuntary, as in the case of displacement of people by the construction of roads, dams or other infrastructure projects. In this paper, the focus is on the voluntary movement of rural families from one to another location. In the literature, this movement has been called “settlement,” “resettlement,” or “land colonisation.” The term “resettlement” throughout this report refers to this voluntary movement. Resettlement has been undertaken on every continent. Depending on the degree of government involvement, it may be spontaneous, government assisted, or government planned and supported. This paper covers government assisted or supported projects undertaken in developing countries, and provides an overview of international experiences with resettlement in order to: offer an international perspective of the PRC resettlement efforts; and draw lessons from the successes and failures of resettlement in other countries to guide future PRC resettlement.

2 The existing literature on resettlement is extensive, but fragmentary, reflecting the diversity of practices around the world and the complexity of experiences. This review relies upon four sources of information: individual studies focusing on specific issues or specific areas of resettlement; evaluations, appraisals and project completion reports of selected World Bank supported resettlement projects, region-specific reviews; and past comprehensive reviews by other researchers.

3 Spontaneous resettlement has been the dominant form of population mobility in the world. About 75 percent of the resettlement is spontaneous, according to estimation by the World Bank. People move in response to changed environment, as in the case of traditional African shifting cultivation, or upon the availability of new and more productive land. The productivity differences may come from increased supply of labour as a result of population expansion in the sending area, the discovery of uncultivated land, or the improvement of technology that increases land productivity in an area that was previously uncultivable. Examples of resettlement on newly discovered land include the resettlements of Europeans in Americas and Africa; those on newly available land include settlements on land cleared of river blindness and sleeping sickness diseases in Africa.


4 World Bank 1978, ibid.
4 In government supported resettlement, spontaneous settlers often initiate the settlement processes and provide the basis for government sponsorship of more settlers. Even in resettlement programmes initiated by the government, spontaneous settlers often arrive in large numbers subsequently. However, despite the dominance of spontaneous settlement, it is often an arduous undertaking: information about settlement areas is difficult to obtain, and settlers often lack financial resources to finance the mobility as well as subsistence in the initial settlement period. Under various motivations, government often intervenes by providing assistance to the settlement.

5 The government can assist resettlement in a number of ways. First, the government can facilitate access to credit constrained families to finance the migration and resettlement. Second, because infrastructure is often a public good, the government can provide infrastructure, and thus increase labour productivity in the settlement area and make settlement more attractive. Third, the government can play the role of defining and protecting the rights of land for settlers.

6 Government intervention in settlement programmes can be categorised into two types according to different degrees of intervention.

- **Sponsored settlement**: Almost the entire process of mobility is sponsored by the government, including providing land, social and physical infrastructure, and technical services, transferring settlers to project areas, and providing living and production support in the transition period.

- **Assisted settlement**: Some basic infrastructure and services are provided by the government, but settler families move to the project sites spontaneously, without the benefit of further government support.

### The Evolution of Resettlement Programmes

7 Most international resettlement schemes have been carried out with the general objective of increasing agricultural output and providing additional employment but they also have political objectives. Economic considerations generally include raising agricultural output and increasing export revenues. Political motives play a more dominant role. They include consolidation of national sovereignty; reclamation land rights from colonists; reducing income inequalities; alleviating political tension between landlords and landless labourers by providing land for farmers who do not own or own little land; and preventing possible political unrest in cities resulting from labour migration from rural to urban areas.

### Africa

8 Land is relatively abundant in tropical Africa, and settlements for political or humanitarian reasons have been more common than economic considerations. In Kenya, post-independence resettlements largely reflect the legacy of colonial rule when African farmers were removed to create space for European settlement. After independence in 1962, the Kenyan government bought out European farms with financial assistance of the UK government and resettled Africans on those lands. By 1965, nearly 1.2 million acres of former European-owned land had been purchased for the ultimate resettlement of approximately 34,000 families. Because the
paramount objective of the Million-Acre Settlement was to accommodate more Africans on the land, the growth of agricultural output was secondary consideration. The government investment in these farms was judged as uneconomic compared to investing in intensifying production in existing African areas. Although landless people were recruited for resettlement, most of these people had either worked on the European farms or other farm or non-farm occupations.

9 In other parts of Africa, post-independence settlements have been used to experiment with socialist ideas of co-operative or collective farming or the mechanisation of agriculture.

Latin America

10 In Latin America, the Amazon tropics have huge arable potential. Before the Second World War, governments sporadically encouraged resettlement in these areas, motivated mainly by a desire to establish territorial sovereignty and provide labour for industrial crop plantations. Since the 1960s substantially more attention has been directed to the colonisation of the tropics. The motivations can be discerned by looking at the experiences of Brazil and Colombia.

11 Brazil has a long history of government involvement in settlement. It probably started with a provincial law to create two settlements in 1835. The prevailing motivation for settlement at that time was to meet the manpower requirements of coffee plantations. The creation of National Agricultural Settlements linked to the Ministry of Agriculture represented a first systematic attempt at settlement in Brazil. National Agricultural Settlements were installed in several states, and the intervention was aimed at helping the industry. In the 1950s and 1960s, land conflicts between landless labour and landowners became common and intensified as modernisation efforts in agriculture resulted in the emergence of labour surplus in agriculture. In response to this situation, an autonomous federal government entity, the National Institute for Rural Settlement and Agrarian Reform (INCRA) was formed in 1971 to take responsibility for settlement. This Amazon colonisation project intended to “bring men without land to a land without people.”

12 In the late 1970s and early 1980s, a series of external shocks and crop failures battered the Brazilian economy. Economic growth slowed down drastically, rural poverty increased and rural to urban migration accelerated. Fearing that the rural poverty might be converted to urban poverty, the government set up 58 Settlement Projects covering an area of almost three million ha in the Amazon region to control migration, but it did not slow down the migration tide. When the democratic government regained power in 1985, it set an unrealistic target of resettling 1.4 million families within a period of five years, but in 1989, only 83,625 families were settled in 515 new Settlement Projects covering an area of 4.71 million ha. The settlement was scaled down during the tenure of the Collor government with 19,000 ha expropriated, but the process began again under President Franco and more than 2,000 families were settled within 99 Settlement Projects covering almost 1.5 million

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5 de Wilde J C, ibid.
Partly as a result of government’s successive efforts in opening up the Amazon region for settlement and development, the population of Brazil’s Amazonian states doubled to more than 9 million inhabitants between 1970 and 1990. Approximately 100,000 km² of native forest were converted to pasture between 1965 and 1995.

Brazil – Alto Turi Land Settlement Project

This project in Brazil was supported by the World Bank with a loan of US$ 6.7 million. It was approved in July 1972 and was expected to be completed in December 1977. The total cost was expected to be US$ 12.6 million. The objective of the project was mainly to provide physical and social infrastructure and help define property rights for spontaneous settlers whose major production area is cattle farming. It was designed to survey and demarcate 5,200 holdings, construct or improve 365 km of roads, and provide for social infrastructure to settlers. The project eventually completed in January 1981 and cost US$ 34.4 million. The goal of providing basic infrastructure was met. The cost overrun was mainly due to delays in project implementation and high inflation, but the benefits were also higher than at appraisal because of a real increase in the price of beef, thus the overall rate of return was still reasonable.

Colombia – the Caqueta Land Colonisation Project

Phase I of the Caqueta Land Colonisation Project was completed in June 1978. Phase II of the Project was appraised in 1974 and intended to provide social and physical infrastructure support to many of the existing 12,000 settler families in the area and assist the settlement of 2,850 farming families. The World Bank provided a loan of US$19.5 million (approved in May 1975) to the Colombian government through the Institute of Agrarian Reform (INCORA) with an expected closing date of October 1982. The assistance to new settler families included clearing forested land and establishing pasture (30 to 200 ha per farm), providing long-term credit to farmers for basic farm investment as purchasing breeding cattle and farm improvement, and providing short-term credit to farmers for cattle fattening facilities and to marketing co-operatives. The project was completed three years behind schedule. The delay was mostly due to slow disbursement of counterpart funds on the part of Colombia and resulted in a cost overrun of 53 percent. Overall, the project was judged as successful because most of the objectives were accomplished and the economic rate of return was 11 percent.

7 Groppo P, 1996, ibid
9 See also End Table 1
10 World Bank, 1985, ibid
11 See also End Table 1
12 World Bank, 1984, "Project Completion Report:: Colombia Caqueta Rural Settlement Project (Phase II)", Washington, DC: World Bank
Asia

14 In Asia, the most noteworthy resettlement programmes took place in Indonesia, Malaysia and Sri Lanka. Indonesia, the fourth most populous nation in the world, has one of the world's largest government-directed voluntary transmigration programmes. The resettlement started under the colonial government of Dutch and continued to date. Between 1903 to 1990, about 750,000 families, or over 3.6 million people were moved from densely populated Inner Islands to less populated Outer Islands (World Bank, 1994). Between 1976 and 1993, the World Bank supported the Transmigration Programme through seven loans totalling US$ 560 million equivalent.

15 The Transmigration Programme was one of the largest land resettlement programmes in the world. It was motivated partly by the population pressure in densely populated Islands of Java and Bali, and partly by the desire of the Indonesian government to exert sovereignty and political control over the outer islands. The economic activities are concentrated in the Islands of Java and Bali where there is increasing number of landless people. In contrast, the outer islands have more natural resources but are sparsely populated. The objectives of the Transmigration Programme were officially stated as to: (i) improve the living standards and employment opportunities of poor, landless families from inner islands; (ii) alleviate population pressures in and promote balanced population distribution and regional development; and (iii) increase agricultural production.
Indonesia – Transmigration  

Five World Bank-assisted projects included in this review consisted of four transmigration schemes (Transmigration I to IV) in the uplands of Sumatra and East Kalimantan, and one swamps reclamation project in coastal lands of Sumatra. The specifics of the five projects are listed below.  

Transmigration I, approved in 1976, was funded with a loan of US$ 30.0 million for the settlement of 4,500 families at one site in Sumatra, with rehabilitation of an existing site where 12,000 families were already settled. Each family was to receive 5 ha to plant rubber.

Transmigration II, approved in 1979, with an estimated cost of US$ 242.0 million equivalent, was to resettle about 30,000 families in four sites along the trans-Sumatra highway. Each family was to receive a 3.5 ha annual crop farm. The annual crop was expected to be largely food crops to address the food security problem in Indonesia at the time.

Transmigration III, approved in 1982, aimed at resettling 2,000 families in the same location as Transmigration I, but on a smaller plot (3.5 ha food crop and tree crop). The total cost was expected to be US$ 187.3 million equivalent.

Transmigration IV, approved in 1983, was to settle 6,000 families in a remote area of East Kalimantan for a total cost of US$121 million equivalent. Each family was to receive a 3.25 ha food crop and tree crop (hybrid coconut) plot.

Swamp I, approved in 1981, was to resettle 3,200 families with a loan of US$ 44.6 million equivalent. Each family was to receive 2.25 ha farm for paddy and other crop production.

The five projects included land clearing, construction of villages and related social and physical infrastructure, construction of settler houses, provision of agricultural services, tree planting (in Transmigration I, III and IV), and construction of a drainage system (Swamp I). Assisting the government in its planning capability was also a component of Transmigration II and was the major component of Transmigration III. This consists of identification, selection and planning of sites for further settlement of 300,000 families. Training, agricultural research and assistance for monitoring and evaluation were other institution building components of all projects. At project completion, the five projects supported the resettlement of 34,553 sponsored families and 1,176 spontaneous families.

16 Malaysia has the world’s most expensive resettlement programmes. It also received the lion’s share of loans intended for land resettlement from the World Bank, which financed a series of land settlement projects in Malaysia initiated in 1968 carried out by FELDA. The main objective of the projects was to generate export revenues through developing new land suitable for industrial crop production and improve the balance of payments.

See also End Table 1
Malaysia - The FELDA VI Land Settlement Project

The FELDA VI Land Settlement Project was the sixth of a series of World Bank-financed FELDA land settlement schemes initiated in 1968. The project was approved in June 1978 and was expected to close in June 1986. The World Bank provided a loan of $28 million with the total cost estimated to be US$92.3 million. The objectives of the project were poverty alleviation and increasing export revenues from industrial crop production. The project included developing 29,000 ha of diversified tree crops (mainly rubber and oil palm) and 200 ha of annual crops, and constructing four urban centres/sub-centres, five villages and related infrastructure and social services. The settlement involved 6,200 families and employment of additional 1,500 workers who would eventually become settlers. Each household was to receive a plot of 4 ha. By the time of project completion, agricultural targets were fully achieved, but infrastructure construction was significantly delayed. Only 42% of the settlement targets were met. Total project cost was estimated at US$ 147.3 million (World Bank 1987).

Sri Lanka – Accelerated Mahaweli Development Programme

Detailed project information is available for the third and final phase of the Accelerated Mahaweli Development Programme, which was supported partly by the World Bank. The World Bank’s loan of US$90 million was made to the Mahaweli Authority of Sri Lanka (MASL), a government agency set up specifically for the management of the Mahaweli Ganga Development Programme. This project was to develop 18,500 ha of irrigated area, provide improved water supply to 5,600 ha of new irrigated area, and provide additional water for 3,600 ha of existing irrigated area. The project involves jungle clearing, land levelling and on-farm development over a gross area of about 31,000 ha. It was to settle 18,500 families each with one ha of irrigated land and 0.2 ha of homestead plot, and 5,500 non-farming families each with a homestead plot. At the project completion, the objectives of developing irrigated area and related resettlement were successfully attained. However, there were substantial delays in the implementation. The loan was approved in 1981 with an appraised project length of six years, but the implementation actually took more than twice as long, which also resulted in 30% cost overrun. The project was judged as unsatisfactory for its low economic rate of return (4%), and less than expected income growth for settlers (twice compared to 5 to 6 times of “without project” income projected at appraisal).

The Organisation of Resettlement Projects

Characteristics of Settlement Area

Settlement areas usually possess at least one of the following two characteristics that prohibited development by spontaneous settlers alone.
A settlement area may be inaccessible to ordinary settlers. This is the case with the Brazilian and Colombian land settlement in the tropical jungles, as well as with Indonesian and Malaysia settlement projects. These areas were isolated from developed areas until access roads were built.

• A settlement area may be unsuitable for agriculture and human living. One possibility is the lack of water supply for irrigation and drinking. Settlement became possible when irrigation projects created new irrigated land, as in the case of Sri Lanka Mahaweli Ganga Development Project. Another possibility is that there are major health risks in the settlement area, as in the case of river-blindness zone in Africa. Settlement in these areas becomes possible after water treatment is made.

Types of Settlers

Because of the objective of providing employment for poor and landless farmers, government-sponsored settlers are usually recruited on a family by family basis according to a defined set of selection criteria. These people tend to own no land or little land, and be poor, young, and come from more than one community. The landlessness, however, does not necessarily mean that they are unemployed and lack of farm experience. Prior to the resettlement, they may often have worked as tenants to landowners. Some of them may be temporarily unemployed or working in non-farm sectors.

Initial Difficulties of Sponsored Settlement

Sponsored settlement has several consequences that can pose potential difficulties in the initial implementation. Specifically:

• since the settlers are from other locations, they are not familiar with the soil, cropping pattern and agricultural technology suitable for the settlement area and adaptation is required;

• since the settlers tend to have low incomes, the supply of informal credit is limited;

• community leaders and entrepreneurs are often under-represented in settlement areas because they tend to be older and richer possessing land in communities of origin, thus social networks must be built from scratch; and

• because the settlement process involves not only agricultural production, but also the moving and settlement of families, it is complex involving the construction of social infrastructure and the establishment of new societal rules and norms. As a result, it takes a longer period of time to implement and complete than, say, an agricultural development project. During the transition period settlers are faced with uncertainties. They tend to be risk-averse and depend on the government for living arrangements and for recommendations and training in production systems.

Spontaneous settlers are more risk-taking and independent by self-selection. They are attracted to the settlement area by economic opportunities in either farming
or non-farming sectors. They are entrepreneurs themselves. They usually bring in resources for initial living arrangements and the development of land. If well incorporated into the settlement process, they can play important roles in making a settlement project successful.

**Steps in Implementing a Voluntary Settlement Project**

22 Because voluntary settlement is a complex process, implementation must be carefully planned and well sequenced. International experience shows that understanding and following a certain implementation steps is crucial in ensuring the success of a settlement project. These steps are as follows 18.

- **Planning and site selection.** This involves feasibility studies, choice of settlement site and production system, design of management schemes, finance and cost recovery methods, and project appraisal.

- **Infrastructure construction and settler recruitment.** Roads, water supply facilities, primary school and health facilities are built in this stage. Project information is provided to potential settlers (including any cost recovery expectations), settlers are identified, and first settlers arrive (often without families) to participate in the construction of housing and the preparation for production.

- **Transition.** Settler families arrive and adapt to the new environment. Settlers strive to be self-sufficient and learn new production techniques on new soils. Initially food crops are grown while waiting for tree crops or cattle to mature. Settlers may also take up non-farm work. This transition process may take three to five years and is the most difficult stage for settler families.

- **Economic and social development.** Incomes rise beyond subsistence levels and settler households begin to rationalise their production system and can afford to take greater investment risks. Settler communities begin to form and function. Social infrastructure is further developed.

- **Handing over.** The supporting agency turns over management functions in the settlement to civil and normal local government organisations.

**The Effectiveness of Voluntary Resettlement Projects**

**A Basic Evaluation**

23 From the investment point of view, the economic rate of return is the most comprehensive criterion for judging the success or failure of a project. It tells whether an investment is able to generate sufficient economic value to cover its cost.

24 Estimates of the economic rate of return (ERR) of some projects are listed in Table 1. The economic rates of return are high for the Indonesian Transmigration I and III (19 and 25 percent respectively) but low for others. The low rates of return in Transmigration II and Swamps I were due partly to the choice of annual crop and small plot size, and the reason that Transmigration IV has low ERR is because of

18 World Bank, 1985, ibid
high settlement costs, low yields and low product price. The ERR of the Malaysian FELDA IV Land Settlement Project was estimated at 14 percent. This excludes the development costs of social infrastructure (settler houses, village roads and amenities). The ERR of the Sri Lanka Third Mahaweli Ganga Development Project was 4 percent. The low return is mainly because of the choice of paddy as the main crop and the low paddy prices. The Colombian Caqueta Rural Settlement Project (phase II) had a satisfactory ERR of 11 percent.

Table 1  Economic Rates of Return of Selected Settlement Projects

<table>
<thead>
<tr>
<th>Project</th>
<th>Rate of Return (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia Transmigration I</td>
<td>19</td>
</tr>
<tr>
<td>Transmigration II</td>
<td>0</td>
</tr>
<tr>
<td>Transmigration III</td>
<td>25</td>
</tr>
<tr>
<td>Transmigration IV</td>
<td>Marginal</td>
</tr>
<tr>
<td>Swamps Reclamation</td>
<td>Marginal</td>
</tr>
<tr>
<td>Malaysia FELDA IV Land Settlement Project</td>
<td>14</td>
</tr>
<tr>
<td>Sri Lanka Third Mahaweli Ganga Development Project</td>
<td>4</td>
</tr>
<tr>
<td>Brazil Alto Turi Land Settlement</td>
<td>13</td>
</tr>
<tr>
<td>Colombia Caqueta Rural Settlement Project (Phase II)</td>
<td>11</td>
</tr>
</tbody>
</table>

Note that the estimated economic rates of return do not capture all the costs and benefits of the resettlement projects. For example, the economic impacts on the originating areas are not included, neither are environmental impacts on settlement areas and originating areas.

Because an important objective of resettlement programmes is to find employment for rural landless poor, the income growth of settlers should be an important evaluation criterion. However, information on pre- and post-settlement incomes of settlers is difficult to find in the World Bank’s project completion reports. An exception is in Sri Lanka Mahaweli Ganga Development Project where settler incomes are estimated to be twice “without project” incomes. An evaluation of the Indonesian Transmigration Programme gives numbers of settler incomes in

settlement areas, but no information is available on previous incomes or “without project” incomes.

27 The impact of settlement projects on the environment is paid much attention because many of the projects involved the clearing of rain forests. While the economic consequences of the deforestation is difficult to evaluate, many recent projects started taking remedial actions. For example, in later Indonesian Transmigration projects environmental impact was taken into account in the site selection process. Rain forests were classified into three categories: conservation forest (to preserve bio-diversity); protection forest (to protect hydrological functions); and limited production forest, regular production forest and conservation forest. It was concluded that to prevent unnecessary environmental degradation, granting land title to smallholders is effective.

Multiplier Effects

28 Government-sponsored voluntary resettlement projects are often criticised as being too expensive and inefficient. Critics point out that spontaneous settlers made better farmers in less time and at less cost than government-sponsored settlers. Defenders of government-sponsored settlement point out that if there had been no government-sponsored settlement, spontaneous settlement would not have taken place in most of the settlement areas. In other words, government-sponsored settlement has the potential of catalysing regional development. Therefore, an important criterion for judging the success or failure of rural settlement projects is to see how well it catalyses regional development. A well-planned and implemented settlement programme has real potential for generating “multiplier effects” for regional development. The effects include the development of non-agricultural activities, employment generation in non-farm sectors, and the growth of markets and towns in the settlement region. The multiplier effects may also be extended to encompass neighbouring regions.

29 Several factors are necessary in order to bring about the multiplier effects in the resettlement programme:

- First, the objectives of settlement programmes need to be broadened. The large majority of resettlement programmes have been planned and implemented primarily as agricultural production programs, but pure agricultural production may not be able to generate high enough incomes to repay the high cost of settlement and land development. An example is the Mahaweli Ganga Land Development Project in Sri Lanka. Although rice self-sufficiency was achieved through the land development projects, the settler incomes were not sufficiently raised above subsistence levels.

- Second, the settlement programmes should be sufficiently large and concentrated and include as many settlement families as possible. This is because the size and density of population is an important determinant of

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24 World Bank, Indonesia Transmigration Program: A Review of Five Bank-Asupported Projects, April 1994
25 World Bank 1994, ibid; Schneider 1995, ibid
market development. A large economy permits specialisation and production for trade, which in turn provides employment and raises incomes of all people involved even though the settlement area may be located far from established market towns. According to a World Bank study, Malaysian experience shows that “a settlement of 2,500 families at full development may provide employment for nearly all of its labour force...while a settlement of 400 families could provide employment for only 70 percent of its much smaller work force.”26 Of course, if the settlement area is close to an established market centre, the optimal size is smaller. The settlement population can be increased if the host population is incorporated and spontaneous settlement is encouraged.

- Third, market infrastructure should be included in the planning of settlement. Unlike established communities where market centres have developed and evolved, such markets do not pre-exist in new settlement areas. International experience shows that it is desirable to integrate a hierarchy of settlement communities with market towns. According to the World Bank (1985), one of the most successful settlement projects in the world was planned and implemented by a private company in Brazil. The project built a railway that linked settlement communities and market towns at 15 km intervals, and larger townships at intervals of 30 to 45 km. Forty years later, the two largest railway towns each had populations of over 100,000, while the population of the smaller centres ranged from 10,000 to 50,000 people.27 Despite the desirability of building market towns along with the construction of settlement areas, few projects have attempted to incorporate market towns within project design. This is mainly because planners often choose to locate settlement area near existing market towns or railways.

- Fourth, employment generation. Many government-supported settlement projects expected settler families to be fully engaged in the chosen mode of agricultural production by planners. Off-farm employment by settlers and the sub-leasing of settler plots are discouraged. These policies have the adverse effect of restricting the spillover of settlement benefits to other people. International experience shows that as net incomes increase, settler families tend to substitute non-family labour for family labour and that the land allocated to one settler family is often sufficient for supporting two families. This is true for both small and big farms. The residual family labour may take up non-farm employment opportunities, or they may opt for less intensive work on their farm. The provision of employment to more labour in the region is the best example of the multiplier effect. If the non-family labour comes from other poor, landless families, then the multiplier effect is extended to other regions. In any case, the inclusion of more labours in the settlement area is beneficial because the population is increased.

26 World Bank, 1978, ibid
27 World Bank, 1985, ibid, p.25
Success Factors

30 Project management is a key factor determining the fate of a project. Adequate management organises the settlement in an orderly fashion, minimises delays, and reduces costs. Yet it is controversial as to what type of management is the best. A parastatal agency manages the projects in most of the countries under review, but there are pros and cons for this arrangement.

31 A strong parastatal agency has the ability to gain government support in every stage of the settlement process, including land acquisition, settler recruitment, and financial support. However, a strong parastatal agency also has certain disadvantages. First, it may prove to be less cost effective because of the lack of accountability by the parastatal agency. Second, while the involvement of settler organisations in the management has the potential of reducing project cost and improving settler stability, parastatal agencies often discourage the participation of settler organisations. Most importantly, a parastatal agency often resists handing the project to settlers at the final stage of implementation. FELDA of Malaysia is a case at point. The result is increased dependence of settlers on the government for subsidisation.

32 The choice of production system is often the decision of settlement planners. The planners often choose one or two crops and settlers are expected to follow the recommended production system in order to be eligible for government support. Crop choice can be pivotal in a settlement project. It is not coincidental that all settlement projects with annual crop as the main production choice are unsuccessful and characterised by low economic rate of return and low settler incomes. The reason is that resettlement projects are costly: they involve, for example, the clearing of forest or the damming of rivers, and the construction of roads, houses, schools. Benefits must be high to justify the high costs and grain crops do not provide high value added to farmers. Even where tree crop production allows settlers to move beyond subsistence levels, flexibility for diversification is also important. Crop diversification allows farmers to deal with crop-specific shocks, such as disease, price fluctuations and so on. In terms of labour diversification, at the early stage of the settlement, settler households often use wage labour to finance the transition, the importance of which may decline as tree crops mature. Wage labour may even become a permanent diversification mechanism.

33 Competent site selection can prevent mistakes on poor soil and hydrological surveys. Considerations are also necessary on the location of a settlement site. It should not be too distant from market centres and major transportation routes.

34 Since settlers are mostly newcomers and are unfamiliar with local soils and crops, extension is particularly important. For this reason the settlers depend on the management agency for the choice of crops and for farming techniques.

35 During the initial years of transition, it is often necessary to provide assistance to settler families. The assistance can take many forms: grants, food assistance (including food for work), wage labour and credit. The method should be carefully chosen to achieve the goal of helping the settlers while not causing dependency of settlers on the government. International experience with land
settlement and rural development in general indicates that grants should be kept to the minimum and all sources of credit should be explored.

36 The projects reviewed present different approaches to land tenure system. Brazil and Colombia issued land titles to settler families at a relatively early stage while the Asian countries (Indonesia, Malaysia and Sri Lanka) are generally reluctant to issue land titles. In Colombia, 51% of settlers bought cleared land from Incora (Colombian Institute of Agrarian Reform, a government agency responsible for land settlement), 32% cleared their own land and obtained title subsequently, 17% used the combination of the two methods 28. The settler families then used land titles as collateral to obtain long-term production loans from Incora, who made land titles as prerequisite for the loans. There is evidence that land titling contributed to a stable form of land exploitation and farmer commitment to the land.

37 A World Bank study found that the practice of land clearing in the Indonesian Transmigration Programme was unsustainable and causes irreversible harm to the environment. “Slopes over 8 percent had been cleared, trees were bulldozed into waterways, erosion measures for long contours were not undertaken, the opportunity to introduce settlers to a range of forest products was lost and no attempt was made to harvest the commercial timber left partly burned in the fields” 29. There was also serious destruction of crops by pests. The report concluded that: “land clearing operations may be undertaken in a more sustainable fashion if settlers have land title to their individual plots” (p. vii). In Transmigration II, although giving land titles to settlers within five years of their arrival (by 1990 at the latest) was a covenant in the loan agreement with the World Bank, it was largely ignored because at the time of the report (1994) only 37 percent of the households had land titles.

38 In Malaysia and Sri Lanka, the governments use land titles as a means for cost recovery. They continue to withhold the land titles until after the settler families pay off the loans or the cost of development. As of the end of 1993, two years after the completion of the third Mahaweli Ganga development project (1981-1991), no payment had been made by the settlers; and land ownership rested with the government of Sri Lanka 30.

39 In Malaysia where settler families received loans for settlement and production, land titles would be issued upon completion of loan repayment. For rubber farms, individual titles would be issued to the settlers; for oil palm farmers, a collective title would be issued to a co-operative of 20 settler households set up solely for the purpose of land ownership. In 1981, the government introduced in a share system whereby settler families would not receive ownership titles, instead they would become shareholders in the oil palm Land Development Corporation managed by FELDA and receive dividend payments as well as wages 31.

28 World Bank, 1994, “Project Completion Report: Colombia: Caqueta Rural Settlement Project (Phase II)”
29 World Bank, 1994, ibid, p. 21
Land titling has the effects of increasing settler security, investment incentive, and access to credit. World Bank evaluators believe that the Malaysian co-operative system was showing signs of failing by the mid-1970s with pressure building up to assign all land individually. The settlers are also said to oppose the share-holding system. Experience from other parts of the world (Mexico, Peru, Honduras, Nicaragua, Zimbabwe, and Kenya) also shows that collective forms of land use in settlement schemes are associated with failure and subsequent subdivision of land to households often occurs.

Financing Resettlement

Costs

Rural settlement projects are invariably expensive. Costs per beneficiary family in rain-fed settlement programmes funded by the World Bank from 1962 to 1975 were estimated at $6,460. By the mid-1980s, costs for World Bank-assisted rain-fed projects ranged from $5,000 to $20,000 per family, the higher costs being for Malaysia FELDA tree crop projects. At that time worldwide irrigation settlement programmes cost more than $10,000 per household.

Cost Reduction

International experience suggests that cost reduction may be achieved if a certain guidelines are followed.

It is recognised that greater private sector involvement cannot only cut costs but also enhance development opportunities. FELDA of Malaysia contracts most of its investment projects to the private sector. The Indonesian government has adopted the same approach since 1987. In this regard, Mahaweli Authority of Sri Lanka was a pioneer. It has long awarded contracts to private contractors, including using a private bank to provide loans to settler families. After testing awarding contracts to small, medium and large contractors, it found that large contractors are preferable. Awarding large contracts covering a range of activities, such as construction of canals, land clearing, rough levelling, and roads to qualified contractors resulted in improved performance and minimised delays.

32 World Bank, 1985, ibid
33 Kinsey B and H Binswanger, 1993, ibid
35 World Bank, 1993, p 5
The Role of the Private Sector in a Voluntary Settlement Project

The World Bank Country Assistance Strategy for Indonesia outlined in 1994 placed the involvement of the private sector at the centre of the strategy. It was decided that institutional arrangements would be considerably simplified by contractual arrangements between the Ministry of Transmigration and private companies. According to this strategy, the private company was responsible for land clearing, planting and maintenance of the entire estate until maturity of oil palms, approximately four years after planting. At maturity, the smallholder plots (normally 2 ha) were transferred to the settlers. The transfer entailed site inspection by the Directorate General of Estate Crops (DGE) in the Ministry of Agriculture, the commercial bank, the private company and the settlers. If the plot was not developed to standards previously established by the DGE, the transfer was in abeyance until the agreed standards were reached; costs during this period being borne by the company. The private company was also contracted by DGE to establish an oil processing plant of commensurate capacity.

In respect of financing, the company receives a 4-year, 16-percent interest-rate loan from a state bank. Standard costs of development per ha were set annually by DGE. Once the plot was handed over to the settlers, the loan was transferred to the settlers, who paid a 12 percent interest to be repaid over 9 years. The experience from Transmigration I and III—where farmers received the tree crop plot on a grant, not a loan, basis—showed that the returns from tree crops provided sufficient capacity to repay some portion of the development costs of three crop planting. Normally the costs of agricultural support services, social infrastructure and roads was not recovered directly from project beneficiaries.

After transfer, the responsibility for crop maintenance and harvest rest with the farmers, the only obligation of the private company was to purchase all the harvested fresh fruit bunches at the prices fixed by DGE provided that quality standards were met. Payment was made to the commercial bank, which deducted 30 percent for loan repayment and released the remaining 70 percent to the farmer.

The system had sufficient checks and balances built to avoid exploitation of the farmers, while the system ensured that the company had an incentive to establish and maintain the plot satisfactorily and that the settlers received a well-developed plot.

As of December 1993, a total of 349,000 ha had been developed to grow oil palm by private companies.

Spontaneous settlers are present in all project areas. Numerically, they dominate settlement areas throughout tropical and sub-tropical areas. In some areas of the Amazon basin more than 80 percent of all settled households are spontaneous. Even where settlement initially is restricted to government-selected settlers (including some or all of the host population), spontaneous settlers subsequently came in large numbers, as in the case with Indonesian Transmigration Program. In settlement areas of Transmigration I and III, spontaneous settlers constituted over 30 percent of households in 1994 and they were attracted by employment opportunities. It is a worldwide phenomenon that settlement regions attract a large number of spontaneous settlers since spontaneous settlers are estimated to outnumber government-sponsored settlers on a three/four to one basis (World Bank 1985, p28).

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World Bank, 1994, ibid, p 6
The Importance of Allowing Spontaneous Settlers

A striking finding about transmigration sites is that they have become living communities, most of which continue to grow continuously since establishment. In 1989, the latest data, which were available, the 6,500 sponsored families in Transmigration III and I had grown to 7,900 families. In addition, 3,619 spontaneous families had moved into these communities. At impact evaluation in 1993, many of the resettlement sites, particularly in Transmigration I, were villages thriving with a broad range of commercial activities as well as social and cultural entertainment. A survey found that one third of total incomes in Transmigration I was drawn from off-farm activities. In value terms, the most important off-farm activities were wage labour in estate crops and trading.

Regions of settlement are attractive to spontaneous settlers because with government provision of infrastructure such as roads and potable water, the cost of settlement (clearing and levelling land and building houses) is significantly reduced, and the benefits of settlement are increased. The latter is reflected in improved marketability of agricultural products, the increase in opportunities for non-farm employment and business activities.

Spontaneous migrants play two important roles in the development of settlement areas:

- First, they demonstrate to government-sponsored settlers what economic opportunities and potentials exist and how to take advantage of them;
- Second, they help enlarge the size of population in settlement areas that in turn generate sufficient demand for locally produced goods and services. The World Bank experience shows that all successful settlement projects had 1,000 settler households or more, the proportion in unsuccessful ones was much less, only 30 percent.

Proximity to marketing centres and roads reduces the cost in two ways. First, it reduces the cost of transportation and thus reduces the cost of constructing roads and houses and production. Second, it increases the access to outside market, which enables specialisation and higher incomes, which in turn enables the repayment of loans.

Resettlement is a complex process. Delays and cost overruns are common, thus careful planning is imperative. Part of the planning involves phasing inputs through time. The Colombia Caqueta land colonisation project is a good example for the phasing of land development. Settlers were required to clear a minimum amount of land before becoming eligible for loans to purchase cattle. The settlers who cleared land first showed their commitment to production, thus are more likely to be serious settlers.

The phasing of settlers is also necessary. Because initial settlers invariably encounter hardship, families can wait while young and strong family members move

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39 World Bank, 1985, ibid, p 23
first to build housing and prepare land. This can be done through organising settler/worker programme.

50 The phasing of infrastructure is also important because the delay of some infrastructure delays the entire settlement process. For example, roads must be built first to establish links between the settlement area and the rest of the regional. At the arrival of first settlers, potable water should be supplied. Schools and health facilities should be built before bringing in settler families. The project delay in Malaysian FELDA VI Land Settlement Project (1977-1985) is a case at point. The infrastructure construction was not yet completed at the project completion. There was no permanent water supplies, and housing construction was only completed for 2,490 of the originally planned 62,000 families. The delays caused unnecessary hardship to initial settlers.

51 Project provided housing is generally the second most expensive item of all component of the settlement, next to roads, yet the houses built for the settler families are often unsatisfactory. International experience suggests that the project should only provide temporary housing for first settlers, then let the settlers themselves build their own permanent housing.

Cost Recovery

52 Cost recovery is a major challenge faced by all resettlement projects and the results are unsatisfactory for the majority of them. Technically efficient projects tend to have better repayment records. Short and medium terms loans tend to have better repayment records than long term loans. The best record is found in the Malaysia’s Jengka projects, in which nearly all short and medium term loans are recovered. At the other extreme are projects, such as in Brazil’s Alto Turi, where, in addition to production credit extended under the project, settlers repay only the negligible real costs of land surveys and demarcation. One problem is the settlers’ ability to pay and the other the refusal to pay given the capability.

The Ability to Pay

53 On the issue of the ability to pay, it is observed that settler incomes are generally low if annual crops are the main source of income. In three Indonesian transmigration projects sponsored by the World Bank (Transmigration I to III), two of them (Transmigration I and III) developed tree crops while the government pushed for annual crops in the third (Transmigration II). The result was the near tripling of annual incomes in the tree crop project families relative to annual crop areas.

54 It is also important to give settler families the flexibility in production choice and employment choice. Governments often expect settlers to engage in activities planned by the project, often narrowly defined to include only a certain types of crop. This is the policy followed in Sri Lanka Mahaweli projects where rice production was emphasised to achieve domestic rice self-sufficiency. A 1984 evaluation survey found that in the initial-settled portions of earlier settlement areas, a majority of settlers had not moved beyond subsistence after five years of settlement in spite of

World Bank 1978, ibid, p. 35
their farming skills. One of the major reasons for the stagnation of income in earlier projects was judged to be the small size (one ha) of the settler plot. Because of the small size and the restriction on crop choice, farmers sought to lease in or out land and engage in off-farm employment activities. The leasing of land was actually done by 18% of the settlers in 1992, but this practice was deemed illegal by the government.

As default is often the result of withdrawal of indebted settlers from the resettlement areas, insisting on evidence of commitment before disbursement of loans may increase the stability of settlers. In Colombia, settlers must have cleared a certain amount of land before being eligible for production loans.

Avoiding over-indebtedness of settlers is also worthy of attention. Given the same technical efficiency, the more indebted a settler family becomes, the less capable it is to pay back the loan. Over-lending may cause over-indebtedness. If a settler is offered too much credit, and if there is no immediate cost associated with the lending, then the settler is not likely to resist the temptation to utilise all the credit available.

International experience shows that a careful calculation must be made regarding the grant elements of a settlement programme. In Africa, where settlers purchased land on credit, efforts to recover the full cost universally failed. There is large-scale default and a consequent withholding of title. It was concluded that “There must be a substantial grant component, credit can be employed to top up settlers’ resources, therefore assisting settlement to serve both the poor and those more asset-rich.”

Resettlement agencies often force loans onto settlers so that participation in resettlement automatically incurs debt. For example, settlement agencies generally insist a high standard to the quality of housing in the settlement areas and do not permit traditional housing. As a result, the settlers are granted a housing loan that they would have otherwise avoided by building temporary housing.

To minimise indebtedness, alternative means of financing resettlement also need to be considered. For example, in Indonesia, many spontaneous settlers worked as wage labourers to accumulate assets before obtaining their own land.

The Willingness to Repay

In many cases, settlers refuse to repay the loans even though they have the ability to pay because experience leads them to believe that defaults would be tolerated. It was found in Kenya that the Nyeri District had one of the worst payment records in Kenya even though agriculture had made impressive progress. On the other hand, the Mossi farmers in the central region of Upper Volta were not only very reluctant to assume debt, but they were tapping every resource to repay those they

41 World Bank, 1985, ibid, p19. The more recent third Mahaweli project has the same plot size.
42 World Bank, 1993, ibid, p7
43 Kinsey and Binswanger, ibid, p24
44 Nelson, 1973, ibid, p 216.
had contracted, even though the credits had apparently not produced a significant increase in their marketed output.\textsuperscript{45}

61 The willingness to repay is found to be linked to the perceived obligation of settlers to repay the loans. For example, in Kenya on the schemes as a whole, those settlers who had been employed on the land when it was still European-owned tended to have the highest rate of default even they had shown themselves to be above-average farmers. Such settlers apparently considered that they were entitled to the land.

62 Given the possibility of default from well-to-do farmers, it is important to design appropriate mechanisms for loan recovery. The following methods have been used in various countries.

- **Use land title as collateral.** In Brazil, for example, settlers receive title to the land that they cleared, and then use the title as collateral for loans. A prerequisite for this to work is to make the land alienable so that eviction can be enforced.

- **Use loan repayment as pre-condition for land ownership.** This method was used in Kenya, Malaysia and Sri Lanka. When used alone, this does not seem to have the effect of preventing large-scale default in Kenya and the indefinite postponement of loan repayment elsewhere. In addition, because land title is withheld from farmers indefinitely, long-term investment from settlers is discouraged.

- **Centralised marketing.** A centralised marketing agent purchases output from settlers and automatically withholds loan repayment from proceeds. Where applicable, this has been the most successful and most commonly used approach to loan recovery around the world. However, the applicability of centralised marketing is limited to crops that need central processing, such as oil palm and sugar cane, and vegetables and fruit for long distance marketing where there is scale economy associated with marketing. For grains and fruits and vegetables for local markets, enforcing centralised marketing is bound to be futile. The negative side of this approach is that settlers lose the opportunity to develop skills and acquire knowledge that will enable them to become independent operators. Exploitation is also to be avoided by the marketing monopoly.

- **Marketing co-operatives.** In many African countries, marketing co-operatives were set up and supported by the resettlement agency. In Kenya, the resettlement agency entrusted collection of payments to the co-operatives on the scheme, paying the co-operative a commission of 1%. Since most of the settler’s sale must go through their co-operative, the latter have the means to deduct any payment due.\textsuperscript{46}

\textsuperscript{45} Wilde, 1967, ibid, p 206.
Phasing the disbursement of loans. In Zambia, settlers had to open an account with a commercial bank in order to obtain loans and had to deposit one-third of the amount of any loan before it was disbursed. Recovery was on a voluntary repayment basis, while the penalty for non-payment was loss of the deposit and further credit facilities. This practice uses the similar principle of micro-finance where credit-worthiness is rewarded and non-payment punished.

It is one of the elementary lessons of experience that credit cannot be developed on a sound basis unless from the beginning there is strict insistence on repayment. The experience in Sri Lanka illustrates that the introduction of new charges or raising charges at later stages in the project can be disastrous. Water charges initially were 50% of the operation and maintenance cost. The Mahaweli Authority of Sri Lanka attempted to increase the charge to full operation and maintenance cost within 5 years. However, payment of water charges in one of the project areas deteriorated from over 90% of amounts due in 1985 and 1986, to 38% in 1998, 25% in 1989, and 5% in 1990.

The Lessons

Many international lending agencies have formalised and adopted guidelines or policies for involuntary settlement projects, first initiated by the World Bank in 1980, followed by Inter-American Development Bank (1990), Development Assistance Committee of the Organisation for Economic Co-operation and Development (OECD) (1991), Asian Development Bank (1995) and other international agencies. Involuntary settlement occurs when a project involves “acquisition or redirection of use of lands that are owned or utilised by individuals and communities”. Examples of such projects include the construction of dams, irrigation canals, highways, railroads, airports, etc. The reason that greater attention has been given to involuntary settlement is obvious: the settlement has adverse impact on the welfare of displaced people.

Because of the adverse impact on the displaced people, the guidelines or policies mostly deal with the compensation or remedial issues. For example, ADB involuntary settlement policy stipulates that the following basic principles should be observed for any project involving involuntary relocation of people:

- Involuntary resettlement should be avoided where feasible.
- Resettlement should be confined to where population displacement is unavoidable.
- Ensure that displaced people receive assistance, preferably under the project, so that they would be at least as well off as they would have been in the absence of the project.

47 World Bank, 1984, p 13
The latter two guidelines also apply to voluntary resettlement. ADB guidelines also stipulate some specific actions that should be undertaken to smooth the settlement. These guidelines are applicable to voluntary settlement, too. These include:

- “The affected people should be fully informed and closely consulted on resettlement and compensation options. Because adversely affected people are particularly vulnerable, resettlement and compensation decisions should be preceded by a social preparation phase to build up the capacity of the vulnerable people to deal with the issue.”

- “Appropriate patterns of social organisation should be promoted, and existing social and cultural institutions of settlers and their hosts should be supported and used to the greatest extent possible. Settlers should be integrated economically and socially into host communities so that adverse impacts on host communities are minimised. One of the effective ways of achieving this integration may be by extending development benefits to host communities.”

- “The full costs of resettlement and compensation, including the costs of social preparation and livelihood programmes as well as the incremental benefits over the “without project” situation, should be included in the presentation of Project costs and benefits.”

- “To better assure timely availability of required resources and to ensure compliance with .... resettlement procedures during implementation, eligible costs of resettlement and compensation may be considered for inclusion in Bank loans financing for the project, if requested.”

In addition to the ADB Guidelines on involuntary settlement, the international experiences of voluntary settlement reviewed in the report indicate that the following principles are also important for the success of a voluntary settlement project:

- Settlers should be fully informed of the resource potentials and risks of the settlement area.

- Settler selection process should be free of political favouritism.

- The host population should be adequately compensated for the loss to new settlers.

- Spontaneous settlement and private sector involvement in project implementation should be encouraged.

ADB, 1995, ibid
## End Table 1 Description of Selected Voluntary Resettlement Projects

<table>
<thead>
<tr>
<th>Project name</th>
<th>Cost at appraisal (million US$)</th>
<th>Project starting time</th>
<th>Settler families at appraisal</th>
<th>Actual Settler families</th>
<th>Production Choice</th>
<th>Plot size (ha)</th>
<th>Actual cost</th>
<th>Cost per settler family</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia 50 Transmigration I</td>
<td>30.0</td>
<td>1976</td>
<td>4,500 new settlers and rehabilitate a site with 12,000 existing families</td>
<td>5,000</td>
<td>Rubber</td>
<td>5</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Transmigration II</td>
<td>242.0</td>
<td>1979</td>
<td>30,000</td>
<td>19,000</td>
<td>Food crops</td>
<td>3.5</td>
<td>N/A</td>
<td>5,100 (a)</td>
</tr>
<tr>
<td>Transmigration III</td>
<td>187.3</td>
<td>1982</td>
<td>2,000</td>
<td>2,000</td>
<td>Rubber</td>
<td>3.5</td>
<td>N/A</td>
<td>13,000 (a)</td>
</tr>
<tr>
<td>Transmigration IV</td>
<td>121.0</td>
<td>1983</td>
<td>6,000</td>
<td>N/A</td>
<td>Food and coconut</td>
<td>3.25</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Swamps Reclamation</td>
<td>44.6</td>
<td>1981</td>
<td>3,200</td>
<td>N/A</td>
<td>Food</td>
<td>2.25</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Malaysia Felda IV Land Settlement Project 51</td>
<td>92.3</td>
<td>1978</td>
<td>6,200</td>
<td>2,490 at PCR</td>
<td>Rubber and oil palm</td>
<td>4</td>
<td>147.3</td>
<td>21,200 (b)</td>
</tr>
<tr>
<td>Sri Lanka Third Mahaweli Ganga Development Project 52</td>
<td>202.4</td>
<td>1981</td>
<td>18,500 farming families and 5,500 nonfarm families</td>
<td>96%</td>
<td>Paddy</td>
<td>1</td>
<td>263.1</td>
<td>N/A</td>
</tr>
<tr>
<td>Brazil Alto Turi Land Settlement 53</td>
<td>12.6</td>
<td>1972</td>
<td>Provide survey and demarcation to 5,200 holdings</td>
<td>N/A</td>
<td>Cattle</td>
<td>N/A</td>
<td>34.4</td>
<td></td>
</tr>
<tr>
<td>Colombia Caqueta Rural Settlement Project (Phase II)</td>
<td>19.5</td>
<td>1975</td>
<td>Provide infrastructure to 12,000 existing families and settle 2,850 families</td>
<td>~2850</td>
<td>Cattle</td>
<td>30-200</td>
<td>29.8</td>
<td>N/A</td>
</tr>
</tbody>
</table>

50 World Bank, 1994, ibid
51 World Bank, 1987, ibid
52 World Bank, 1993, ibid
53 World Bank, 1985, ibid
Voluntary Rural Mobility Approaches and Experience in PRC

Summary

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Summary

The paper identifies the types of resettlement in PRC that have taken place and provides the historical background to voluntary rural resettlement. It reviews the necessity for resettlement of the poorest from remote mountainous areas and compares this with other alternatives for poverty reduction. It concludes that resettlement is the preferred though last resort option in many remaining areas of PRC. It identifies land availability for resettlement and the barriers to its spontaneous occurrence and concluded that government involvement is necessary for resettlement to take place. It describes the institutional structure for managing voluntary resettlement and the settlement process. It summarises the economic, poverty reduction, cultural and ecological effects from the limited available evidence and shows that this can be positive. It reviews the sources of funds for resettlement, their uses and notes that cost recovery is not yet prevalent in voluntary resettlement schemes. It concludes by identifying problem areas to be addressed through improvements in voluntary resettlement policies and guidelines.

Since 1949 there have been three types of resettlement in PRC. There has been involuntary resettlement mainly associated with reservoir development. There has been spontaneous resettlement in response to famines in the 1960s and more recently in the search for employment in the more developed eastern coastal regions. There has also been voluntary rural resettlement sponsored by government. This paper is concerned with the latter.

There are some early cases from the 1960s, but the “3-Xi” programme, which began in 1982, is the first large-scale programme. This programme moves poor people from resource poor areas in Dingxi and Xihaigu on the loess plateau to the more fertile Hexi area. This has increased output in the Hexi area, reduced poverty in the Dingxi and Xihaigu areas and improved the environmental conditions in the latter. In the 1980s and 1990s the governments of Gansu and Ningxia have also had resettlement programmes and had moved 630,000 people by the end of 1998. In Guangxi about 106,000 people have been moved from remote mountainous areas to better conditions in 22 counties. Guangdong Province has resettled about 187,000 people from remote mountain areas. Hubei, Shaanxi, Jilin and Shanxi Provinces also have voluntary resettlement programmes.

In many remote mountainous areas, the resource base is poor and poverty has been exacerbated by population growth. At the end of 1999 there were still 34 million people in absolute poverty in PRC, 90 percent of whom lived in such areas. For historical reasons, this population is dominated by minority nationalities. The population pressure has resulted in over cultivation and deforestation leading to soil erosion and desertification. The alternatives facing government for these areas are to assist the poor on the spot through the provision of improved technology and introduction of environmental protection measures, but there are limits to this in view of the population pressure; assisting farmers to become migrant workers, which provides a temporary solution for as long as the migration lasts; and resettling farmers, which if successful provides a permanent and self-sustaining solution. Voluntary resettlement is thus the government’s preferred, but last resort option. LGOP estimate that this option will need to be used about 5 million people to lift them out of poverty.
Land is available for resettlement. There are 13 million hectares of cultivable wasteland, 111 million hectares of land suitable for afforestation and tree crops and 4.5 million hectares of state farmland that can provide areas for resettlement.

Resettlement is impeded because the development of under-utilised land cannot take place spontaneously in PRC. Aside from the investment costs, the current property rights system makes acquisition of large blocks of land difficult; the household registration system restricts movement and lack of registration results in lack of access to social services; and farmers in poor mountainous areas do not have the information to take advantage of opportunity and may not have the skills to farm in new areas. These barriers cannot be overcome by market mechanisms at the present time, so the involvement of government is necessary.

To manage resettlement, the provinces involved have set up leading groups at provincial, municipal, county and township level to oversee the process. Implementing agencies are also appointed to carry out the work. These vary and may be quasi government organisations or corporations. The fieldwork indicates that within county resettlement is relatively easy, but that trans-county and trans-regional settlement is more difficult to implement because there is more than one local government administration involved. In the newly resettled communities, governance structures sometimes follow those of local government and sometimes are special structures, at least initially. The dominant form of resettlement is where government develops the resettlement areas and organises the process.

Criteria for settlement areas are centred on adequate land availability, the development of infrastructure at reasonable cost, and the convenience of overall access to the area. The criteria used to choose settlers, apart from poverty and a willingness to relocate, focus on their ability to work and minimum primary education requirements. County authorities allocate settlement places to townships and villages and villagers apply for resettlement. Applications are reviewed and approved at county level and representatives from villages are given the opportunity to visit the resettlement area and report back. Potential settlers are then free to decide if they actually want to move. Contracts between settlers and local governments are not usual for within county settlement, but are common for trans-county and trans-regional settlement.

The extent of site development varies. In Ningxia water storage and irrigation systems are developed, land levelling carried out, utilities installed, paved roads laid and social infrastructure completed before settlement takes place. Basic housing is also constructed. In Gaungxi, cultivable land and dwelling plots are designated and utilities, roads and social infrastructure constructed, but housing is not provided. Funding for the start-up of activities has increasingly been provided through loans rather than grants in recent years.

Voluntary rural resettlement has demonstrated positive economic effects. Evidence from Ningxia and the World Bank’s “Northern Irrigation” project shows substantial increases in production and output, gains in per capita incomes and substantial accumulation of assets by the settlers. There is also evidence on the development of non-farm business activity.
There is evidence that settlers are able to re-establish their culture in new locations, for example the Muslim Hui people of Ningxia have built mosques in many settler villages. The dropout rate for settlers is low. Although 10 percent return to their native village at some point, eventually only two percent do not return to the new settlement.

In some areas there is evidence of positive environmental impact with the mountain villages improving land use and land allocation. In others there is not. This appears to depend mainly on the local government. In the resettled areas, newly irrigated land has helped to arrest desertification.

Funding has come from various sources: special funds from central government, food for work appropriations, subsidised loans, local fiscal funds, assistance from richer provinces and the World Bank. Overall investment per capita appears to range between 1,450 and 1,650 yuan. Cost recovery has not yet predominated in any schemes although loan funding for productive activities has been more prevalent in recent years.

For the future, there are some identifiable problems for the consideration of policy makers arising from experience of resettlement in Gansu, Ningxia and Guangxi. In the outmigration areas: while it is reasonable of the host area to stress the aptitude and physical fitness of settlers, care needs to be taken to ensure that those left behind are not only the most vulnerable, otherwise alleviating poverty for some only increases it for others; and greater attention can be paid to improving the environment in the outmigration areas through helping remaining villages to reorganise the use of resources. In the host areas: the problem of permanent residence registration for the trans-county and trans-regional settlers needs to be resolved by government; and where settlers rent land or have the a limited period of use rights, first options for renewal should be granted to allay settlers concerns that they may have given up their original land only to be later dispossessed of the land on which they have settled. In the economic environment: market risks faced by settlers can be better addressed by fostering investment in agroindustry and providing support services for its development including vocational training for settlers; and market mechanisms can be more widely applied, in Gansu and Ningxia, for instance, water fees can be raised step by step. The international experience can assist in providing insights into best practice elsewhere and how elements of it may be applied to address these issues.
Introduction

Types of Resettlement

1. Since 1949, there have been several large-scale resettlements in PRC:

   - Involuntary resettlement: such as the placement in the countryside and mountain areas of 17 million educated urban youth during the Cultural Revolution (1966-1976), and the relocation of several million residents in the reservoir areas during the past 50 years. These two types of resettlement are characterised either by moving from the cities to the countryside, or moving from rural areas with better living conditions to the rural areas with poorer living conditions.

   - Spontaneous resettlement: such as the flow of population during the famine years in the 60s when the farmers in Shandong Province moved to Heilongjiang Province. There has also been a seasonal flow of farmers toward the cities and the developed coastal areas starting in the middle of the 80s, the scale of which reached 80 million people per year. The characteristic of this type of resettlement is that people move from the poorer areas to areas with better living conditions.

   - Voluntary resettlement sponsored by the government. In 1983, the government began to aid the poor regions of Dingxi, Hexi of Gansu Province and Xihaigu of Ningxia Autonomous Region (abbreviated to “3-Xi”) through development projects. This has continued in the 90s, with the government using resettlement as the last resort to reduce poverty in regions where the natural resources are deficient and the population pressure too great. This type of resettlement is the movement from rural areas with low income to rural areas with higher potential income. This type of resettlement is the subject of this analysis.

The Historical Perspective

2. There are early successful cases of voluntary rural resettlement organised by the government in the 70s, but it did not become the means of reducing poverty large scale until 1982. In that year, there was a 5-month-long drought in the central area of Gansu Province. The government appropriated substantial disaster relief, but it was this incident led to the start of “3-Xi” programme. Under the programme, the Ministry of Finance has appropriated 200 million yuan each year to the 3-Xi regions. Hexi has good productive natural resources while Dingxi and Xihaigu are areas with dry hilly lands and gullies on the loess plateau. The strategy of the government has been to move part of the population from the dry Dingxi and Xihaigu areas to the Hexi area. Through this programme, poor households that resettled have been able to improve their living conditions, while those who stayed gained access to increased resources. This achieved three goals: to increase the grain output of Hexi area, to reduce poverty in the Dingxi and Xihaigu areas, and to protect the ecosystem of the three areas. In the 1980s and 90s the governments of Gansu and Ningxia also initiated resettlement programmes. Some 320,000 people were moved from the poor remote mountainous areas to newly developed irrigated areas by the end of 1990. The number of settlers had reached 630,000 by the end of 1998.
3 Guangxi Autonomous Region has also been a model for voluntary rural resettlement in the 90s. In 1993, the government decided to move and provide settlement for 250,000 poor from mountainous areas within seven years. Although significant inroads had been made previously into poverty reduction, some 5 million poor remained, 80 percent of whom were in remote mountain areas. The problems faced included lack of land (250,000 people had less than 0.3 mu of the cultivated land per capita and more than 500,000 people had less than 0.5 mu); fragmentation of land parcels making cultivation difficult; lack of water due to the karst topography; and lack of access. Between 1993 and 1996, the local government invested 360 million yuan to establish 122 settlements. Some 20,000 poor households (102,000 people) were resettled from 22 counties. In 1997, Guangxi received 60 million yuan in assistance from the richer Guangdong Province to provide settlement for 4,000 more absolute poor (20,000 people) in the Hechi and Baise areas.

4 Guangdong Province is another southern province using resettlement to reduce poverty in mountainous areas. Between 1993 and 1998, Qingyuan City of Guangdong Province resettled 39,459 households (186,850 people) from karst areas to 1,177 new villages that were allotted 152,409 mu of cultivated land.

5 Besides Gansu, Ningxia, Guangxi and Guangdong; Hubei, Shaanxi, Jilin and Shanxi have also used resettlement for poverty reduction since 1996.

Table 1 The Situation of the Resettlement Projects

<table>
<thead>
<tr>
<th>Province</th>
<th>Planned 10,000 People</th>
<th>Implemented 10,000 People</th>
<th>Methods</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gansu</td>
<td>60.0</td>
<td>38.0</td>
<td>Undertaking water conservancy projects; setting up settlements; developing lands</td>
</tr>
<tr>
<td>Ningxia</td>
<td>72.4</td>
<td>24.4</td>
<td>Undertaking water conservancy projects; setting up settlements; developing lands</td>
</tr>
<tr>
<td>Guangxi</td>
<td>25.0</td>
<td>23.0</td>
<td>Setting up settlements; cultivating barren hills</td>
</tr>
<tr>
<td>Guangdong</td>
<td>22.5</td>
<td>19.4</td>
<td>Setting up settlements, agricultural and Industrial development zones</td>
</tr>
<tr>
<td>Hubei</td>
<td>20.0</td>
<td>4.0</td>
<td>Making new lands; building tree farms and tea plantations</td>
</tr>
<tr>
<td>Shaanxi</td>
<td>24.5</td>
<td></td>
<td>Setting up settler development zones</td>
</tr>
</tbody>
</table>

Sources: edited according to the reports of the above provinces, ref. Development and Becoming Rich (1997-1998)
*: The data of Gansu, Ningxia and Guangxi is that of the end of 1998, the others are the actual data of 1997

The Necessity for Resettlement

6 Mountains, highland and hilly lands account for about 70% of the total area of PRC. Poor populate many of these areas, their poverty brought about by adverse living conditions. In the northern loess plateau, in the hilly lands and gully areas of Gansu and Ningxia, there is poor water supply, and the average annual rainfall is only 200-400 mm. Drought is common. In the karst areas of Guangxi and Guizhou, the soil is relatively thin and water drains rapidly into the porous limestone.
In these resource impoverished areas, poverty has been exacerbated by population growth and particularly by the policy of encouraging childbearing for minority nationalities. In the “3-Xi” areas for instance, from 1949 to 1983, the population of Dingxi in Gansu increased from about 2.6 million to about 5.7 million, a rise of 118.8%, and an average annual increase of 2.3%. During the same period, the population of Xiahaigu in Ningxia increased from about 0.48 million to about 1.4 million, a rise of 192.9%, and an average increase of 3.0%. These compare with an average national growth rate of 1.9% over the same period. According to official statistics, by the end of 1998, there were still 4.2 million people who did not have enough food and clothing. Ninety percent of them live in the remote resource poor areas where the population is dominated by ethnic minorities.

Over-cultivation and severe deforestation in many areas has served to increase poverty. In the northwestern dry areas and southwestern rocky and mountainous areas, the ecological balance was fragile in the first place. Exploitation of these resources has seriously destroyed the ecological balance. The impact of soil erosion and desertification reaches beyond where poor farmers live. Yet it is not possible to effectively protect the environment given the lack of production opportunities and the population pressure. Resettlement measures are necessary to ease the population pressure.

From the fieldwork it was found each household in the dry areas of Gansu and Ningxia burns 4,192 jin of sod every year, which means each household scrapes 60 mu of sod on the barren hills per year.

In the south-western rocky and mountainous areas, farmers with scant per capita cultivated land have developed land with slopes above 25 degrees, resulting in serious soil erosion.

The volume of sand content in the Qianjiang section of Hongshui River in Guangxi was 0.5 kg/m³ in the middle of 50s. The volume is now to 0.7 kg/ m³ .

Desertification of rocky and mountainous regions has reached 470,000 square km, accounting for 52.8% of the mountainous area of the Guangxi Autonomous Region.

The Liupan mountain area in the south of Ningxia is the source of many rivers. Due to the destruction of the environment, soil erosion has reached 5,000 ton/km³ per year. Rivers also cease to flow in certain periods.

There are three ways to address the poverty problem in areas with adverse living conditions and insufficient per capita resources:

- aiding the poor on the spot by striving to increase the productive efficiency of the existing lands, for example, through water conservation, terracing, water storage, and use of plastic mulching;
- helping farmers to become migrant workers in the developed coastal areas by providing loans and training and employment information; and
- resettling the farmers to provide better resources for those that move and to take pressure off resources for those that stay behind.
10 Although these methods can all reduce poverty, they have different costs and benefits. Specifically:

- aiding the poor on the spot can overcome basic poverty, but production potential is still constrained and it may be uneconomic to construct all types of infrastructure in all areas, so there are limits to improvements;

- helping farmers to become migratory workers provides cash income, but only for the duration of the migration and does not of itself address the ecological problems of the impoverished mountain areas to which migrant workers may eventually return; and

- resettlement provides a permanent means of addressing both the poverty and environmental problems, and although costs of both the government and thesettler families are high, if the outcome is successful the solution is self-sustaining and permanent.

11 This is why resettlement is the government’s preferred, but last resort, option for the most impoverished in remote resource poor and environmentally damaged areas. Table 2 summarises the comparison.

### Table 2 Comparison of Different Methods of Poverty Reduction with Regard to Costs and Benefits

<table>
<thead>
<tr>
<th></th>
<th>Costs</th>
<th>Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Input of the Government</td>
<td>Input of the Farmers</td>
</tr>
<tr>
<td>On the spot assistance</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Migratory work</td>
<td>+ +</td>
<td>+ +</td>
</tr>
<tr>
<td>Resettlement</td>
<td>+ + +</td>
<td>+ + +</td>
</tr>
</tbody>
</table>

12 In 1996, the leaders of the PRC government pointed out that: “The policy of cross-region development and the resettlement of impoverished people should be implemented in the few extremely poor areas where the lack of basic productive and living conditions means there is no alternative.” In 1999, the PRC government held a conference on aiding and developing poor areas. At the conference participants re-examined the goals of the 8/7 poverty reduction programme, and concluded that at the end of 2000 there will still be two types of poor: those who need welfare support because for one reason or another they are unable to work; and those who live in resource poor areas where the remaining viable option is resettlement. There are over 20 million poor in these two groups. (Wen Jiabao: July 22, 1999). The total number of people to be resettled in six of the poorest provinces (Gansu, Ningxia, Guangxi, Guangdong, Shaanxi and Hubei) is estimated at about 2.2 million, and nationally at over six million (although there is no comprehensive data on the national situation). About 1.2 million poor have already been resettled, and LGOP estimate that the remaining task is to resettle about 5 million people.
Land for Resettlement

13 New land is required for resettlement. Although the potential additional cultivable land resources of PRC are limited, there are possibilities. These include:

- Cultivable wasteland. There are over 30 million hectares of wasteland suitable for agriculture in PRC, among which 13 million hectares can be cultivated.

- Cultivable barren hills and slopes. According to the fourth survey of national forest resources (1989-1993), there are 260 million hectares of forestland in PRC, which account for 25% of the national territory. Among these forestlands there are only 129 million hectares of forest, and the remainder comprise 63 million hectares of uncultivated hills and lands suitable for forestry, and 48 million hectares of sparse woodlands and shrub lands. That is to say, there are still 111 million hectares of land suitable for afforestation, accounting for 42.2% of the total forestlands.

- State-owned farms and forestry farms. In the 50s, the country waged a campaign of cultivating wastelands and setting up state-owned farms and forestry farms. During the Cultural Revolution, a large number of cadre schools were set up all over PRC. The state-owned farms and forestry farms occupy large areas of land, and the state farms alone occupy 4.49 million hectare of cultivable land. Most of the cadre schools and labour camps have been deserted and part of these can be used for resettlement.

Barriers to Resettlement

14 On the one hand, there are still a large number of poor who are trapped in an adverse natural environment and cannot feed or cloth themselves. On the other hand, there is a large amount of land resource that is under-utilised. This comes about because of the following factors.

- Cultivating new lands requires substantial investment. In the wasteland areas, irrigation and drainage systems must be constructed, while in the hill and slope areas, infrastructure such as access roads must be developed. This investment will not take place spontaneously in PRC because of the other factors.

- The current property rights system of public-owned land (state-owned or collectively owned by farmers) in PRC imposes restrictions on the land market and the dealing of the land property rights making the acquisition of land for settlement problematic.

- The current household registration system also restricts the flow of residents, and migrant farmers between regions may not be able to obtain registration and may have access to public services such as education restricted or made prohibitively expensive as a result.

- Farmers in the impoverished mountain areas are poorly educated, and lack the knowledge and skills necessary for cultivating new lands. Additionally, the
differences in nationalities and cultures make resettlement in a different social environment more difficult.

15 The above barriers to resettlement cannot be overcome by the market mechanisms. The constraints can only be relaxed with the intervention of government.

The Organisation of Voluntary Resettlement

Institutions for Organised Resettlement

Leading Institutions

16 Since resettlement has many aspects (both between regional governments and also functionally within government in planning, agriculture, poverty-relief, finance, water conservancy, electricity, transportation, education, and household registration for example) the provinces involved in resettlement have set up leading groups at the local government level to manage the complex intergovernmental relations involved. Representatives concerned with these aspects are included in the leading groups. The leading groups are responsible for oversight of resettlement planning, ensuring good relations between the originating place for settlers and the host government and population, and for the co-ordination of the various government departments involved. Resettlement leading groups are also established at municipal, county and township levels.

Executive Institutions

17 Provinces concerned appoint organisations to be responsible for the actual implementation of the resettlement projects to work under the leading groups. Gansu Province has set up the “2-Xi” Construction Headquarters, Ningxia Autonomous Region has entrusted the responsibilities to the Commission of Agricultural Construction, while Guangxi Autonomous Region assigned the job to the Poor Area Development Offices (PADOs) at various levels. The functions of these organisations are to make detailed plans; co-ordinate action among various governmental departments; manage inter-regional governmental relations; and manage financial matters. County and township governments are responsible for site selection; ensuring there is adequate land; publicising settlement opportunity and motivating settlers to migrate; and for day-to-day management of the process.

Examples of the organisations involved in the implementation of the resettlement projects are as follows:
- the Planning Committee and the Bureau of Finance: to examine and review projects, approve of projects and provide funds;
- the Agricultural Bureau and Bureau of Animal Husbandry: to assist production planning and provide technical services;
- Police Substations in both settler destination and source locations: to handle matters concerning household registration and to administer security matters in the resettlement
areas;

- **Land Administration Bureau**: to examine and approve landuse planning and assist with the formalities of land requisition and transfer;
- **Water Conservancy Bureau, Electricity Bureau and Transportation Bureau**: for the construction of utilities and access;
- **Construction Bureau**: for construction of houses for settlers;
- **Property Exchange**: to help administer house property certificates; and
- **Education Bureau and Public Health Bureau**: to assist to construct schools and clinics.

18 Guangxi Autonomous Region initiated the approach of forming a Company of Cross-Region Poverty-relief and Settlement in Different Areas, an economic organisation, responsible for organising settlers to bring barren hills under cultivation. The company gathers funds to purchase or rent land and signs contracts with settlers. The settlers carry out production and the company provides technical services and promotes produce marketing.

19 Fieldwork indicates that it is a relatively easy job for the county government to co-ordinate the local governments of the destination and originating places provided that the resettlement is conducted within the same county, but trans-county and trans-regional resettlement present more difficulty in co-ordination and supervision due to the two places in question belonging to different administrative regions. Moreover, matters concerning settler’s household registration, children's schooling and social welfare have given rise to many difficulties. If an economic organisation rather than government manages the resettlement the potential difficulties are greater still.

**Organisations in the New Communities**

20 In Ningxia Autonomous Region each resettlement area sets up a local government structure including township governments and village governments for settlers, and villager's committees.

21 In Guangxi Autonomous Region for resettlement within a county: each development zone for resettlement is divided into subdivisions, and settlers are expected to engage in production under the direct management and guidance of the subdivisions concerned. For resettlement involving different counties the system is similar to the one in Ningxia.

22 For trans-regional resettlement involving different areas, corporations are employed to manage the resettlement. If the corporation does not have strong links to the local government in the resettlement location, it has more often than not proved hard to resolve the matter of the settlers’ household registration and the administrative affiliation.

23 Compensation is usually paid for land provided for settlers to the host government or to the collective organisation that owns the land. Fieldwork shows that the fee for land use in some areas is relatively low. In some cases local farmers have felt disadvantaged when settlers have benefited from land development and they have not, or when grazing is restricted because previous grazing land is developed
for settlers. However, local farmers can benefit from electricity supply and better transportation as a result of resettlement and may regard this as partial compensation for their loss of land.

The Resettlement Process

There are three types of process in PRC:

- farmers move to live near their relatives or friends voluntarily and can obtain subsidies to do this (for example Ningxia Autonomous Region stipulates that host counties can supply each settler with 2 mu of arable land and each household 2 rooms);
- companies organise resettlement through the creation of job opportunities in agricultural production; and
- government develops resettlement areas within one county, between counties and between regions.

The latter is dominant. For example, the resettled population of Ningxia between 1983 and 1998 was 244,000, of which resettlement through connections with relatives or friends accounted for less than 3 percent. The resettlement in Guangxi from 1993 to 1999 is for 250,000 people, yet the part done by companies is not more than 10 percent. The following discussion is centred government organised resettlement.

Choosing and Confirmation of Resettlement Locations

The criteria are that: settlers have enough land for production and dwelling; water storage, electricity supply and roads can be developed at reasonable cost; and overall access to the area is convenient. At present the favourite places for trans-county resettlement in Ningxia are the undeveloped wastelands at the margin of the irrigated area of the Yellow River, while the land for resettlement used in Guangxi comprises the private plots and mountains under household care distributed to local farmers since 1981 but not cultivated by 1994 and former collective-owned barren hills and land left uncultivated by 1994 and other barren land left uncultivated for many years.

Once leading groups in the outmigration and destination areas have reached agreement in principle about resettlement, the government of the outmigration area will organise representatives of those willing to resettle to make an on-the-spot examination of the conditions in the host area. After this participatory investigation it is left to potential migrants to decide for themselves whether to move or not.

Criteria for Choosing the Places of Settler Origin

The fundamental criteria for places of origin are as follows: the natural conditions are very poor, there is a lack of land resources, the area is hard to get to, and the population is living in destitution and finds it hard to meet basic needs. In Ningxia the potential settlers are those living in the southern mountainous areas where the annual rainfall is 200 to 400mm and the Liupan Mountain area which is high and cold. In Guangxi the settlers are those in the poverty-ridden townships and
villages in the Dashi mountain areas where the arable land per capita is less than 0.3 mu.

Choosing the Settlers

29 The criteria for choosing settlers, apart from being poor and willing to relocate, also stress the ability of the settlers to work and develop the host places. In Ningxia settlers must be young, able to do farm work and have a good primary education. The criteria in Guangxi are that migrants should be the absolute poor farmers from Dashi (registered as poor households and confirmed as such by county level poverty-relief officials), have good primary education, and be in good health.

30 In the process of selection, the county authority allocates settlement places to qualified townships and villages as they become available at different sites. Villagers apply for resettlement. The county authorities review and approve resettlement applications, and arrange for some villagers to visit the resettlement site. Villagers then have the right to decide whether to resettle or stay and if there is a choice to choose one site over another.

31 Normally settlers within the same county do not have to sign any agreements with the government concerned. In trans-county and trans-regional resettlement, governments of source places and host places (or enterprises that undertake resettlement) often require written agreements. The content generally covers: the obligations of the settlers, the obligations to construct water storage, power supply, roads and living quarters at the resettlement site, matters concerning school education for the children, subsistence funding for immediately after migration before income is generated, the land area provided for development and land rights. In Guangxi trans-county settlers have to sign an agreement with the county office of settlement. The main content is that settlers must meet the planned timetable to settle; after settlement they should be self-reliant and work hard; and that they should comply with requirements of the county office of settlement, observe the local village regulations and try to live harmoniously with the host population.

Site Development

32 In Ningxia prerequisites are the completion of water conservancy and irrigation works, basic land levelling, installation of domestic water and electricity supply, paved access and internal roads, and completed social infrastructure such as schools and clinics. In early resettlement projects the government provided temporary housing and basic building materials for settlers to build their houses through their own efforts. More recently the government has constructed basic housing before settlers move in. In Guangxi the 3 to 5 mu of barren hills and valleys is designated for each settler for production, living areas of 25 to 30 square metres for each household are allocated, and infrastructure (water, electricity, roads, schools and clinics) is constructed in advance.

Start-up Funding

33 Production costs for the first year after resettlement, for seeds, chemical fertiliser and fodder were provided as grants by the government in 1980s, but in the 1990s farmers have had to contribute of them in cash and borrow the remaining
requirements. Expenditure in the first year is mainly met by earnings from agricultural and other wage labour and livestock rearing. For migrants developing fruit tree plantations where income is two years away, intercropping provides subsistence.

The Effectiveness of Voluntary Resettlement

Economic Effects

Through development of resettlement projects, formerly idle land resources have become major production bases. Ningxia has used the state funds for “3-Xi” projects and the loans for “Northern Irrigation” projects provided by the World Bank to build large-scale irrigation projects to resettle poor farmers in 8 southern counties to develop and cultivate 917,000 mu of arable land. Guangxi took over for use or rent 1,324,000 mu of barren hills most of which have become economic woodland or orchards.

Production has increased. In 1997 when the “Northern Irrigation” project undertaken by the World Bank was completed, the grain yield in the project area had increased by 155,000 tons or five times that before implementation. The annual incremental production of grain and other crops was 0.604 billion yuan from an investment of 0.424 billion yuan. In Guangxi, the major development projects are fruit tree cultivation and forest planting for economic purposes. Owing to the long cycle of these projects and the uncertain factors in terms of market pricing, an economic assessment cannot yet be made.

Poverty Reduction Effects

Resettlement projects have resulted in increased incomes and improved living conditions. In 1998, net income per capita among the settlers in various bases of Ningxia averaged 1,200 yuan, and grain production per capita average over 450 kg. Settlers’ income has been more than that of the farmers in their original places. The net income per capita of the 78,000 farmers who stayed in Jingyuan County of Ningxia averaged only 774 yuan in 1998, while that of 25,000 settlers from this county was 1,378 yuan or 1.8 times as much.

In the World Bank’s Northern Irrigation Project 11,000 households (54,000 farmers) have resettled. In 1989 the average income of these poor farmers was only 325 yuan. In 1997, when the project was complete, the net income per capita was 1,469 yuan, 4.5 times as much as that in 1989.

Guangxi only started actual resettlement in 1996 and forest and orchard production has not yet yielded. Nevertheless, the net income per capita of settlers in Hechi area has reached 843 yuan with grain production per capita of 341 kg, while settlers in Baise area had per capita incomes of 933 yuan and grain production of 169.49 kg.

Settlers from Jingyuan County of Ningxia who moved to Diaozhuang Village in the Lucaowa area have gradually accumulated assets over a decade. Farmers have 62,000 mu of land (which if reckoned at the current price of 3,000 yuan per mu, has a total value of 186 million yuan); productive assets of 97 million yuan; and other fixed assets (such as housing and infrastructure) of 57.8 million yuan. If the total
value is divided by the 5,17 households, each household has about 64,000 yuan of assets. In Baise and Hechi areas of Guangxi each settler household also owns assets worth over 10,000 yuan including houses, fruit trees and forests for economic purposes.

40 Settlers’ living conditions have been improved thanks to water and electricity supply and roads. Apart from engaging in agriculture, settlers have taken advantage of the transportation network and better information on opportunities to do part-time work outside the area or run small enterprises in business and catering, thus widening employment and income sources.

Cultural Effects

41 There are some examples of where the cultural traditions of minorities have survived and even been enhanced by resettlement. For example, in the original villages of the Hui Nationality people of Ningxia there were no mosques because of poverty. In the new settlements of the Hui farmers most villages have been able to construct mosques with the farmers’ own money and labour.

42 About 10 percent of settlers return at some point to their native village, but often again return to the settlement area. Overall, only 2 percent of settlers do not stay in the long term. In some resettlement projects settlers can retain the rights to their land in their village of origin for up to three years. This helps to encourage settlement and provide security for settlers who are uncertain about the move, but for the vast majority settlement appears to be the preferred option.

Ecological Effects

43 Ecological effects take time, but some trends are apparent. In villages where there were a large number of migrant farmers, the scarcity of cultivated land has been alleviated. Fieldwork showed that some villages have re-planned land use, with some hill-land changed from cultivation to forest or grass. In others there was no evidence of environmental improvement.

44 In Ningxia and Guangxi autonomous regions, the development of settlement bases has helped to protect environment in the settlement areas. Many settlement bases are located in the edge of desert. The construction of irrigation systems has prevented the expansion of desert. In Guangxi, special attention was given to environment protection and construction in the overall development. For example, in the Liulong Development Zone of Tianlin County in the 14,670 hectare settlement area trees have been planted on 5,470 hectares that were previously without any.

Resettlement Funding

Sources of Funds

45 Sources of funding for resettlement in Ningxia and Guangxi are shown in Table 3.

Table 3 Source of Resettlement Funds

|------------------|---------------|

11
The Utilisation of Funds

46 Tables 4 and 5 show the available information on resettlement costs.

Table 4 Resettlement Cost in Gansu (1983-92)

<table>
<thead>
<tr>
<th>Unit</th>
<th>Central Gansu</th>
<th>Hexi of Gansu</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number of settlers</td>
<td>Person</td>
<td>228,721</td>
</tr>
<tr>
<td>Total irrigated land</td>
<td>mu</td>
<td>425,798</td>
</tr>
<tr>
<td>Total investment</td>
<td>1,000 yuan</td>
<td>371,670</td>
</tr>
<tr>
<td>Investment per capita</td>
<td>yuan</td>
<td>1,625</td>
</tr>
<tr>
<td>among which:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>cultivation expenses</td>
<td>yuan</td>
<td>1,510</td>
</tr>
<tr>
<td>moving subsidy</td>
<td>yuan</td>
<td>93</td>
</tr>
<tr>
<td>public welfare</td>
<td>yuan</td>
<td>18</td>
</tr>
<tr>
<td>management expenses</td>
<td>yuan</td>
<td>4</td>
</tr>
</tbody>
</table>

Table 5. “Northern Irrigation Project” of Ningxia

<table>
<thead>
<tr>
<th>Unit</th>
<th>South of Yinchuan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment</td>
<td>1000 yuan</td>
</tr>
<tr>
<td>among which:</td>
<td></td>
</tr>
<tr>
<td>Civil Construction</td>
<td>1000 yuan</td>
</tr>
<tr>
<td>Conveyance system</td>
<td>1000 yuan</td>
</tr>
<tr>
<td>Electricity supply</td>
<td>1000 yuan</td>
</tr>
<tr>
<td>Mechanical equipment</td>
<td>1000 yuan</td>
</tr>
<tr>
<td>Resettlement</td>
<td>1000 yuan</td>
</tr>
<tr>
<td>Newly developed irrigated area</td>
<td>hectare</td>
</tr>
<tr>
<td>Improved old irrigated area</td>
<td>hectare</td>
</tr>
<tr>
<td>Settler population</td>
<td>person</td>
</tr>
<tr>
<td>Investment in civil construction per mu *</td>
<td>yuan/mu</td>
</tr>
<tr>
<td>Total investment per mu *</td>
<td>yuan/mu</td>
</tr>
<tr>
<td>Total investment per mu</td>
<td>yuan/mu</td>
</tr>
<tr>
<td>Settlement expenses per capita</td>
<td>yuan per capita</td>
</tr>
<tr>
<td>Per capita cultivated land in new irrigated area</td>
<td>mu per capita</td>
</tr>
</tbody>
</table>

* Excluding the improved old irrigated land

Cost Recovery

47 A substantial part of the resettlement expenses is paid by the central and local governments without recovery. When the “3-Xi” project was started in the
beginning of the 80s under the planned economy, repayment was not a consideration.

48 The cross-region resettlement in Guangxi started in the 90s under market economy conditions. Land acquisition and some infrastructure construction such as water and electricity supply, road building and housing for the farmers has been paid for by government. However, funding for productive activities has been in the form of loans to settlers.

**Future Developments**

49 There are some identifiable problems for the consideration of policy makers arising from experience of resettlement in Gansu, Ningxia and Guangxi.

- In the outmigration areas:
  - while it is reasonable of the host area to stress the aptitude and physical fitness of settlers, care needs to be taken to ensure that those left behind are not only the most vulnerable otherwise alleviating poverty for some only increases it for others; and
  - greater attention can be paid to improving the environment in the outmigration areas through helping remaining villages to reorganise the use of resources.

- In the host areas:
  - the problem of permanent residence registration for the trans-county and trans-regional settlers needs to be resolved by government; and
  - where settlers rent land or have the a limited period of use rights, first options for renewal should be granted to allay settlers concerns that they may have given up their original land only to be later dispossessed of the land on which they have settled.

- In the economic environment:
  - Market risks faced by settlers can be better addressed by fostering investment in agroindustry and providing support services for its development \(^1\) including vocational training for settlers.
  - Market mechanisms can be more widely applied in Gansu and Ningxia, for instance, water fees can be raised step by step.

50 The international experience can assist in providing insights into best practice elsewhere and how elements of it may be applied to address these issues.

\(^1\) See appendix A11, "PRC Agroindustry and Rural Enterprise Development Approaches and Experience"
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Specialists Consulting Committee of Science Committee of Ningxia ed., 1995, “Report on the Mobility Approaches in Yanghuang (Hong Sibao) Irrigation Area For Poverty Reduction in Ningxia”


International Agroindustry and Rural Enterprise Development Approaches and Experience

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Summary

This paper sets out the key issues related to agroindustrial and rural enterprise development in the context of their relationship with poverty reduction. It draws the distinction between enterprise viability that is a prerequisite for poverty reduction and poverty reduction potential that is not a prerequisite for enterprise viability. It discusses the general conditions for viability with special reference to those conditions that most affect agroindustry in poor and often remote areas such as the areas with remaining pockets of poverty in the People’s Republic of China (PRC). It discusses the key considerations in procurement, processing, marketing and environment that are of concern to any enterprise in attaining viability. The paper goes on to review the international experience on linkages between poor farmers and agroindustry. It considers enterprise driven linkages that are essential vertical linkages between the producer and the marketplace organised by the processing enterprise (such as "dragonhead" enterprises in PRC) and farmer driven linkages that are essentially horizontal linkages between farmers (such as co-operatives and co-operative type organisations). The analysis is then broadened to consider the role of rural enterprise generally and the predominance of SMEs in this sector. This compares to the predominance of TVEs and emergent private sector businesses in the rural industrialisation process in PRC. It considers the generic constraints that are faced by SMEs in developing and transitional economies and the initiatives that can assist their development: creating efficient and unbiased financial markets, a good business operating environment, appropriate education training and capacity building facilities and access to information; and identifies the lessons learned internationally about successfully fostering SME development (of which agroindustry is a special case). It concludes with a summary of the effectiveness of agroindustry in poverty reduction and the lessons PRC policy makers can usefully consider the lessons from international experience.

World-wide the last three decades have seen major shifts in rural economies. Subsistence peasant farming systems have been replaced with small farm businesses and have been increasingly integrated into the wider economy. Both domestic and international markets have opened and the opportunities for value added production and processing in rural areas have increased with increasing urban consumer living standards and demand for a wider variety of products.

The main issues in relation to agroindustry and its impact on poverty reduction are: how to ensure enterprise viability because without this any initiative is unsustainable; how to develop effective linkages between agroindustry and poor farmers in the context of the need for industry viability; the circumstances under which it is appropriate to focus on the development of non-farm employment, particularly in the light of the dominant role of SMEs in economic growth (including in PRC where TVEs and more recently the private sector account for increasing and significant shares of employment and output); and what support mechanisms are appropriate in the context of a market economy.

Factors in enterprise viability that are of particular importance for rural poverty reduction relate to arrangements of the individual enterprise for procurement, processing, marketing and environmental management. From the poor farmer’s perspective, the main concern is to be able to produce raw materials profitably on a
sustained basis without being held hostage to a monopoly processor. There is a mutual concern by both farmer and processor for the quality of raw materials because higher quality will generally mean higher income for farmers and the processor. From the processor’s perspective, there is a need to ensure quality by investing in extension and other support services for the farmer where these are not available (or not available at a sufficient standard) from the public sector. From the processors’ viewpoint, issues of the necessary scale of technology influence plant location because of the need for adequate raw material production within a cost-effective distance from the plant. The need for good infrastructure also affects plant location. Therefore, geographic and agronomic factors are important determinants of enterprise viability and enterprises are not (and should not be) drawn to remote rural areas unless these conditions are satisfied. As a consequence the proximity of poor areas to infrastructure affects the ability of agroindustry to impact on poverty.

All aspects of marketing: planning, research, promotion and distribution have the same importance for agroindustrial enterprise as they do for any other business. Marketing considerations should take precedence over technology and production potential in investment appraisal, but they often have not. Market linkages, as with “dragonhead” enterprises in PRC, are important because they contribute to enterprise viability and sustainability and therefore indirectly to poverty reduction where poor farmers are the primary producers. Environmental considerations are also important determinants of sustainability for any rural enterprise, and corporate environmental conduct is increasingly scrutinised and penalised if it is detrimental to the environment.

Many of PRC’s remaining pockets of absolute poverty are in remote mountain areas. Research into enterprise development (agricultural and otherwise) in mountain areas shows that there are generally location-specific opportunities that can be exploited, but that the single most important factor that has resulted in the development of comparative advantage has been accessibility. The research also shows that the absence of market research into product potential and hence information on opportunity has constrained development of many mountain specific products.

Agroindustrial enterprises have choices between having production under their direct control; relying on the market for raw material supply with varying degrees of intervention with farmers to help assure supply; and joint venturing with farmers on a contractual basis (which may or may not involve distribution of a share of enterprise earnings). Enterprise-driven linkages have evolved over the last three decades. In general, there has been a move away from plantation production with hired labour towards greater reliance on small-scale farmers for raw materials. However, many enterprises still use the nucleus estate in combination with supply from outgrowers to assure a minimum quantity of raw material supply, but avoid the higher investment costs of total own-production. This is rational behaviour for commercial enterprise because it does not particularly empower farmers other than in relation to obtaining ordinary market prices for a part of the raw material supply, and this combination can be adjusted to have similar overall costs and risks to joint venturing with farmers. For some crops (for example, seed potatoes and certain types of fruit and berries) where an agronomic need for high altitude and often geographically fragmented production areas make enterprise management of production difficult, farmer production systems predominate. However, farmer ownership of processing plants in joint venture with enterprises is not common except where farmers themselves are
organised into co-operative or co-operative type organisations that give them a strong basis for such arrangements.

Farmer driven linkages are also important in poverty reduction. There are many examples of the success of co-operatives or co-operative type organisations (not including collectives). The UN estimated in 1994 that the livelihoods of nearly half of the world’s population (about 3 billion people) had been made secure by co-operative enterprise of some type. Agricultural farmer’s organisations are important world-wide in production, marketing and lobbying with government on agricultural policy. Depending on business purpose these may be groups, associations, pre-co-operatives, unions, co-operatives, federations, syndicates, partnerships or farmer-controlled companies. The research demonstrates that there are many advantages to these organisations: they mobilise capital and pool resources in underserved rural areas; foster entrepreneurship and democracy; and allow farmers to achieve economies of scale, vertical integration and access to capital investment. The research also shows that there are certain conditions critical to the success of farmer organisations. Specifically there should be: visible benefits to group action; no government involvement in management or its appointment; treatment of organisations as private and professional and not as an extension of state authority (or as “against government”); a high degree of farmer equity; accountability to members and by members; and a common purpose supported by a diversity of skills. Where these conditions are not met, external assistance can focus on developing them as a precursor to capacity building for farmer organisations themselves.

Other non-farm rural enterprises are important generators of employment and economic growth, internationally and in PRC. SMEs are particularly important in accounting for a high share of employment and output. However, despite their phenomenal growth SMEs have common systemic constraints to their development. These affect agricultural SMEs as well as other rural enterprises. SMEs face a range of constraints which governments and donors can help to address by facilitating efficient and unbiased financial markets; a suitable business environment; education, training, and competitive capacity; and access to information, networks and the global market place. In many cases market failure in financing has led donors to develop special credit and other financial facilities for SMEs.

There are many actions that government and donors can support to facilitate the business environment ranging from infrastructure provision to ensuring an equitable tax base and adequate company, accounting and contract law. Research shows that technical innovation can be sponsored, most effectively by creating competition for the resources that fund the development and dissemination of new technologies. Broad-based non-financial business development services that work in response to demand in a competitive environment have proved more sustainable than government sponsored services because they have been market driven rather than prescriptive. This includes not only training and advisory services, but also market information services. Export promotion has also proven to be more effective where there is competition for resources for specific initiatives rather than bureaucratic trade promotion.

From the international experience and approaches it is concluded that in the utilisation of agroindustry for poverty reduction, enterprise viability is the primary consideration. Enterprises should only be encouraged to locate in poor areas if
viability criteria can be satisfied and the viability is not be created through operational subsidy. Infrastructure provision and sponsorship of market research and product development are ways in which government can help to overcome barriers to private sector market entry in poor areas. Enterprises should be free to choose the type of linkage they have with farmers. Governments and donors can be useful in empowering farmers through supporting the development of farmer organisations, provided that such organisations are not instruments of government policy and are private and autonomous. Support service of various kinds can be provided to SMEs and because the problems faced by agroindustrial and other rural enterprises are similar, there are advantages to developing general SME support services rather than sector specific ones. Viable enterprise by definition can withstand commercial interest rates and the use of ordinary capital resource (OCR) funding is not in itself contentious. Where there is financial market failure governments and donors can intervene to correct this through credit lines and other financing facilities. The development of other support services (for example market research and technology development, business development and information services) can contribute to SME success, but a private sector orientation with competition for resources is preferable to government services.
Introduction

The Historical Context

1 In Latin America, Asia and Africa – in the developing world as a whole – the last three and half decades have seen very substantive changes in rural economies. Subsistence farming systems and feudal land ownership regimes have progressively evolved into small farm businesses with increasingly strong property rights and individual freedom to determine the use of assets. Progress has been uneven, but the general trends are the establishment of democratic processes and governments, resolution of external debt crises, introduction of reforms aimed at reducing state intervention in economic activities and the liberalisation of markets.

2 Peasant economies, once perceived as being outside the market system, have been increasingly integrated into it. This has not necessarily resulted in strong economic growth or in significant inroads into poverty reduction and many earlier approaches have been demonstrated to be inefficient or even ineffective in their poverty reduction impact. Rural development policies in many countries have been more oriented towards maintaining the extant political system than in developing the socio-economic well being of rural populations. Industrialisation has swelled the ranks of urban dwellers rapidly there has often been a growing gap between urban and rural living standards. In rural areas there has also often been a growing gap between those who live closer to urban centres and markets and those who live in remoter regions.

3 Economies are becoming increasingly internationalised and markets increasingly open. Due to declining tariffs, domestic enterprises are increasingly forced to compete with international suppliers, and have also been able to enter export markets. Competition continues to intensify and the improvement of technology, management and marketing at all levels of enterprise has become increasingly important. This in turn has raised issues about economy of scale, quality, and how to retain value added in rural areas and more particularly with poor farmers.

Key Issues

4 In this global context, consideration of how agroindustry can be used to effectively reduce poverty must address a range of issues in addition to the linkages between farmers and enterprises, because effective linkages can only operate in the context of viable enterprise and a conducive policy environment. The same conditionalities about enterprise viability and sound policies apply to other non-agricultural rural enterprise development. Although agroindustries create farm level employment as well as direct employment and therefore benefit farmers indirectly, non-farm rural enterprises, particularly SMEs have been major creators of employment. The specific considerations are:

See appendix A5, “International Poverty Reduction Approaches and Experience” paper for further perspective.
International Agroindustry and Rural Enterprise Development Approaches and Experience

• how to ensure enterprise viability: agroindustrial enterprises themselves generally have no particular interest in poverty reduction or in giving preference to poor farmers as suppliers of raw materials, and because enterprise viability is the primary concern of the business it must also be the primary concern of any supporting policies or services because without enterprise viability there can be no successful and sustainable poverty reduction linkages;

• how to develop effective linkages: linkages can be of two non-mutually exclusive generic types: enterprise driven linkages which tend to vertically integrate production with processing and marketing, and farmer driven linkages which tend to horizontally link producers to give them more power in the marketplace and with government to obtain improvements in the policy environment;

• when is non-farm rural enterprise development more appropriate as a poverty reduction strategy: non-farm rural enterprise has been the engine of economic growth in many countries and has proven important in the creation of work opportunity for the poor including farmers who are prepared to become migrant workers, and there are synergies that can be exploited in its development in parallel with agroindustry;

• what measures are necessary develop support mechanisms for agroindustry and rural enterprise: what can government do to assist in overcoming market failure and barriers to market entry that will stimulate viable agroindustrial development, how can government promote poverty reduction linkages, and what can the private sector do to assist.

5 International experience in each of these areas can provide insights into possible new directions in PRC and can contribute the to lessons learned.

The Evolution of Agroindustry and Rural Enterprise

Enterprise Viability

General Conditions for Viability

6 The conditions for agroindustrial enterprise viability are well documented. It is not the purpose here to describe in detail the principles of project design, but to highlight aspects of enterprise viability that have proved particularly important in international experience in the context of developing agroindustry that is effective in poverty reduction. Key considerations for the enterprises linking to farmers in poor areas are:

• procurement factors including: the profitability of raw material production for farmers, the sustainability of production, the quality of raw material, the organisation of procurement, and the role for producer’s organisations;

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processing factors including: the consistency of the processing technology with the qualitative requirements of the market, the quantitative raw material production potential, and enterprise location relative to raw material supply;

marketing factors including: the adequacy of consumer demand for the end product at the prices at which it can be offered, the potential of the products to compete with like products and obtain market share, and efficiency with which the distribution system connects the enterprise to markets; and

environmental factors, particularly the need for sustainable resource utilisation and pollution control.

All these factors affect the viability of agribusiness located in poor areas. They are different for each agroindustry and each enterprise. Consequently it is not possible to generalise about which agroindustries are most suited to poor areas in PRC or elsewhere and each investment needs to be evaluated on a case by case basis.

**Procurement**

Procurement factors primarily relate to the linkages between farmers and agroindustry. From the farmer’s perspective, raw material production must be profitable, and profitability must be sustainable and not too variable from year to year. Poor farmers will generally opt for “minimum regret” scenarios which means that arrangements where they obtain a minimum guaranteed price or have alternative market outlets or access to storage to allow them to hedge against potential monopoly power exerted by traders are desirable options. Confidence in the market (or the agroindustry promoting a particular type of production) and alternative market outlets are important if production requires long-term investment on the part of the farmer such as in tree crops.

Quality of raw materials is a mutually important issue for farmers and processors: farmers can benefit from price premiums for supply of quality material; while processors will generally benefit because of higher conversion rates from raw material to finished product thus lowering variable operating costs; and may be able to produce higher grades of product thus gaining greater value added. The involvement of the farmers in initial quality control of raw material at the field level is important to reduce deliveries of poor and rotten products to the processing enterprise. In Latin America, where many processing plants are located close to urban centres, controlling the pollution and problems of handling tons of wasted agricultural products is increasingly expensive, so enterprises have developed systems to stimulate the farmers to only send high quality produce to the processing companies. Typical incentives are: payment according to quality: regular samples are taken of each lot arriving to the factory, and payments are decided according to agreed formula; deduction of payments if the amount of non-suitable products goes over a set level, based on regular testing; and refusal to accept the produce if the quality is not up to an agreed standard.

Because quality is so important for the enterprise, agroindustries will often provide private extension services to farmers supplying them, and may supply inputs or production credit to help assure quality (and quantity). Bulk buying by the enterprise may also reduce the cost to the farmer of inputs. However, in many cases the enterprise will support the production of commodities which have good processing parameters, but are not so good for fresh consumption, such as high dry...
matter content in tomatoes and vegetables which are good for freezing but not so suitable for direct consumption. In this way, competition from the fresh market can be reduced.

11 Having its own extension service allows an enterprise to: check that farmers’ production is according to plan and on schedule; give advice related to use of fertilisers and agrochemicals; estimate the expected supply to the processing plant, period and amounts; develop the use of new and better varieties of crops; and introduce new farmers in the neighbourhood to contract arrangements with the processing plants. The cost to the enterprise is relatively high but is traded off against investment savings in own production and better quality resulting from the advice.

12 The additional importance for the enterprise is that the farmers develop a regular relationship with the processing plant, building loyalty, because without the loyalty farmers can easily sell produce to other buyers if some other better option appears.

Production of Vegetables for Freezing in Califor, Montevideo, Uruguay

A co-operative that operates a freezing plant outside Montevideo, obtained technical assistance from Europe to develop linkages with vegetable producing farmers. In the spring the farmers get the seed to plant and planting instructions. The land has to be prepared in such a way that the moisture is even to enable the seed to sprout at the same time. The total seeded area is divided into sections, each section with the same average sun hours per growing section. The sections are seeded in a schedule over several weeks, enabling the freezing enterprise to harvest the fields over a stretch out period. The plant has a steady flow of fresh vegetables coming to the processing plant and the maximum waiting time before processing (washing, blanching and freezing) is only some three hours.

Comment: the close technical integration between the enterprise and the farmers gives high quality products and good prices to the farmers.

13 Enterprises use various collection systems: directly from the fields by their own transport; through collection centres with their own transport; through subcontractors who collect and pay for produce; and direct delivery to factories by producers. The type of collection system varies according to the type of commodity. The most sensitive products, like milk, need a fast and efficient collection system, other commodities can be handled in a less sophisticated ways.

Processing

14 Processing factors pose special problems for agroindustry which impinge indirectly on the potential for poverty reduction. Increasing competition and growing consumer demand for quality have resulted in much obsolescence in agroprocessing technology. Agroindustries in developing countries and the Former Soviet Union (FSU) have found that older technologies (both domestic and imported) have rendered them unable to compete on world markets, and that there is an increasing need to adopt the technologies in use in developed economies. Greater awareness of food safety, stringent import requirements in the developed world, and increasing regulation in the developing world have often reinforced this need.

15 The adoption of these technologies has brought with it minimum scale requirements which in turn mean minimum raw material production potential within a defined radius of a processing business. Distance to raw material supply can
significantly affect the economics of agroindustry and thus its profitability at enterprise and farm level. To operate effectively and produce quality products, minimum infrastructure requirements: water, electricity, a transport network and good communications, are essential. These are not generally found in the more remote and poorer rural areas. Therefore, agroindustry has a predilection to locate in, or close to, urban areas. The need for basic infrastructure within a relatively short distance of poor areas, perhaps 20 to 50 kms at most, is thus often a prerequisite for investment.

**Marketing**

16 Weaknesses in marketing have been responsible for the failure of many agroindustries. This has been most true in centrally planned and transitional economies where consumer demand and preferences have not previously been considerations. Industries have been founded on the basis of raw material or technology availability rather than demand for the end product at the prices at which it can be profitably offered. Industries have also been founded without regard for competition and substitute products and no assessment of the market share needed for viability or whether this is realistically obtainable. Final prices and quality are affected by the efficiency with which the distribution system connects the enterprise to markets. This becomes an increasingly important consideration with the remoteness of the enterprise, for example in or close to poor rural areas at considerable distance from the main centres of population and consumption. It is also an important concern for exports because domestic transport costs contribute to final price.

**Environment**

17 Environment has become an increasing concern of governments, banks, investors and donor agencies. Enterprise and farm viability depend on sustainable resource utilisation which may in turn have cost implications associated with maintaining sustainability. For example, yields from organic production processes are significantly lower than those that use agrochemicals in the process. Prices of organic produce are generally higher, but consumer demand for “greener” products is needed to drive such markets. Pollution control has become more stringent in most countries following the Rio Conference and its increased emphasis by donors through the 90s. From a financial standpoint, good environmental practices are important for investors and bankers. Fines and clean-up costs can reduce profitability and repayment ability, in some countries result in contingent liability, and can result in reputational damage to investors and lenders affecting public opinion and product sales.

**The Special Case of Development of Viable Enterprise in Mountain Areas**

18 Many of PRC’s remaining pockets of absolute poverty are in mountain areas. These mountain economies have been self-contained in the past with most of the needs being met internally with limited external inputs. Over the years, this self-sufficiency has broken down because: with rapidly growing populations, traditional agricultural systems have proved inadequate to meet basic needs, leading to extension of cultivation on to marginal and forest lands, and environmental degradation; and improvements in access to other areas and an increased flow of information has exposed the rural people to different standards of living, resulting in raised aspirations, and creating an imperative for alternative employment and income generation. Hence, the change from predominantly food-centred subsistence
activities to others that are based on comparative advantages and which use limited land resources more efficiently.

19 The International Centre for Integrated Mountain Development (ICIMOD) has sponsored studies in five of its regional member countries to document experiences of micro-enterprise development in mountain areas\(^3\). The case studies included:

- the process of transformation from subsistence to enterprise-based farming;
- the growth of enterprises based on mountain-specific products;
- development potential of enterprises based on specific local crops;
- enterprise development training programmes;
- credit and micro-enterprises; and
- NGO initiatives in micro-enterprise development.

20 The findings from these studies indicate that most mountain areas have a variety of products for both local use and trade. These are not necessarily mountain specific, nor is specialisation in products with comparative advantages attempted where there is limited accessibility to outside markets, but the study found that improvements in accessibility bring a shift toward a product structure with comparative advantages. Most areas have the potential to develop a variety of such products on a sustainable basis.

21 Areas with better-developed and commercialised agriculture have more productive and faster growing enterprises. However, appropriate policy regimes for developing linkages with markets have also led to rapid development of SMEs in mountain-specific products in areas without developed agriculture. In both cases, improved accessibility through a developed transport network has been the crucial factor.

22 The ICIMOD studies also found that the ability or potential to grow produce that could be used for value-added products has not necessarily led to development of enterprises because of lack of research, including particularly market research. Sometimes these efforts have been concentrated on marketing raw produce with no attempt to add value through processing. Often, the absence of innovative and promotional efforts in product and market development has kept the natural resource-based activities at a primitive level, basically serving requirements of local households. On the other hand, resources and products traditionally known, but limited only to local use, have been transformed into nationally and internationally unique products, resulting in tremendous economic benefits to local farmer-entrepreneurs through sustained product and farmer-focused research, demonstration of processes and products, and market research; and by linking producers with larger modern marketing organisations.

Examples from India

The farmers of Garampani area of Nainital District in the Central Indian Himalayas have developed specialised skills in cultivating off-season vegetable crops. The present study was conducted to identify the factors and circumstances leading to the switch over by farmers from subsistence to commercial crops, the process of change and adoption, economic impact of change, and its replicability potential.

Study suggests that the existence of a primary market at Nainital was the main factor that induced the farmers from nearby villages to adopt vegetable farming. Gradually this spread to other villages. Many socioeconomic and behavioural factors influenced the pace and extent of adoption. Markets developed almost autonomously with the increase in the volume of production.

Currently, vegetables are grown in 63 per cent of the area under cultivation. It has increased the farmers' income 2.72 times and direct employment 2.69 times. It has rectified, to a great extent, the unequal distribution of workloads among males and females and checked the rate of migration.

Experiences from the Garampani area suggest that adopting off-season vegetable crops can ensure the sustainability of mountain agriculture.

And from PRC

In Western Sichuan, mountain-specific products have been developed over the last 20 years. A recent study highlights the important factors responsible for the rapid development of enterprises which include: uniqueness of the products insofar as they are based on mountain-specific, local natural resources; development of infrastructure; strong and integrated policy support from government for promotion of enterprises and development of the region; and a well-planned marketing strategy and link-up with larger companies and organisations for marketing nation-wide and abroad.

Enterprise Driven Agroindustrial Linkages

Trends during the Last Three Decades

23 During the 70s many large scale commercial agricultural projects were implemented in different parts of the developing world, involving a large number of farmers, both as suppliers of commercial commodities and as farm workers on estates. Products such as cotton, tea, sugar, natural rubber, palm oil, orange and pineapple were produced on large-scale plantations. The thinking was that by employing the traditional farmers as farm workers, production would be streamlined, efficient and yields would be high; and the final product, normally semi-processed, would go to the world market for hard currency earnings.

24 Commodity prices, from being relatively high in the early 70s, dropped later during the decade, and a considerable part of the estate system broke down. This was because many estates and the related industries had little financial reserve to withstand a period of low world market prices, and, in most cases, the local market could not absorb the surplus production. In addition, it was shown that the efficiency of using farmers as farm workers did not increase the yields, and instead yields dropped. Financial difficulties for large estates and commercial production farms severely affected the economies of some smaller countries.

25 During the 80s and early 90s the trend changed. Large production units are still in operation, but farmers have had more involvement in the production, either as part owners of the production-processing units, or operating their own area under the

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5 Lu Rongsen, 1998, “Enterprises in Mountain-specific Products in Western Sichuan, China”
umbrella and support of central collection and processing plants. Fluctuations in world market prices has been better absorbed by these arrangements: if the prices are high the farmers get better paid, and if the prices fall the enterprise, as well as the farmers, share the reduction in margins. Yields have increased, and, presently, weather conditions affect output more than any other factor.

The Relationship between Agroindustries and Poor Regions

26 Studies conducted by ECLAC, FAO6 and others in Argentina, Brazil, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Honduras, Jamaica, Mexico, Nicaragua, Paraguay, Peru, Trinidad and Tobago on ways to spread technical progress among small agricultural producers and integrate them into society and the broader economy have indicated that agroindustries can be an important modernising agent for small agriculture. Governments have supported this process by creating incentives for agroindustry to invest in such regions. This has not only been in developing countries, but it is also a clear policy of the European Union (EU), which channels a large part of the total common budget to develop the backward and poor regions within Europe.

27 The objective of commercially viable agroindustry is to obtain good raw material at a competitive price, delivered at the time agreed to a collection centre or a processing plant. In a normal commercial relationship, the processing plant would not be concerned about the financial status of the farmers providing the raw material. However, in poor rural areas, agroindustries are often more closely linked to the community, creating employment and paying taxes and the well being of the farm community is in fact important for the successful operation of the enterprise7.

28 However, subsidies from government have not always created wealth for poor farmers. Subsidised funding can create capital intensive investments, with little indirect employment impact. For example, to develop the north east of Brazil, the Government gave large and wealthy enterprises in the southern part of Brazil a tax incentive: either pay the tax to the Central Government or use the same amount of funds to invest in projects in the north east of Brazil. Most enterprises took the second choice and developed different types of industrial investments in the poor region, some creating indirect employment, others not.

Agribusiness Development in NE Brazil

In the late 1970s and early 1980s Banco Cental do Brazil supported, and gave large loans to large enterprises to develop large areas, especially in the north east of Brazil, one of the poorest regions of the country. The motto was “we have to make some people rich before we can start distribute the wealth, otherwise all people will continue to be poor”.

The policy has not paid off well. The establishment of large fundos or fazendas (in Brazil) has created tension between the individual farmers (especially small holders) and large enterprises. The fundos

6 Source: English language synopsis of Agroindustries y Pequena Agricultura: vinculos, potencialidades y oportunidades comerciales (Agroindustries and Small-Scale Agriculture: Links, Potential and Trade Opportunities), ECLAC publications website.

7 As an example, Ingettolgoi Co Ltd in Mongolia cultivates some 3,000 ha in a remote small town (Selenge) north of Ulaan Baatar. Out of the town population of 3,500 persons only some 600 have formal employment, of which the enterprise engages some 500. The remainder of the employed population work for the Government.
are normally well fenced and the people living around in the area can not avoid being confronted with the wealth of the large enterprises. Tension between the rich enterprises (and individuals) and poor farmers has become a source of social unrest.

Types of Linkage

29 From a poverty reduction (rather than an enterprise viability perspective) the issues centre on the organisation of procurement to obtain minimum specified quantities for the profitable operation on a timely basis. Enterprises have three main choices about how to do this:

- they can produce the raw material themselves;
- they can rely on supply from farmers in the market place without contracting for production; or
- they can contract with farmers to produce specified quantities at specified times.

30 These choices are not exclusive. Many enterprises operate “nucleus” estates on which they produce some of their requirements and rely on small farms for the remainder. Some contract for this, some do not but most agroindustries are characterised either by backward integration of this type or by some horizontal integration of producers (for example into co-operatives) that provides a focal point for procurement and information dissemination. In the latter case, producer’s organisations can also strengthen the position of farmers in the market through increased bargaining power for input supply and sales. In this regard, there is no difference between the types of vertical integration at the procurement level in PRC and other countries and there are the same advantages and disadvantages for the enterprise as there are for “dragonhead” businesses.8

31 Joint ventures with poor farmers are rare. Although in theory these have many advantages for farmers and potentially have moderate risks and costs for the enterprise, enterprises more often seem to choose a combination of nucleus production under their direct control and a relatively loose association with farmers for the remainder of supply requirements. This can be seen as rational behaviour from the enterprise point of view, because it is organisationally less complex and has similar overall investment costs and risks to a joint venture, but does not require the enterprise to engage in profit sharing nor does it empower farmers in their trading with the enterprise.

Regional Linkages

32 World Bank research9 shows that recent economic reforms and political changes within Southern Africa have opened up new opportunities for intra-regional

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8 See paras 47 – 50 in appendix A12, “PRC Agroindustry and Rural Enterprise Development Approaches and Experience”
agricultural trade and other forms of agribusiness collaboration. This collaboration is
vital, given the relatively small size of individual country markets and the fact that no
single country in the region has the resources and capacity to mount a sustained
drive to achieve international market prominence and competitiveness. Recommendations for regional collaboration include the transfer of technologies and
management systems, joint logistics and international marketing, cross-border
investment, product research and development, human resource development, raw
material sourcing, and regional trade in inputs and consumer products. In the PRC
context developing linkages between provinces, particularly richer coastal provinces
and poorer inland provinces along these lines has good potential.

Farmer Driven Agroindustrial Linkages

33 The role of farmer organisations in farmer empowerment has often been
stressed by development organisations\textsuperscript{10, 11, 12}. The World Bank has reviewed how
best to support development of private support service farmer organisations and
what its role should be in their development. The World Bank concludes that in many
countries, with the demise of government controlled marketing bodies and increasing
recognition of the inappropriateness of using co-operatives as instruments of public
policy, there is an opportunity for accelerated development of farmer organisations.
These farmer organisations have important roles in providing services to their
members and in positively influencing policies, with potentially significant benefits at
micro and macro levels and sustained impact on poverty reduction.

\textsuperscript{10} Cleaver K, 1993, “A Strategy to Develop Agriculture in Sub-saharan Africa”
\textsuperscript{11} World Bank, 1993, "The Development of Co-operatives and Other Rural Organisations" Technical
Paper 199.
\textsuperscript{12} Environmentally Sustainable Development Division of Africa Technical Department, 1994, "Farmer
Examples of Co-operative Success

The co-operative movement is significant both in terms of membership and impact. The United Nations estimated in 1994 that the livelihoods of nearly 3 billion people, or half of the world's population, were made secure by co-operative enterprises. Nearly 800 million individuals are members of co-operatives. They provide an estimated 100 million jobs. They are economically significant in a large number of countries providing food stuffs, financial services as well as the provision of services to consumers.

Examples of the economic significance of co-operatives can be seen by the market shares they hold. In Burkina Faso, agricultural co-operatives are the largest producers of fruits and vegetables for the national market and in Côte d'Ivoire they are responsible for 77% of cotton production. In Uruguay, co-operatives process 90% of national milk production and export 70% of the surplus wheat production. In the United States, in 1998 33% of the agricultural market was comprised of co-operatives and rural electric co-operatives operated more than half of the electrical lines in US, providing power to more than 25 million people in 46 states. In 1997, the contribution of co-operatives to Gross Domestic Product (GDP) in the Philippines was 16%. During the same year, co-operatives in Denmark were responsible for 94% of milk processing, 69% of farm supply and 66% of cattle slaughtering. In Korea 40% of local agricultural produce was marketed through co-operatives.

Co-operatives are also major employers. In Brazil, the Organisation of Brazilian Co-operatives provided over 296,000 jobs throughout the country in 1996. In Canada it is estimated that co-operatives employed over 70,000 persons in 1996. Co-operatives have created over 13.8 million jobs in India, with 92% of the jobs created through self-employment through worker co-operatives. In the Philippines, it is estimated that the contribution of the co-operative sector to the national workforce was 5.01 million or 16.24% of the total job market in 1997.

34 Depending on business purpose, local preferences and legislative frameworks, farmer organisations are diverse and may take the form of groups, associations, pre-co-operatives, unions, co-operatives, federations, syndicates, partnerships, or farmer-controlled companies. However, there are only two main functions of farmer organisations: they are business organisations, which focus on economic services, and representative organisations, which focus on representation.

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of interest, communication and consultation. These are not mutually exclusive and both functions are often found in one organisation.

35 Based on many case studies over more than a decade and consultation with co-operative development specialists, the World Bank's analysis identifies the characteristics of effective farmer organisations and the best practices that are critical for their success. Specifically they are: private-sector organisations, operating within a market-based economy; freely established with voluntary membership; legally owned and controlled by persons who benefit from the services provided; have partners as the dominant stakeholder group; and are based on the concept that benefits accrue to members in accordance with their participation in the organisation.

36 The World Bank argues that farmer organisations: mobilise capital and pool knowledge in underserved rural areas; foster entrepreneurship and democracy; and allow farmers to achieve economies of scale, vertical integration, and access capital investment. They can enhance research and extension; add value in marketing; reduce costs in bulk buying; manage communal resources such as water use for irrigation; help to avoid negative impacts of food distribution at concessional prices; and obtain improved repayment rates and lower costs for rural finance. In the Bank's view the time frame for such organisations to evolve should be viewed in terms of decades.

37 The research of the World Bank and the UN goes on to identify the key components of best practices which are critical for the success and self-reliance of farmer organisations. Specifically there should be:

- a clear advantage with visible benefits for farmers to act as a group rather than as individuals;
- no government involvement in the hiring/firing of farmer organisation managers or in the criteria for member eligibility, with participation subject only to the approval of existing members according to criteria they have themselves established;
- perceptions that farmer organisations are to be treated as private and professional, and neither as an extension of state authority nor as "against governments";
- a high share of farmer equity in the overall capital, backed up by continuous savings;

These have included Agricultural Co-operative Development International (ACDI), the Swedish Co-operative Centre (SSC), Groupments Associations Villageoises Organisations Paysannes (GAO), and the Plunkett Foundation for example.

These principles essentially reflect those laid down by the International Co-operative Federation.


World Bank, 1995, ibid

International Agroindustry and Rural Enterprise Development Approaches and Experience

- an adequate management and operational structure to ensure transparent accountability to members, supported by clear internal agreements which are formulated, accepted and respected by members;

- homogeneity in terms of members' common purpose identity with main problems, but heterogeneity of skills and non-bureaucratic structures and linkages, based upon cohesive primary groups.

38 Few of these criteria can be observed in farmer organisations in many countries, including PRC, because government involvement is ubiquitous and farmer organisations are used as an instrument of government policy. The recently closed Rural Credit Foundations (RCFs) in PRC were probably the organisations that have been closest to satisfying these criteria in PRC.

39 The World Bank concludes that external influence and assistance should focus on encouraging a more positive enabling environment including the adoption of appropriate legislative, economic, institutional and political frameworks to create conditions for farmer organisations to flourish, and on supporting initiatives to strengthen the management of farmer organisations.

The Original Co-operatives

"In Western Europe, North America and Japan, co-operatives were set up solely through private initiative and were, and still are, completely independent of government, based on the principle of self-administration. They operate as private sector companies in a market system, just like other companies. Membership is voluntary. In Germany, for example, the only governmental control over national co-operatives is that each must, by law, be a member of a registered audit association. The State has granted these associations the right to audit and to examine the commercial position of the co-operatives to ensure that they have conducted their affairs properly. As normal commercial companies, co-operatives in Germany compete with other commercial companies. For this reason, there are usually no special economic or tax arrangements made for them. The only reported exception to this rule is that agricultural and forestry-based commercial and marketing co-operatives are exempted from corporation and trade taxes if they conduct business exclusively with their own members. The State does not in principle provide any specific financial assistance to co-operatives."

29 Abstracted from UN, 1998, ibid.
and ... Some Changes of the 90s

As a result of globalisation, countries in Africa, Asia and Latin America have had to confront various forced retrenchments, structural adjustment programmes, a process of democratisation and the need for modernisation of production and investments in rural and urban areas. In addition, rapid changes in Eastern and Central Europe and FSU have shaken the belief in a centrally planned and party-controlled economy. Many Governments have reconsidered their regulatory role, deregulation and decentralisation, privatisation of SOEs, cuts in government spending and restrictions on government involvement in economic affairs. A mainstream policy of the state withdrawal from supervising co-operatives has brought about various changes in the legislative and administrative framework governing co-operatives in the 1990s. The changes were mainly to ensure the autonomy as well as the efficiency of co-operatives, to incorporate the internationally recognised co-operative principles, to diminish the role of the state, to simplify and clarify existing provisions, to expedite administrative procedures, to provide regulation for new types of co-operatives and to make co-operatives self-sustaining, self-reliant, self-managed and commercially viable for faster development.

For example ...

The Governments of Colombia and Uruguay have made numerous changes in their co-operative legislation and administrative regulations since 1990. Among them are the elimination of many restrictions earlier posed on co-operatives, the reduction of governmental bureaucracy over co-operative movement and the treatment of co-operatives like other commercial entities. In Paraguay, a law was approved in 1994 establishing a new legal framework for co-operatives and recognising their special character. It lowered an average market interest rate for co-operatives based on capital investment, established advisory and consultative councils with co-operative representation and advanced the autonomy of co-operatives. In contrast, in Argentina, in 1996, the National Institute for Co-operatives was merged with the state-controlled National Mutual Institute, despite the disapproval of the co-operative movement. The merger, it was explained, resulted from budgetary economy, but it was harshly criticised by Argentinean co-operatives, as they have never been integrated within State or parastatal structures.

Other Rural Enterprises

40 SMEs have assumed an increasingly prominent role in economic and social development. A significant increase in number of employees in SMEs as a share of total workforce that has been registered in many countries including PRC 30. The Organisation for Economic Co-operation and Development (OECD) has found that 90 per cent of new jobs are generated by enterprises with fewer than 100 employees. SMEs have become important in many economies. In Asia for example31:

- in Brunei, 98 percent of the private sector workforce is employed in firms with less than 100 employees accounting for 57 percent of manufacturing employment;
- in the Philippines, 99 percent of industrial firms have less than 200 workers and account for about 55 percent of industrial employment and 28 percent of manufacturing value added; and

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30 See appendix A12, “PRC Agroindustrial and Rural Enterprise Development Approaches and Experience” for details of the expansion of employment in TVEs and the private sector.
31 Singapore Productivity and Standards Board, 1997, “ASEAN Small and Medium Enterprises”
• in Thailand more than 90 percent of industrial businesses are SMEs with less than 200 employees accounting for 65 percent of industrial employment and 47 percent of manufacturing value added.

41 As a result, governments and donors have given increasing support to this segment in developing and transitional economies in much the same way as the sector has received support in developed economies where it also accounts for a major proportion of employment and output.

Japanese Support for SMEs  

In Japan, SMEs have long played a major role in the economy. Their importance is indicated by their large shares in total enterprise numbers, value of output and total employment. In 1994, out of 6.53 million private enterprises (excluding primary industry), SMEs accounted for 6.47 million (or about 99%). Of the 54.16 million people in employment nation-wide (excluding those in primary industry), 42.27 million (or 78%) were employed by SMEs. SMEs accounted for: 51.4% of manufacturing sales (in 1993); 61.4% of wholesale business and 76.8 % of retail trade (in 1994). These ratios have remained more or less constant over the three decades.

Although SMEs are major players in the economy, compared with large corporations, they do not have adequate resources in terms of personnel, capital, technical capability, and the ability to gather information. Therefore, the Japanese government has various programs to assist SMEs in overcoming their problems. The Japanese Small Business Corporation (JSBC) was established by the government in 1980 to provide assistance to SMEs. It promotes modernisation and upgrading of SMEs; provides information, advice and training; and assists with technology development and access to export markets. Projects are developed in co-operation with the SME Agency of the Ministry of International Trade and Industry, and implemented in conjunction with the prefectural governments, government-affiliated corporations and SME organisations.

42 The liberalisation of government regulations together with the breakdown of larger SOEs has had a positive impact on SMEs. SMEs have also increased in importance because consumers have become more demanding for specialised products and services that are suited to SME production. In PRC the rapid growth of TVEs and more recently private sector businesses mirrors these developments elsewhere, and now accounts for more than 60 percent of industrial employment and more than half of industrial value added. However, in PRC (and other countries) agroindustry makes up a small share of total SME employment and output. As a result, in other countries, SME development programmes have not focused only on agroindustry, but have rather included it in mainstream SME development. SME development programmes can be wide ranging, addressing many systemic constraints.

43 Figure 1 is illustrative of this and summarises the problems faced and the initiatives taken under a UNDP regional programme for the Former Soviet Union (FSU).


33 In PRC agroindustry accounts for about 2.6 percent of light industrial employment and 2 percent of light industrial output.
Figure 1 Problem Areas and Suggested Initiatives for SME Development

<table>
<thead>
<tr>
<th>Problems</th>
<th>Initiatives</th>
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<tbody>
<tr>
<td>Technical Assistance:</td>
<td>• Preparation and training of national trainers / counsellors;</td>
</tr>
<tr>
<td>• High costs</td>
<td>• Application of successful experiences;</td>
</tr>
<tr>
<td>• Few support institutions</td>
<td>• Promotion and development of institutions for support services of technical assistance.</td>
</tr>
<tr>
<td>Entrepreneurial Attitude:</td>
<td>• Entrepreneurial training and preparations;</td>
</tr>
<tr>
<td>• Tendency towards isolation</td>
<td>• Dissemination of successful associative experiences;</td>
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<tr>
<td>• Lack of organisation, integration and tendency towards</td>
<td>• Support to, and co-operation with, existing business / entrepreneurial</td>
</tr>
<tr>
<td>improvisation</td>
<td>associations;</td>
</tr>
<tr>
<td>• Little willingness to undertake associative entrepreneurial</td>
<td>• Training and preparation of enterprising young people.</td>
</tr>
<tr>
<td>projects.</td>
<td></td>
</tr>
<tr>
<td>Financing:</td>
<td>• Association-grouping;</td>
</tr>
<tr>
<td>• Limited access to financing, both for start-ups and expanding</td>
<td>• Assistance in establishment of credit schemes targeting SMEs (mutual</td>
</tr>
<tr>
<td>enterprises;</td>
<td>guarantee schemes etc).</td>
</tr>
<tr>
<td>• Lack of endorsement and guarantees</td>
<td></td>
</tr>
<tr>
<td>Policy and Enabling Environment:</td>
<td>• Identification of specific obstacles and bottlenecks;</td>
</tr>
<tr>
<td>• Excessive regulations and formalities;</td>
<td>• Recommendations for change and improvement within these areas;</td>
</tr>
<tr>
<td>• Political and economic instability.</td>
<td>• Adaptation and adjustment of legal framework.</td>
</tr>
<tr>
<td>Gender Imbalances:</td>
<td>• Entrepreneurial training and preparation;</td>
</tr>
<tr>
<td>• Difficulties for women to start up businesses;</td>
<td>• Sharing of experiences and best practices for women entrepreneurs;</td>
</tr>
<tr>
<td>• Difficulties for women entrepreneurs to get access to</td>
<td>• Assistance in establishment of microcredit schemes geared towards women.</td>
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<tr>
<td>support and finance services.</td>
<td></td>
</tr>
<tr>
<td>Qualification of Human Resources:</td>
<td>• Skills training;</td>
</tr>
<tr>
<td>• Little specialisation and training;</td>
<td>• Managerial training;</td>
</tr>
<tr>
<td>• Low level of productivity;</td>
<td>• Improvement of the work environment, organisational climate.</td>
</tr>
<tr>
<td>• Low valuation and encouragement to work.</td>
<td></td>
</tr>
<tr>
<td>Market:</td>
<td>• Entrepreneurial training and preparation;</td>
</tr>
<tr>
<td>• Low share in the domestic market and almost no share in</td>
<td>• Counselling and advisory services by qualified personnel;</td>
</tr>
<tr>
<td>external markets;</td>
<td>• Information links, regional and international networks;</td>
</tr>
<tr>
<td>• Problems in acquisition of inputs;</td>
<td>• Establishment of business/entrepreneur associations;</td>
</tr>
<tr>
<td>• Lack of expertise in the area of domestic and external</td>
<td>• Vertical integration (possible labour specialisation)</td>
</tr>
<tr>
<td>marketing;</td>
<td></td>
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<tr>
<td>• Lack of insight into product differentiation and other</td>
<td></td>
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<tr>
<td>competitiveness issues.</td>
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</tbody>
</table>

The Policy Environment

44 OECD work on government policy for enterprise development advocates best practices in four broad areas related to SMEs. These practices are appropriate for both agroindustries and other rural enterprises. Specifically, OECD advocates facilitating:

- efficient and unbiased financial markets for SMEs;
- a suitable business environment for SMEs;
- education, training and the capability of SMEs to compete; and
- access to information, networking and the global marketplace for SMEs.

OECD, 1999, “Best Practice Policies for Small and Medium-Sized Enterprises”
Each of these is discussed in more detail in the following sections.

Facilitating Efficient and Unbiased Financial Markets

Access to finance, particularly long-term finance, is frequently cited as a constraint on agroindustrial and rural enterprise development. In many developing countries and in the FSU commercial banks are focused on short-term opportunities, often in trade finance or foreign exchange business that offer high profit potential. In some, high rates of inflation and repeated currency devaluations have resulted in mistrust of the currency, capital flight and a weak long-term deposit base to match with investment finance. In others, credit quotas or allocations through state controlled banks may be biased in favour of state-owned or quasi-public enterprises impeding access for the private sector and small businesses. Recognising that financial sector deepening is a long-term task, many donors have “by-passed” the normal credit and investment decision-making processes by establishing special purpose lines of financing for credit, investment and guarantee purposes in efforts to remove bias and facilitate access for SMEs or subsectoral industries like agriculture. This has normally been done with resources at market rates.35

By definition, viable enterprise can withstand “commercial” funding. Capital investment and working capital (the funds used in any enterprise) are funded by owner’s equity and loans. Owner’s generally expect returns that are in excess of the opportunity cost of capital and in return will be prepared to bear greater risks. Banks expect commercial rates of interest and need these in the interests of their own viability. Subsidised lending does not assist in ensuring enterprise viability and will generally undermine it. In addition to normal commercial funding relationships between commercial banks and agroindustry or rural enterprise, there are both direct and indirect mechanisms commonly sponsored by official development assistance agencies.

Direct loans and equity investments are made, for example by the International Finance Corporation (IFC), the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB), and the UK’s Commonwealth Development Corporation (CDC) as a response to domestic financial market failure and as a means of drawing in other investors. Poor farmers can be the indirect beneficiaries of such investment.

See appendix A4 for examples of funding for agribusiness at commercial rates.
Outgrowers in the Philippines

IFC is providing long-term financing to a local company (Marsman Drysdale Agribusiness Holdings) in Davo del Norte and South Cotabato, Mindanao, Philippines that it would otherwise be unable to access. Reinvestment in this well-established firm will renovate existing banana plantations and create new banana production creating 1,900 new jobs. The project will also start an outgrower enterprise for asparagus, papaya and okra. Here the company has contracted with 750 local farmers for about 377 hectares of production.

Malt Producers in Argentina

IFC is providing two loans totalling US$ 7 million to Malteria Pampa’s US$ 14 million programme to expand malt production capacity and improve product quality controls. The company exports over 80 percent of its production, mainly to Brazil. Because malting barley cultivation requires close collaboration between farmers and malt producers, Malteria Pampa will expand working relationships with farmers in three provinces providing seeds, technical assistance and increasing its purchases. The project both strengthens the competitiveness of Argentinean export industry and has an important development impact.

The IFC Reach Initiative

In 1996 IFC launched a three-year pilot programme to find workable solutions to overcoming impediments to private sector investment in the poorest countries. It placed field staff in 16 countries (or contiguous groups of countries) mandated to develop an understanding of the private sector’s needs, build relationships with local entrepreneurs, financial institutions and governments, and work with clients to develop viable projects. To support the initiative it created a US$ 40 million Small Enterprise Fund to invest in projects with total costs of between US$ 250,000 and US$ 5 million with the intention of contributing up to 40 percent of project costs in most cases. The fund is flexibly designed to provide loan finance, equity, quasi-equity and guarantees.

IFC provides direct financing to indigenous entrepreneurs in the SME sector (for example about 50 new SME loans are made annually into Africa and through intermediaries. The high transaction costs of direct investment or lending have led IFC to give more prominence to the development of partnerships with local financial institutions (banks, leasing companies and venture capital firms) and the organisation is particularly keen on fostering venture capital because it brings elements of good governance with the investment. IFC has also been progressive in experimenting with mechanisms other than the traditional credit line approaches preferred by Asian Development Bank (ADB) and the World Bank. In particular it has been innovative in risk sharing. In West Africa, it has started to offer partial credit guarantees in local currency to financial institutions willing to finance SMEs that it has appraised. In Ghana and Zimbabwe it has explored the possibility of selling on
some of its SME loans with guarantee backing to local financial institutions in order to recycle the capital.

Aquaculture de la Mahajamba – A Case Study

This company was created to produce and process shrimp in a remote area of Madagascar. It is 73 percent owned by an indigenous firm and about 5 percent owned by IFC. Its facilities include a hatchery, a 675 ha shrimp farm and a processing plant. Production in 1996 at the time of the case study was about 2,350 tons of shrimp per year most of which was exported to Europe and Japan.

IFC’s participation provided critical support through long-term foreign exchange financing that was not available in Madagascar. Of total investment costs of about US$ 33 million, IFC provided US$ 5.8 million in loans and US$ 772,000 in equity. IFC played an important role in mobilising funds from other investors who accepted IFC’s appraisal as a basis for their decision-making. IFC also provided technical assistance support on best practice in shrimp farming.

This commercial project has had significant development impact. The project generated employment during construction and during operations continues to procure substantial supplies locally. It has created some 1,000 direct jobs and generated local microenterprise to supply workers with everyday needs. At least 80 percent of the workers had not previously held wage-paying jobs, and most were subsistence farmers.

Indirect lending through one or more participating financial institutions (PFIs) is common. There are many examples of commercially funded credit lines for agroindustry with linkages to poor farmers. Generally, such credit lines are based on three sets of criteria: criteria for the PFIs which try to ensure that they are sound counterparties for the funding agency; criteria for the borrowers which try to ensure that PFIs in turn on-lend to sound counterparties; and criteria about the type of enterprise which focus the credit line proceeds on particular sectors. These can be varied: for example, agribusiness, SMEs, environmental businesses; and can include specific requirements that, for example, orientate the credit line towards economic growth or exports or poverty reduction.

Albania Private Enterprise Development Project

This World Bank project aims to improve enterprise access to finance and strengthen financial intermediation with the emphasis on long-term finance. It consists of two components: a line of credit for US$ 7.5 million to provide fixed asset and working capital finance through PFIs and a TA component for US$ 0.5 million to assist PFIs with institution building programmes. Subloans are targeted at SMEs with a maximum size of US$ 300,000. Equity positions of US$ 50,000 can also be taken by PFIs and refinanced from the credit line. The project design, based on lessons from previous World Bank credit lines is not sector specific, use market based interest rates, and focuses on the selection of high quality intermediaries leaving these to determine the project investments within a criteria framework.

43 See appendix A4 for examples of recent approvals.
Facilitating the Business Environment

Creating the Market Environment

51 Governments can facilitate agroindustrial and rural enterprise development by creating a market environment that fosters steady economic growth. Key features of such reforms are liberalisation of prices for inputs and outputs, a unified tax system, withdrawal of government from productive enterprise, withdrawal of government from credit allocation, other measures that foster financial deepening, creation of ownership and management structures that allow management autonomy in day-to-day operations, freedom in use of assets, freedom of movement of goods, and freedom in labour mobility. These general reforms that favour economic growth can be supported by policies and initiatives that encourage certain types of enterprise, where appropriate linked to poverty reduction.

Looking Beyond Market Reforms

52 PRC, like other countries, has experienced both successes and failures in agroindustrial development. Many TVEs have closed, but many have expanded. Study of private agribusiness internationally can provide some insights into how policy makers can help to facilitate the business environment beyond market reforms.

53 Research shows, for example, that despite policy reform in many countries, the operating environment is still not conducive for major investments. Firms face considerable non-commercial risks and high costs of intermediate goods such as spare parts, and in the short-term structural adjustment has adversely affected many processors geared towards the domestic market because tight monetary policy, public sector layoffs and other measures have restricted consumption, especially of high value products. An uneven implementation of reforms and residual market controls have also inhibited development while weak physical infrastructure and weak financial market development have inhibited private sector firms ability to respond to those market opportunities that are available.

54 The research concludes that initiatives are needed in three main areas:

• improvement of public goods and services: investments in roads, ports, telecommunications and water supply have an important bearing on private sector agribusiness investments and competitiveness. The same applies to support for agricultural, post harvest and food technology research, training, and information dissemination;

• development and spread of agribusiness management skills that are not widely developed because of the past dominance of processing and marketing by state organisations. Weaknesses resulting from this situation are particularly in marketing management skills which inhibit penetration of international markets for non-traditional products; and

• support for more complex forms of contracting, organisation and co-operative action. Market liberalisation programmes have often focused on improving commodity markets for staples, but less so on the more complex needs for high value perishable products which often need complex forms of contracting such as outgrower schemes, franchising arrangements, producer and trade associations, and other types of contract which in turn need to have proper legal status.

55 Many of these aspects are relevant to the development of agroindustry in PRC, particularly in less liberalised western PRC where SOEs are still a dominant force in the economy.

Identification and Planning

In Mexico, for example, the Government has policy to analyse, define and publicise its objectives within most agroindustrial sub-sectors, making it clear to investors what support an enterprise can get from the Government if the objectives in the sector are fulfilled. The Government has encouraged diversification over as broad range of products as possible, in order to expand the market and to avoid oversupply. Sub-sector analyses were made, and clear recommendations were presented under a World Bank “Producer Integrated Agro-Industries Project”

Institutions dealing with agroindustries: la Direccion General de Fomento y Desarrollo Agroindustrial, and with producers: la Direccion General de Organizacion de Productores were created to simulate and develop producer-processor integrated projects.

Technical Innovation

56 The International Labour Organisation (ILO) Enterprise and Co-operative Development Department has developed a methodology for upgrading the technology utilised by Agroindustry and Rural SMEs. The FIT methodology is currently in use in Africa, Asia and Latin America

57 The FIT programme is based on the belief that small-scale farmers and entrepreneurs are best placed to diagnose their own, immediate needs and contribute toward possible solutions for those needs. Approaches that are being adopted by FIT to ensure the participation and input of the key players include:

• strengthening small producers’ associations,

• training in market appraisal,

• organising meetings between producers and users of equipment to ensure designs meet the needs of users,

• collection and distribution of existing design drawings, and
• promotion of links between micro and small enterprises and larger producers in the formal sector.

58 Meanwhile, organisations promoting the micro and SME sector also need to develop a clear understanding of the existing situation of SMEs and their unrealised potential. In this way, interventions can be designed for maximum impact. FIT works with a range of local organisations to enhance knowledge of the needs and opportunities facing micro and SMEs. FIT works closely with local consultants, NGOs and Government agencies to strengthen local capacities in this area.

59 Governments and the private sector can support technical innovation in agribusiness. In Brazil, for example, Embrapa (the Brazilian Agricultural Research Company) is a private company linked to the Ministry of Agriculture. Established in 1973, it has researched and recommended more than 9,000 agricultural technologies. In the food processing and manufacturing businesses in Brazil, more than 780,000 people are employed in about 46,000 factories. These are of similar average size as private sector agribusiness companies in PRC. Embrapa’s research combines reduction of losses in production and post harvest processing with trying to enhance nutrition. The organisation aims through a regional network of agroindustrial extension centres to help to develop micro and small business throughout the country. Embrapa provides technical assistance and training to such firms.

Private Sector Research in Indonesia

Liberalisation resulted in significant increase in private sector research in agribusiness in Indonesia. In the post 1983 adjustment period, the most rapid growth in production was in poultry, oil palm, shrimp and potatoes. Private sector research played a dominant role in their development, with commitments of between USD 3 and USD 4 million per year in the mid 1980s to technology scanning and product development. These investments yielded high payoffs with rapid private sector expansion and were followed by further investments in first generation biotechnology research in the early 1990s, again funded by the private sector.

60 Dissatisfaction with traditional mechanisms of funding agricultural research has led in recent years to the introduction of Competitive Agricultural Technology Funds (CATFs), a model now favoured by donors. A recent review of ten funds concluded that:

• where there is sufficient agricultural research and dissemination capacity to constitute an effective market, a competitive fund will stimulate competition and efficiency, and where there is not, donors should concentrate on building up this capacity through institutional development support in the private and public sectors;

51 Gill G J and D Carney, 1999, “Competitive Agricultural Technology Funds in Developing Countries”, Overseas Development Institute
funds work best where government leads the institutional reform initiative by “corporatising” research and putting in place the mechanisms for competition for resources; and

fund management is best located in independent institutions that do not themselves bid for projects and the governing body should be pluralistic with no majority from any one stakeholder, though it should set priorities in line with national policies.

The advantages of CATFs include: increased effectiveness by directing resources by merit; increased efficiency by reducing costs, eliminating duplication, increasing accountability of research resources, and increasing utilisation of infrastructure by providing operating resources; closer alignment of agricultural research and development with national research priorities; promotion of a demand-driven national system; strengthened links between research and extension organisations, agricultural production and agricultural policies; induced institutional change in the national innovation system; merit review and expert feedback. The disadvantages include: lack of support for a medium to long-term research agenda, human capital development or new research infrastructure; higher funding uncertainty; time required for applying, revising and reporting reduces time for research; low sustainability of funding when national constituency is weak and external funding sources dry up; and in some countries there are too few potential providers to create a competitive market.

Some Examples of CATFs

Africa Regional: ATTF/ASARECA: The Agricultural Technology Transfer Fund (ATTF) of the Association for Strengthening Agricultural Research in East and Central Africa (established 1994 to support transfer of agricultural technologies; entirely funded by World Bank and USAID)

Chile FONDECYT: Fondo Nacional de Desarrollo Científico y Tecnológico (The National Fund for Scientific and Technological Development) under Chile’s National Commission for Scientific and Technological Research (established 1981 under government science and technology development programme; 100 per cent government funded)

Chile FONDEF: Fondo de Fomento del Desarrollo Científico y Tecnológico (Fund for the Promotion of Scientific and Technological Development) under Chile’s National Commission for Scientific and Technological Research (established. 1991 with loan from Inter-American Development Bank, but majority (72 per cent) local contribution)

Colombia PRONATTA: Programa Nacional de Transferencia de Tecnología Agropecuaria (National Programme for the Transfer of Agricultural Technology) of the Ministry of Agriculture and Rural Development (established 1989 as part of government’s decentralisation programme; funded by World Bank loan with government counterpart co-financing)

India AHRS: The Ad hoc Research Scheme under the Agricultural Produce Cess Fund of the Indian Council of Agricultural Research (Cess established 1940, scheme established 1966 to fund basic and applied research in agriculture; 100 per cent funded by cess (tax) on agricultural produce)

India VBKVK: Agricultural Research Fund of the Vidya Bhavan Krishi Vigyan Kendra (Agricultural Science Centre) of Udaipur, Rajasthan State, India (established 1995 with Ford Foundation support; no local contribution)

Kenya ARF: The Agricultural Research Fund managed by the Kenya Agricultural Research Institute (established 1990 on initiative of national researchers: funded by DFID and USAID grants and IDA loans)

Mali IER: Fund under the Institut d’Economie Rurale of the Comité National de Recherche Agricole (National Committee on Agricultural Research) (established 1994 by World Bank and CNRA; World Bank funded)

Senegal NRBAR: Fund under the Natural Resource Based Agricultural Research Programme of the Institut Sénégalais de Recherche Agricole (Senegal Institute for Agricultural Research) (established 1991 by USAID and ISRA; USAID funded; local contribution in-kind only).

Tanzania NARF: National Agricultural Research Fund of the Department of Research and Development, Ministry of Agriculture and Co-operatives (established 1993; funded by loans from IDA and African Development Bank)

Developing Competitiveness

Researchers have identified how the state can play an important role in provision of business development services by:

- carrying out research as an input to policy formulation and research generally where the costs would not normally be borne by the private sector;
- setting standards and accrediting business development service providers;
- opening procurement processes to small enterprises so that they can win tenders to supply goods and services;

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• giving fiscal incentives for private business development service providers to introduce innovative services;
• building a consensus among all of the stakeholders in business development service provision;
• ensuring that infrastructure is adequate (privatisation of telecommunications services has been cited as a potentially useful step in this respect); and
• introduction of appropriate teaching modules in schools (for example teaching design skills for future technology development).

Business Development Services

63 Business development services are broadly defined as non-financial services provided on a formal or informal basis to micro and SMEs. Business development service providers can be a variety of types. For micro scale enterprises and the smaller SMEs, business service providers tend to be NGOs supported by donors or the state. For larger SMEs, commercial business development service providers, including individual consultants, may compete for clients. In addition, business associations may perform a business development service provider role.

64 In the past, it was assumed that there was no market for business development services for micro and SMEs; or that, if there were a market for such services, micro and SMEs would not be able to pay for them. As a result, in Latin America as elsewhere, business development services were typically provided by donors or governments on a non-sustainable basis. This distorted markets and displaced private providers.

65 The new paradigm states that there is a market for a broad range of business support services to micro and SMEs, and that enterprises are capable and willing to pay for such services provided they are appropriate. Intervention by development organisations focuses on facilitating interactions between providers of such services and their potential clients. The achievement of sustainability is particularly important, because sustainability means that: the outreach of the service is no longer limited by the amount of donor funding or government subsidy available and in principle, therefore, the service may ultimately reach a high proportion of the target group; donor agencies can have some confidence that work will carry on after their input has come to an end; and the willingness of small enterprises to pay the full cost of the service on a commercial basis is taken as a reasonable proxy or secondary indicator of impact.

66 In the Latin American context the development of effective and self-sustaining business development services has profited little from experience in the developed countries. This is because: wealthy countries typically provide a range of state-funded services that developing countries cannot afford to provide; support in this form is often distorted by social, political and economic objectives; and such support is often provided through institutions that have emerged from difference legal and cultural bases.

67 In Latin America, assistance to small rural enterprises started in the 1960s and 1970s with vocational and business training. Entrepreneurs lacked technical know how and business skills, including marketing, financial management and other
skills. Governments and development organisations often provided this training, which would typically include technical and business management subjects geared to the problems experienced by entrepreneurs. By the 1980s, when the number of entrepreneurs had grown to substantial levels, the demand for consulting services to support entrepreneurs and promote enterprise growth also grew. In some cases, consulting services to solve business problems were initially provided directly by development organisations. Such direct services eventually gave way to support for private sector enterprises that provide enterprise support services, including technical and production-oriented training, administrative, management and entrepreneurial training and services and sometimes associated financial services.

68 Experience has demonstrated\(^5\)\(^6\)\(^5\) that best practice consists of:

- supplying business services to enterprises on a demand-driven basis;
- a business-like approach on the part of business development service providers toward the management, development and delivery of their services on an explicitly financially sustainable basis;
- ensuring a competitive environment for suppliers of business services;
- SMEs should have access to the full range of needed services including financial, non-financial and technical services;
- utilisation of financial information for business decision making, allocation of costs and revenues to products, setting of targets for product delivery and using evaluation as an input to product development; and
- ensuring the providers of business services do not bear any responsibility for the success of the enterprise: the survival, success and growth of the enterprise must depend on the entrepreneur at his own risk.

69 The foundation of this approach is the belief that market relationships can be developed and these offer the best opportunity for sustainable and effective business development service delivery and markets for business development services, while underdeveloped, can be stimulated through the development of more effective business development service providers and by increasing the effective demand for business development services through promotion, subvention of training, fellowships and similar activities. The system relies on the existence of a number of private sector business development service providers with the potential for growth.

70 The impact of business development services can be measured at the macro level by employment and sales. At the enterprise level, client willingness to pay for business services serves as an indicator that the supply of business development services has an impact. At the service provider level sustainable profitability of the individual service is the measure of the success of support.

\(^5\) Hagnauer H, C Rivera and J Valcarcel, 1999, “The Business Development Centre Approach of Swisscontact in Peru; and
Most recently, there has been a trend toward Business Development Centres (BDCs), which provide a range of services and training geared for small enterprises. Intervention by development organisations inside and outside the countries tends more and more to focus on support for BDCs. Support from development organisations more often focuses on improvement of the ability of BDCs to supply the services required by enterprises on a sustainable basis and increase the effective demand for such services by enterprises through training on how to select and use these services. To a lesser extent, efforts have also been expended on regulation of the supply of services, for example through certification of BDCs.

Swisscontact has developed a unique and innovative approach to financing and developing business service providers, which centres around creation of a framework of rules and set of support instruments to promote the development of BDCs capable of delivering appropriate business support services to enterprises on an effective and self-sustainable basis. This approach is in use in Latin America, Africa and Asia.

The business centre approach does not depend on the services provided, which are different in the different Swisscontact BDCs. The critical factor is how the services are offered: they must be carefully costed and provided at a profit, responsive to the demands of clients, continually evaluated on the basis of income generating capacity, focused on services that generate the greatest return to the BDC, and optimised to attract and retain clients.

In practice, few micro-level enterprises are served. Micro level enterprises cannot usually be served unless costs are at least partially covered by donor funding, under which circumstances BDC attention tends to shift from the needs of the client to the needs of the donor. Also, micro level enterprises form an unstable client base in the medium term. The main clientele of Swisscontact BDCs consists of SMEs with turnover between USD 50,000 and USD 1.5 million equivalent and a workforce of between 5 and 200. Assets are usually below USD 500,000.

Most client SMEs are not owned by the poor and the percentage of women owners varies. However, SMEs of this size are considered a source of dynamism and employment within the local economies and thus contribute indirectly to poverty reduction.

Swisscontact requests tenders from business service providers and offers its support to the BDC operators with the most attractive proposals. Proposals are judged highly where the BDC has identified what appears to be a gap in the market that can be filled by its proposed or existing services. Ownership of the BDC is not restricted, except that organisations that are themselves conglomerations of organisations are barred on the grounds that, in such organisations, responsibility for results is dispersed.

Transparency and accuracy of accounting is essential for identification of detailed financial targets that form the basis for the contract between the individual BDC and Swisscontact. Key financial indicators used to judge the performance of the BDCs on a monthly basis include:

- Achievement of full self-sustainability within 2 to 3 years;
- Efficiency of delivery of services (number of services per client);
- The efficiency of delivering different services (inputs against deliverable outputs); and
- The gross margin contribution of different services.

The development of businesslike organisations is encouraged by providing an immediate funding environment that simulates real market-based conditions. Short-term support covers a portion of fixed costs, while incentives are given for achievement of agreed financial performance targets and penalties are assessed for falling below target. In Peru, over a 5-year period, support typically totals...
Service Sustainability

72 However, developing sustainable services, particularly if emphasis is on poverty reduction rather than economic growth, is not without its design challenges. These are:

• the stress on financial self-sustainability may force business service providers to focus on larger clients to the detriment of micro and SMEs, and the challenge is to develop low cost products that can be profitably delivered to such clients;

• the lack of knowledge or perception of high risk on the part of SMEs with respect to investing in business development services means that the immediate market may be small, and the challenge is to demonstrate the benefits of utilising business development services to SMEs quickly so that providers can achieve financial self-sustainability;

• selecting a few business service providers for support may drive out other providers and may create an unfair competitive situation, and the challenge is to provide support on a transaction basis rather than on a donor-beneficiary basis, so that support is provided that is actually needed and is used effectively;

• some services, such as corporate provision of technology services, may not be sustainable using present product delivery mechanisms when the target market is made up of the poor or the smallest micro enterprises, and the challenge is to develop innovative service delivery mechanisms to enable these services to be provided on a sustainable basis.

73 These challenges are more acute in economies in transition where there is no recent history of private sector service provision for functions that have been the preserve of government and academia.

NGOs in Business Development

74 In recent years, many programme designers have selected NGOs as the implementing agents of choice, and NGOs are very active in delivery of business development services. However, some practitioners have detected limitations with respect to the use of NGOs in some situations. This is because:


the most dynamic NGOs have become very specific about their mission and mandate but few have incorporated the development and delivery of innovative business development services into this strategic vision;

similarly, many NGOs have focussed outreach on target groups, for example geographically within a specific town or province, and 'scaling-up' of programmes to national and regional levels therefore becomes difficult;

NGOs are perceived by entrepreneurs as non-profit, and it is widely known that NGOs receive substantial external funds, therefore many entrepreneurs feel strongly that such organisations should not be charging substantial fees for their services, but should rather be passing on the largesse from which the NGO itself is benefiting;

the non-profit approach of NGOs, which has its origin in industrialised countries where philanthropists wanted to be sure that their generosity was not being abused through the enrichment of one company or individual, may not be suited to recent approaches, where there is more emphasis on impact, value for money, sustainability and other indicators of performance.

These arguments have caused programme designers to explore other vehicles through which to implement programmes for delivery of services to small enterprises.

There is increasing interest in delivering services through private sector means, in particular in providing donor funding to private service providers for delivery of measurable services. Such relationships would be contract-based and contracts would be performance-based, rather than containing elements of core funding. They would also be designed with a built-in exit strategy, whereby the private sector entity would be fully commercialised in the medium term.

Facilitating Access to Markets

Information Services

Market information services have long been advocated as means of increasing the efficiency of marketing systems and promoting price formation. Improved information provides a basis for farmers to plan their production in line with market demand, schedule harvesting, decide which market to access and negotiate on a more even footing with traders. Improved information can also assist traders to move produce from surplus to deficit markets and to take decisions about the viability of storage.

Although these arguments are widely accepted, the track record of market information services has not been particularly satisfactory. Research by the Food and Agriculture Organisation61 (FAO) has shown that while many countries operate such services, the majority are not commercially useful. FAOs work concludes that a large percentage of services are primarily data-gathering exercises and that they

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suffer because they are operated by government officials who lack a commercial approach, face significant resource constraints, and have often been unsustainable having been set-up by donors and “overdesigned” with little attention to sustainability once donor support has been withdrawn.

Private Market Information in South Africa

Agritel is a privately run information service supplying market information from South Africa’s wholesale markets and 11 major abattoirs. The markets are computerised and all transactions (price and volume) are recorded. Agritel receives data daily on all the markets and it then processes and packages this in a user-friendly format. The result is a comprehensive service covering both price and volume data for all commodities, varieties, classes, sizes, and packages.

Agritel has approximately 400 users who pay monthly fees ranging from US$ 28 to US$ 38 depending on the number of services and markets the user wishes to access. Users include producers, packers, caterers, butchers, wholesalers, market agents, and the markets themselves. In addition to paying the subscription fees, users must have access to Beltel, which is the national telephone company’s electronic transmission network. Access can be obtained through a terminal hired from Beltel, or through the use of a personal computer and modem. The telephone to Beltel is toll-free.

The Agritel service is completely menu-driven and easy to use. The system provides the following information for the current and previous days’ trading for each market: the highest price and the volume traded at the highest price; the weighted average price for the day; the lowest price of the day and the volume traded at the lowest price, the volume traded between the average price and the highest price of the day; the volume traded between the average price and the lowest price of the day; the volume on offer at the beginning of the day; the total quantity sold for the day; and the volume unsold and carried forward to the next trading day.

In addition to the current trading data, users can access historical information using a graphics package supplied free of charge by Agritel to its larger customers. The historical information shows trends since the start of the service. Agritel allows the use of market information to its fullest potential. It is, however, only cost effective because of the ease of access and availability of fully computerised data. It is unlikely that Agritel would be commercially viable if the company had to collect the information itself, rather than being able to rely on available data sources.

Conversely, FAO concludes that the benefits of good market information services include: facilitation of efficient allocation of productive resources; improvements in the bargaining position of both farmers and traders; reduction in transaction costs by reducing risks; and assistance to market entry and facilitation of competition. The analysis also concludes that market information can be useful to policy makers as it facilitates the understanding of markets; it can serve as an early warning system for food security; and that information systems have particular value in countries where there is change-over from a state controlled marketing system to a demand driven one in that it creates awareness of market opportunity.

The Indonesian Market Information Service

The Indonesian Service was set up in 1978 with technical assistance from the German Government. Lengthy and extensive participatory fieldwork was carried out to identify the needs of the potential users of information. The results of this fieldwork were that it was decided to place emphasis on prices at the farm level, either at the point at which traders met farmers or at the local assembly market. Research showed that prices at this stage were the ones farmers most wanted. It was also

62 FAO, 1997, ibid
decided to concentrate on vegetables, as these were cultivated commercially while, at that time, fruits were just backyard crops, at least as far as small farmers were concerned.

Indonesian vegetable farmers enjoy many advantages. Volcanic soil and reliable rainfall mean they can get three crops a year and have time for a 60-day fallow period. Consequently, seasonal price fluctuations are relatively minor. Market information is thus not so much required by farmers for long-term planning as for purposes of negotiation with traders. They use the Service to check that they bargained successfully the previous day or to get an indication of the price they should ask for the next day.

In contrast, the Service does not appear to be widely used by traders. They have their own information networks: phone connections are good and the markets they supply are generally no more than five hours away from the growing areas, with the result that either they or their employees visit the terminal market daily. Even though the MIS is an efficient one, traders tend to be more up-to-date with the prices.

The Indonesian MIS collects prices from Monday to Friday in nineteen production areas and at twenty wholesale markets in eleven of the country's 27 provinces. Price collectors receive training annually. Despite having to work outside normal hours and receiving an average salary of just $75 a month, the field staff appear well motivated and have good relations with farmers and traders. Prices are collected at different times of the day depending on the location. Usually, prices in production areas are collected in the mornings, while prices in wholesale markets are recorded in the afternoons when supplies from the production areas have arrived. Average prices are then sent to provincial headquarters where they are compiled into reports for broadcast on local radio stations in the vernacular, at 19.30 on the same day. They are also forwarded to the main MIS Unit in the Ministry of Agriculture in Jakarta. Transmission of data is mainly by radio, with telephone and fax also being used.

The Jakarta Unit prepares selected prices from around the country for broadcast on national radio in the national language every night at 20.05. It also sends prices from around the country to provincial headquarters for broadcast, where relevant, on local radio. Prices are also published in newspapers and the Unit prepares a quarterly report and an annual volume that contains monthly averages for all the prices collected. Price collectors are responsible for daily updating of notice boards with local and regional prices, although these appear to be less well appreciated by farmers than are the price broadcasts.

The Indonesian MIS has proved remarkably sustainable and provides a valuable service, most notably for farmers. A measure of its impact is that the Ministry of Agriculture has since copied its approach in setting up Market Information Services for meat and fish. The current cost of running the Service is around $850,000 a year which equates to about 0.1 per cent of the value of vegetable production.

**Enterprise Networks**

80 Rural enterprise development has been assisted by enterprise networks. Enterprise networks are collections of individual SMEs that form a network in order to provide mutual support, learn and emulate best practice and gain scale to deal more effectively with suppliers and meet large orders. These networks have been used in a range of countries, including some developed countries such as Chile, Denmark, Italy and the United Kingdom. A “triple C” approach to SME promotion has been proposed, which advocates:

- customer orientation, with support targeted toward market requirements;
- collective action, working with groups of firms and promoting networks; and

81 Successful networking programmes involve:

- keeping networks small and organised around practical goals;
- using network brokers to overcome resistance to co-operation and provide practical benefits to participants; and
- opening-up new market opportunities.

**PRODAR**

The Programa Cooperativo para el Desarrollo de la Agroindustria Rural (PRODAR, program for development of rural agroindustry) is a network that developed out of projects to develop rural agroindustry as a way to reduce food losses and provide stable sources of food and income. This network is now a federation of national agroindustry networks (REDARs) in 15 countries in the region, each with its own group of local institutions providing a range of support services for the development of the rural enterprise sector.

**PRODAR**

Official support agencies and ministries in the past focused their efforts and resources on primary agricultural production, with almost no attention to the use of the produce after harvest. It was assumed that ministries of industry and private enterprise were able to attend to subsequent steps in the food- and fibre-production chain. Unfortunately, the interests of small-scale agroindustrial participants fell outside the focus of the main institutions. Nevertheless, a variety of small projects and experiments demonstrated that, with support for small-scale agroindustry, considerable income-generating capacity could be developed.

Gradually, the idea emerged that support for agroindustry required a more integrated approach that involved government policy, institutional awareness, training programs for technical staff and rural producers, university curricula, and rural-development programs in addition to the technological aspects. PRODAR was conceived as a co-operative programme to integrate the efforts of international and national entities, financial and other support groups, and NGOs to help producers solve their problems and improve their agroindustry enterprises or form new ones.

PRODAR has three co-ordination levels: hemispheric, regional, and national. Hemispheric co-ordination is responsible for analysis and evaluation of overall policy issues, design of programme strategies and co-ordination and implementation of hemisphere-wide activities. Regional co-ordination deals with problems and activities in a group of countries related by physical proximity and similar rural socio-economic structures and problems. Responsibilities and activities include the design of strategic policy and the articulation of hemispheric and national co-ordination. At the national level, members carry out program activities as part of the normal pursuit of their own development objectives.

Operating without resources or a defined structure, PRODAR initiatives have depended heavily on communication tools to spread agroindustry knowledge and increase awareness. These have included newsletters, bulletins, workshops, international meetings, technical exchanges, horizontal co-operation, training courses, and publications. The recently established of an electronic communication system will accelerate dissemination of information and broaden PRODAR’s influence.

PRODAR started to place more emphasis on research in 1992. National diagnostic surveys carried out by each country’s REDAR were key elements in raising awareness of the importance and potential of agroindustry in rural and national development. Research showed that weak management practices, lack of marketing strategies, restricted finances, indifferent product quality, and little product differentiation were hampering the growth of small-scale agroindustry enterprises.

**PRODAR has provided technical assistance in project formulation and implementation to almost all of the REDARs, including training programmes and workshops. The network aids connection of training needs of**

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Enterprise networks can have poverty reduction impact where, for example, they are able to facilitate the exchange of information about successful approaches in contract relationships with poor farmers or where they identify demands for particular products in which poor areas have some comparative advantage. The “dragonheads” and other inter-provincial linkages developed in PRC are particular examples of vertical enterprise networks, but horizontal as well as vertical linkages could assist in replication of successful initiatives.

**Export Promotion**

Export trade promotion initiatives began with the rapid decline in the share of emerging economies of world exports during the 1950s, from 32 percent of total world exports in 1950 to 21 percent in 1962. At an United Nations Conference on Trade and Development (UNCTAD) meeting in 1964, a recommendation was made to establish permanent centres in developing countries for trade information and market research, leading to the concept of the Trade Promotion Office (TPO). In the same year, UNCTAD set up the International Trade Centre. This was followed by the start up of over 70 TPOs, mostly in the 1960s and 1970s, as single central service providers, based within a ministry or public agency and providing services free of charge. A study of the nature and success of this type of export promotion has revealed it to be a disaster. Specifically: TPOs rarely demonstrated measurable impact on export performance; only 3 of 70 TPOs were rated by more than one survey respondent as “relatively effective”; 28 typical negative characteristics of ineffective TPOs were listed in the study, which estimated that over half could be found in the majority of TPOs; and most TPOs continued to require aid support ten to twenty years after establishment, mostly in the form of institutional strengthening. The study concluded that a single central service provider could not meet the diverse needs of the national population of exporters, and placing this single service provider in the public service made an inherently flawed concept worse, at least by ensuring continuing support.

In contrast, a cost-sharing grant scheme for export promotion has been used by World Bank in India, Indonesia, Kenya, Mauritius, South Africa and Uganda with good results. The grant scheme offers support initiatives that improve export

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competitiveness to the extent of a 50 percent grant toward all outside services. The service purchaser chooses what the initiative will be, what services will be purchased from whom and in what order and what the acceptable level of service will be. Typically, a grant scheme consists of a mix of three complementary interventions: active promotion to potential users of the benefits of utilising export development services to build competitiveness; on-going advice on the process, on such subjects as how to select a provider, how to draw up a contract and how to use the results of a consulting report; and 50 percent cost-sharing grants for the costs of the actual export promotion work. Schemes are temporary, with most lasting three to four years. Grants are paid after the cost is incurred, on the basis of proof of payments made.

**AMKA: Export Market Development Services for SMEs**

Since its establishment in 1992, AMKA has provided business training and advisory services, trade promotion and intermediary services, and market research for intermediary organisations and producers seeking to export. AMKA provides quarterly one-to-one advisory and counselling services to its regular clients (18 in mid-1998), as well as business development training workshops, trade fairs and support services for intermediary organisations, Government institutions, and producers and buyers.

AMKA’s services represent an export-development niche within a local context where other more general business development service providers are emerging. Its concentration on the food processing and handicrafts sector is a key strength.

The proportion of internally generated funds has increased from 5 percent of costs at start, to 41 percent in the last year. The bulk of this income derives from consulting and associated charges, rather than from local core services. AMKA has been successful in:

- Diversifying its sources of donor finance, and
- Generating revenue from consulting work or support services.

Its future emphasis will be on market-based pricing for its core services and this will assist its financial self-sustainability to exceed 50 percent. AMKA is now considering setting up its own export-trading arm, partly in order to generate revenue. This will also raise serious challenges.

Since its establishment, AMKA has assisted its clients to increase their export sales by around USD 1.1m.

### The Effectiveness of Agroindustry and Rural Enterprise in Poverty Reduction

The research shows that agroindustry and rural enterprise can be effective in rural poverty reduction. Agroindustry can bring both direct employment benefits and indirect benefits for poor farmers who supply raw materials. Other rural enterprise brings employment and income benefits, but does not benefit primary producers to the same extent. However, other rural enterprise, both in PRC and elsewhere has been the main generator of new employment and thus in itself is a major contributor to poverty reduction.

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68 Similar schemes exist in Britain and the USA where potential exporters investigating new markets can obtain cost support for 50 percent of specified market development activities.


34
86 Agroindustry is first concerned about enterprise viability, not about poverty reduction. Vertical integration, backwards to producers and forwards to the market can greatly assist the viability of agroindustry because it helps to assure the supply of raw material and disposal of finished product. However, from a poverty reduction perspective, it is the procurement linkage to farmers that is of the most importance. For this linkage to be viable the preconditionality is that an adequate quantity of raw materials at a specified quality and price is available on a timely basis for the processing plant. All of these factors in turn link to plant scale: the quantity of supply must be sufficient to match the necessary scale of the technology, which requires a given volume of production within a given distance of the plant; and location which in general will require access to good infrastructure. These factors make viability and hence the possibility of successful linkages to poor farmers both site and product specific. It is unwise to generalise about specific products although, for example, the research shows that products can be successfully developed in mountain areas. Vehicles for regional linkages that help to transfer technologies, marketing expertise and investment can be valuable in speeding up the development of opportunity.

87 Governments can encourage agroindustry to locate in particular regions through incentive programmes. This has primarily been through tax breaks of various types. However, if the objective is poverty reduction, care needs to be taken in the design of such incentives. Mechanisms should: not undermine the viability of the enterprise, not encourage short-term exploitation of farmers or resources, and foster long term commitment. Competitive funding mechanisms that allocate resources in relation to poverty reduction impact may be appropriate if there is market failure or barriers to market entry. Such mechanisms need not necessarily focus on private goods, but can also develop public goods, such as infrastructure, that will encourage private sector investment.

88 Farmer organisations can be effective means of organising production and marketing and empowering poor farmers to develop market opportunity and influence the policy environment. Producer and marketing co-operatives are amongst the most common, but the research shows that certain preconditions need to be met for their eventual success. Private sector organisations in a market environment with voluntary membership operating without government participation have proven to be most effective.

89 The evidence that non-agroindustrial SME rural enterprises have been the main economic growth area and responsible for very significant employment creation in both developed and developing economies is overwhelming. Consideration to fostering rural enterprise as a whole as a means of poverty reduction through direct employment creation therefore remains important, both as a means of employing the urban population and migrant rural labour. The research shows that problems in

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70 See paras 18 - 22 and Case Studies 1 and 2 in appendix A12, “PRC Agroindustry and Rural Enterprise Development”
71 See para 32.
72 See for example the Challenge Fund mechanism discussed in the overall strategy for poverty reduction projects.
73 See paras 33 – 37.
74 See paras 40 – 41.
SMEs are common to agroindustry and other rural enterprises. Consequently, developing stand alone support services for agroindustrial SMEs will not take advantage of the synergies that could be achieved by addressing the SME sector as a whole in which agroindustry may only be a small part\textsuperscript{75}.

90 In this broader context (but with the same relevance to rural agroindustry that links to poor farmers), efficient and unbiased financial markets; a business environment that does not impede private sector development; and a wide range of support for skill development, technical innovation, business management, information services and export opportunities can all contribute to the more rapid development of agroindustry. Again, sustainable services that charge for assistance and the creation of competition for resources ensure that buyers are discerning about the services received and the sellers are focused on customer satisfaction.

The Lessons

91 In the context of PRC’s rural industrialisation and the experience with TVE development (both successful and otherwise)\textsuperscript{76}, international approaches and experience can offer some useful guidelines for making agroindustry and rural enterprise more effective for poverty reduction. The specific guidelines can be summarised as follows.

- Enterprise viability is the primary consideration. This is enterprise and location specific and generalisations should not be made other than that relevant procurement, processing, marketing and environmental aspects need to be examined in each case.

- Enterprise should be encouraged to locate in poor areas or to obtain raw materials from poor areas only if the criteria of viability can be satisfied. This should not be brought about by direct subsidy to enterprise operations, but government can assist though infrastructure provision and by sponsoring market or product development research for specific uses of raw materials from poor areas, particularly if these are unique to those areas due to agroclimatic or other factors.

- Enterprises should be free to choose the type of linkage that they form with poor farmers based on their own judgement of the risks and rewards of different types of linkage. Government should not attempt to force enterprises to joint venture with farmers because it restricts enterprise autonomy, but can actively encourage the development of farmers organisations that are able to negotiate effectively with enterprise and/or joint venture with it.

- SME non-farm rural employment creation, although it does not directly benefit poor farmers, has been the engine of economic growth in many economies including PRC, and has created work for migrant labour from poor areas. The constraints to SME development generally are shared by agroindustries and

\textsuperscript{75} Agroindustrial SMEs in PRC account for only 2.6 percent of light industrial employment and 2 percent of light industrial output.\textsuperscript{76} See appendix A12, “PRC Agroindustry and Rural Enterprise Development”

36

other rural enterprises, and so synergies can be exploited in developing support services by targeting these at SMEs generally rather than agroindustrial SMEs specifically.

- By definition, “viable enterprise” can withstand commercial funding and it is inappropriate to develop enterprise that cannot. As a consequence the use of OCR or other commercial resources for funding agroindustry is not a contention. However, where there is financial market failure donors and governments can address this through the creation of specific financial facilities (loans, equity and guarantees) that assist SMEs or more specifically private agroindustry. There is often a particular need for long-term capital because of the lead-time to full production for agricultural SMEs. The provision of long-term capital should not be subsidised for this reason, rather the terms and conditions of the financing should relate to realistic schedules for the enterprise to repay.

- Support services of various kinds (for example market research and technology development, business development, and information services) have all proven useful in assisting development of rural enterprise including agroindustry. The research generally shows that self-sustaining market oriented services that compete for resources and customers can be more effective than government operated services. Government can sponsor the start-up of such services as a means of overcoming specific market failure and can assure their direction towards SMEs or agroindustry or poverty reduction though the eligibility criteria that are used to allocate resources.
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Summary

The introductory section of this paper reviews the historical context and recent trends in employment by type of enterprise in the People’s Republic of China (PRC) and the key issues in assessing the potential for impact of agroindustry and rural enterprise development on poverty reduction. It draws a distinction between viable enterprise that is a prerequisite for successful poverty reduction impact, and effective poverty reduction linkages to poor farmers that are not a prerequisite for viable enterprise. The issues of viable enterprise and effective poverty reduction are then addressed in turn. The paper first considers the trends in rural enterprise development in terms of the declining state-owned enterprise (SOE) sector and the emergence of township and village enterprises (TVEs) and the private sector as alternative employment opportunities. It analyses the reasons for the success of TVEs, their rapid expansion in numbers, their more recent decline and their future competitive position in relation to the private sector. It considers the role of agroindustry in the overall rural economy; regional differences in agroindustrial employment, output and growth; and issues of corporate governance in SOEs and TVEs that are germane to enterprise viability. Specific consideration is then given to “dragonhead” agroindustry, the different models, the risk factors, the observations drawn from the fieldwork case studies, and the advantages of the “dragonhead” approach over other approaches. It assesses the effectiveness of agroindustry in poverty reduction and arrives at conclusions about the future potential, policy needs and the means of improving enterprise viability and the criteria for effective poverty reduction linkages.

PRC’s economic development has been characterised by a shift from an agrarian to an industrial economy. Non-farm employment has become an essential component of rural incomes, and the structure of employment is changing rapidly. The proportion of the population employed in the state sector is declining, employment in TVE’s, formerly the engine of economic growth, is static (and has been for more than a decade in the agroindustrial sector), while engagement in private sector activities, particularly in small business, is expanding very rapidly.

Reform of PRC’s 400,000 state-owned enterprises (SOEs) progresses slowly. Outstanding loans to SOEs are estimated to be 70 percent of Gross Domestic Product (GDP) and bad loans 20 percent of GDP. This restricts the available credit to other productive enterprise including TVEs and the private sector and will result in a significant fiscal burden for government that reduces the potential level of future public spending, including potential public spending on poverty reduction projects. SOEs continue to face increasing competition from TVEs and the private sector, and while their "corporatisation" is urgent, reform is slow because of the impediments to social asset transfer. However, progressing the restructuring of SOEs (agroindustrial or otherwise) has important implications for poverty reduction because viable, "corporatised" SOEs will: help to stem the increases in urban unemployment; provide a continuing market for TVEs as subcontract suppliers (which is important in some areas and sectors); increase credit availability for other enterprises; and can free-up public spending for poverty reduction1.

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1 As is demonstrated elsewhere in the overall strategy for poverty reduction, the freeing-up of resources generally can make a significant contribution if those resources can then be used directly, indirectly or through parallel funding mechanisms for poverty reduction.
Rural industrial enterprises (TVEs and the private sector) have been the main engine of PRC's economic growth and now account for more than half of national industrial output. These enterprises are generally small and medium-scale enterprises (SMEs). TVEs account about three-quarters of the output from this sector, but the private sector share is increasing rapidly. Historically, TVEs have been more successful than private enterprise because their "community" ownership structure, which includes local government, has given them preferential access to finance, greater protection of property rights, and access to resources controlled by the state sector. In an economy where product markets have developed ahead of asset markets, the development of such community enterprises has been an effective way of turning community assets, particularly land, into cashflow while at the same time generating tax revenue and bolstering employment. However, research demonstrates that TVEs are losing their comparative advantage over the private sector with economic liberalisation and urbanisation, and that the traditional, opaque ownership structures with their ambiguities between ownership and management will turn from advantage to disadvantage as reform progresses. Support for the full commercialisation of TVEs, their restructuring, and addressing the systemic management constraints is important to maintain viable enterprise and thus employment, growth and the availability of credit and budgetary funds for poverty reduction and other purposes. This applies to all TVEs not just the agroindustrial ones.

Agroindustry is not the main rural industry even though TVEs are located in the countryside. In fact, by 1996, TVEs that use agricultural products as raw materials accounted for only 2.6 percent of employment and 2 percent of the output of all TVEs. Within this relatively small sector, the eastern and central regions of PRC are dominant although there are signs that there has been a small degree of "catch-up" over the last decade or so with the relative share of employment and output of the central and western regions growing. This is an expected phenomenon, and the research bears out the hypothesis that TVE growth would initially be greatest in the most reformist provinces (in this case in eastern PRC), but that as reforms spread other provinces would begin to "catch-up".

TVEs are of different types. Models include those developed using local surplus resources, private capital, foreign capital, and SOE sponsorship. However, TVEs without exception enjoy local government sponsorship either through participation in the ownership or because of their importance in revenue remittances at the local level. Although TVE managers have more day-to-day autonomy than SOEs, they are still subject to some control from local government, and in western PRC in particular the traditional SOE management styles suited to a planned economy have often been applied to TVEs. Separating management and ownership and introducing modern business management and marketing practices is as important for TVEs as it is for SOEs if TVEs (or their successor enterprises) are to retain a pre-eminent position in the economy.

The "dragonhead" approach in which a larger, well-established enterprise assists with the establishment of a new enterprise in a different region has been advocated as a mechanism for poverty reduction. "Dragonheads" do not necessarily operate in poor areas, and depending on their structure, have varying poverty reduction impact. Those that establish their own self-managed production bases have little impact. Those that rely on farmers for raw material supplies have moderate impact, while those that are joint ventures with farmers and share profits can have greater impact.
still. Case study research under the TA indicates that there are location specific opportunities for successful "dragonheads" in poor areas; processing plants need to be located where there is adequate infrastructure which will not usually be in the poor area itself; government support, particularly through access to finance has been important; advanced technology, experienced management and market oriented buying and selling behaviour are characteristics of successful TVEs and are often injected by the "dragonhead" enterprise; and technological support for producers and provision of working capital are essential.

The key characteristic of "dragonheads" is their vertical integration. Imperfect information, lack of access to markets and low levels of farmer education and farm technology contribute to making the alternative of farmer based organisations such as co-operatives, or production for the open market, less effective means for poverty reduction at present in PRC. More importantly, government's preoccupation with making enterprise types (SOEs, TVEs and co-operatives) instruments of policy rather than market based institutions greatly inhibits the development of sustainable farmer organisations. The recent closure of Rural Credit Foundations (RCFs) and the current insistence on the use of Rural Credit Co-operatives (RCCs) as the only vehicle for microfinance are illustrative of this.

From the PRC experience it is concluded that agroindustry can make an effective contribution to poverty reduction. In western PRC, if the TVE growth trends of 1987 to 1997 continue, then tentatively there is potential for the creation of more than 400,000 direct jobs. Further scientific research is needed into the potential for indirect employment creation. As an example, if for each direct job there are between 35 and 50 indirect farmer beneficiaries, then the potential is to benefit between about 15 and 20 million farm families\(^2\). It is also concluded that poor areas have both comparative advantages and disadvantages, generalisation is inappropriate, and investment needs to be treated on a case by case basis. This can be accommodated within a traditional credit line approach using eligibility criteria to assist the focus on poverty reduction, drawing on experience in PRC and internationally and through new mechanisms being pioneered by IFC and others.

With regard to future development accelerating the restructuring of SOEs (including those with strong linkages to agroindustry in poor areas), rationalising TVE governance for a competitive market economy, removing barriers to private sector market entry, and fostering the continuing growth of both private sector and TVE-type SMEs should be the policy agenda priorities. Addressing the systemic management constraints in all types of enterprises should be a priority for action, and the establishment of "business development centres" that would provide information, advice, training and facilitate all types of business linkages is consistent with the government's regional development strategy and worthy of consideration. Access to credit to facilitate SOE restructuring, and for SMEs and rural entrepreneurs generally, continues to require special interventions in the absence of a fully reformed banking system and a high level of non-performing loans in the state bank sector. Measures that foster effective linkages for poverty reduction can be built in to the design of the technical and financial support mechanisms.

\(^2\) It is stressed that this is an illustrative example and not an estimate.
Introduction

The Historical Context

1 The fundamental trend in PRC’s economic development has been the shift from an agrarian to an industrial economy. As PRC industrialises, farmland is being lost to industrial and residential development. It is estimated that the transfer of land for urbanisation is causing the total farmed area to shrink by 0.5 percent per year. To counteract this, PRC plans to reclaim about 300,000 hectares per year that is suitable for farming but currently in disuse. While increases in yield and reduction in post harvest losses through technological innovation can serve to increase grain production and farm incomes, the already small size of farm holdings means that generating non-farm income and employment has been increasingly essential for improving rural livelihoods.

2 The development of agroindustry and rural enterprise in the context of poverty reduction is an indirect means that creates both non-farm and farm employment opportunities. In this context, examination of trends in the structure of employment is important because it provides insights into where to apply policies and support mechanisms for both direct and indirect employment creation. The recent trend in the structure of employment in PRC is shown in Table 1.

Table 1 Employment by Business Type in PRC 1993 and 1996

<table>
<thead>
<tr>
<th>Business Type</th>
<th>1993</th>
<th>1996</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>million</td>
<td>% of total</td>
</tr>
<tr>
<td>SOEs</td>
<td>109.20</td>
<td>36.0</td>
</tr>
<tr>
<td>Subtotal</td>
<td>109.20</td>
<td>36.0</td>
</tr>
<tr>
<td>TVEs</td>
<td>123.45</td>
<td>40.6</td>
</tr>
<tr>
<td>Urban collectives</td>
<td>33.93</td>
<td>11.3</td>
</tr>
<tr>
<td>Subtotal</td>
<td>157.38</td>
<td>51.9</td>
</tr>
<tr>
<td>Joint ventures</td>
<td>0.66</td>
<td>0.2</td>
</tr>
<tr>
<td>Stock companies</td>
<td>1.64</td>
<td>0.5</td>
</tr>
<tr>
<td>Foreign funded enterprises</td>
<td>1.33</td>
<td>0.4</td>
</tr>
<tr>
<td>Private urban enterprises</td>
<td>1.86</td>
<td>0.6</td>
</tr>
<tr>
<td>Urban sole proprietors</td>
<td>9.30</td>
<td>3.1</td>
</tr>
<tr>
<td>Private rural enterprises</td>
<td>1.87</td>
<td>0.6</td>
</tr>
<tr>
<td>Rural sole proprietors</td>
<td>20.1</td>
<td>6.7</td>
</tr>
<tr>
<td>Subtotal</td>
<td>36.76</td>
<td>12.1</td>
</tr>
<tr>
<td>Total</td>
<td>303.34</td>
<td>100.0</td>
</tr>
</tbody>
</table>

3 The table shows the declining share of SOEs in total employment, a relatively static share for TVEs in recent years (following earlier rapid growth) and a declining share for urban collectives resulting in overall decline of the collective sector, and rapid expansion of private firms of various types and self employment. The most dramatic increases are in private rural enterprise and individual businesses. These trends in rural enterprise development are important in the consideration of how best to address poverty reduction through linkages to agroindustry.

6 Source: China Data Centre, University of Michigan
Key Issues

4 In assessing the potential for impact of agroindustry and rural enterprise development on poverty reduction in PRC it is necessary to consider a wide context because of the unique way in which industrialisation has taken place in PRC, the linkages between SOEs and TVEs, and the indirect nature of the poverty reduction impact of rural industry. Specifically aspects include:

- the factors underlying the trends in rural enterprise development including the decline of SOEs, growth of TVEs and the emergence of the private sector;
- the relatively limited role of agroindustry in the context of overall rural industry;
- the regional differences in TVE development;
- the linkages of rural industry in general to local government and to SOEs and their impact on corporate governance; and
- the means to promote linkages between successful businesses and poor farmers.

5 It should be noted that while the linkages between poor farmers and agroindustry are obviously essential for indirect poverty reduction impact, the considerations relating to development of viable and sustainable agroindustry itself are broader and equally important. The distinction is made between successful agroindustry per se which is a prerequisite for successful poverty reduction impact, and effective poverty reduction linkages that are not a prerequisite for successful agroindustry. In the context of developing viable agroindustry and rural enterprise, consideration needs to be given to addressing systemic constraints at the policy and firm level across the board (in SOEs, TVEs and in the private sector) as a foundation for healthy economic growth. Agroindustry can, but should not, be treated in isolation, because it forms a small part of the industrialised rural economy and major growth in employment is more likely to come from other sources. Each of the main issues is considered below.

The Evolution of Agroindustry and Rural Enterprise

The Trends in Rural Enterprise Development

SOE Decline

6 Reforming its 400,000 SOEs remains a major challenge for the PRC government. Despite various incentives to SOEs such as the revenue retention scheme, the corporate income tax system and the contract responsibility system that have been experimented with and widely adopted, the performance of the SOE sector has steadily stagnated. SOE's share in total industrial output fell from 78 percent in 1978 to 34 percent in 1995. This has been accompanied by a gradual decline.
rise in the percentage of loss-making SOEs from about 10 percent in 1985 to over 38 percent by 1995\(^8\).

7  In the early 1990s it was argued, mainly by SOE managers and government officials, that SOE's poor performance was due to an unfavourable external environment (for example higher taxation, price setting and government intervention in investment decision-making) and was not related to ownership structure itself. Accepting this argument, in 1992 the State Council introduced various measures\(^9\) to improve the external environment. Others claimed that the environment for TVEs was even less favourable than for SOEs, pointing to a relative lack of subsidy, lack of cheap raw materials and energy and relatively unfavourable access to credit and argued that TVEs success stems from their non-state ownership. This latter argument which pointed towards restructuring of SOE ownership rather than further financial assistance has subsequently been shown to be the more correct\(^10\).

8  SOEs have been borrowing from state-owned banks since 1984 when the government began to phase out direct budgetary funding. Borrowing grew quickly and by 1988 SOEs debt to equity ratio had risen to 82 percent. Subsequent rapid further escalation in borrowing resulted in the debt to equity ratio reaching 570 percent by 1995. It is estimated that outstanding loans to SOEs have reached nearly 70 percent of GDP and bad loans are about 20 percent of GDP\(^11\). This situation restricts the available credit to other forms of productive enterprise. It will in the end require the transfer of the debt to government as public debt resulting in a significant fiscal burden that will also hamper future public investment\(^12\).

9  Faced with continued and growing competition from the TVE and private sectors the SOE position continues to deteriorator\(^13\). To address the situation but maintain state ownership over industrial sectors deemed strategic or economically important, the PRC government has elected to focus on "corporatising" rather than privatising SOEs. Reform is aimed at increasing management autonomy and separating management from ownership so that the businesses are more market responsive\(^14\). Progress has been slow because SOE responsibilities for housing, health care, and pensions are difficult to remove, impeding their ability to compete in the market\(^15\). There is also been a reluctance on the part of government to create unemployment from closures and restructuring.

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8  Ma J, 1997, "China's Economic Reform in the 1990s"
9  These included allocating more funds for technical transformation, reducing mandatory plan quotas for selected enterprises, increasing depreciation rates for selected enterprises, increasing funds for product development, providing additional working capital, lowering interest rates, granting external trade rights, clearing inter-enterprise debt, eliminating ad hoc levies and charges from local authorities and reducing the income tax rate from 55 to 33 percent.
10  Ma J, 1997, "China's Economic Reform in the 1990s", IMF
13  UNDP, 1996, "National Development Situation from a Sustainable Human Development Perspective", UNDP Advisory Note
15  World Bank, 1992, "China - Trends in Developing Economies"
Nevertheless restructuring of SOEs has important implications for poverty reduction because the creation of viable businesses will:

- maintain employment opportunities within the state sector, reducing potential urban unemployment;
- afford the continuation, where commercially viable, for subcontract relations with TVEs (and the private sector) to flourish in turn creating more rural employment; and
- free-up national credit and budgetary resources for alternative investment, including poverty reduction activities.

In addition to resolution of the problems of governance and social asset transfer, SOEs suffer from systemic management constraints concerned with profit and market orientation, outmoded technology, and limited management skill that are common in transitional economies. These constraints are in common with many TVEs.

**TVE Emergence and Increasing Private Sector Competition**

It is widely considered that rural industry has been the main engine of economic growth. By 1995 employment in rural enterprise had reached 165 million, equivalent to about 40 percent of non-farm employment nationally. Rural industry includes both private firms and TVEs (community and government run firms). Between 1979 and 1993 the share of TVEs in national industrial output grew from 9 percent to 27 percent and the share of private firms from 0 to 9 percent and by the end of 1997 their total share had risen to more than half. By 1995, private firms accounted for 8 percent of rural employment and TVEs about 30 percent. The relative shares of rural industrial employment have changed over time, with the private sector increasing its share.

TVEs are important because of the employment they have created, and their economic contributions. In 1997, the added output value of TVEs was RMB 1,800 billion and exports were valued at RMB 700 billion. They help state and community governments to raise revenues and to offset fiscal crises that result from the decline of planning-based revenues and the underdevelopment of market-based taxation systems that have afflicted most other transition economies. They also help to correct the biases towards allocating revenues to urban areas typical of developing economies, and consequently aid overall rural development efforts.

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13 Estimated to be 56 percent for TVEs, Ma J, 1997, ibid
14 China Business Information Net, 1998, Beijing Systron Information and Technology Corporation Ltd

14 There are many suggested theories as to why TVEs have uniquely flourished in PRC. These include:

- **TVEs have advantages in terms of investment financing compared to private enterprise because they are able to access a larger pool of capital from community government and banks** \(^{23}\) \(^{24}\);

- **TVEs enjoy greater government protection than private enterprises, particularly with regard to property rights and are less likely to be the subject of discretionary revenue extraction** \(^{25}\) \(^{26}\);

- **TVEs have developed in an economy characterised by weak market institutions and poorly specified property rights with a declining but still functional state sector. TVEs have had preferential access to resources controlled by the state sector and often have subcontracting relationships with it** \(^{27}\) \(^{28}\);

- **TVEs have been one of the only practical vehicles for turning community assets (particularly land) into cashflow because product markets have developed in advance of asset markets, the rental market is imperfect and operating a business on land is one of the few feasible ways to exploit the asset value** \(^{29}\);

- **a collective heritage that gave an organisational advantage to TVEs over private enterprise** \(^{30}\);

- **the revenue imperatives for community level government created by the fiscal contracting system in the 1980s encouraged the development of local community owned enterprise, particularly in the absence of an accounting and taxation system that readily afforded tax collection from private enterprise** \(^{31}\); and

- **localised rural employment creation has been a major priority for community leaders, particularly in the context of restrictions on labour mobility in PRC** \(^{32}\).

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\(^{24}\) Che J and Y Qian, 1995, "Governance of Firms under Imperfect Market and State Institutions: Understanding China's Township-Village Enterprises", Stanford University

\(^{25}\) Che J and Y Qian, 1995, ibid

\(^{26}\) Che J and Y Qian, 1996, "Insecure Property Rights and Government Ownership of Firms", Stanford University


\(^{28}\) Otsuka K, 1996, "Rural Industrialisation in East Asia", Tokyo Metropolitan University

\(^{29}\) Naughton B, 1996, "Why are China's Rural Industries Publicly Owned?", mimeo


\(^{31}\) Oi J, 1992, "Rural China Take-off: Incentives for Reform", Harvard University

15 In PRC, where the differential rights of owners and manager are ambiguous, TVEs have provided an institutional form in which the ambiguity has given competitive advantage\textsuperscript{33}. Recent econometric analysis of factors affecting TVE development\textsuperscript{34} showed that the shares of TVEs in industrial employment and output are positively correlated with a high level of credit supply from state-owned financial institutions, local political strength relative to central government, a large size of the state sector, urbanization and the initial level of collectively owned assets. The opening of PRC markets to private sector financial institutions which will accelerate rapidly following PRC accession to the World Trade Organisation (WTO) will increasingly favour private sector firms and relatively increase their access to investment capital. The result will be more intense competition for TVEs. While local political strength may continue to protect TVEs to protect tax revenues, econometric analysis shows that this does not restrict the development of private sector firms\textsuperscript{35}. The consequence will be that private sector participation may continue to gain on TVE participation, and competition will intensify.

16 The analysis also shows that while a political shift towards conservatism (as there was in 1989 and 90) does not have any immediate effect on private enterprise because it takes time to enforce restrictions, liberalisation (as there was in 1992) results in an immediate uptake of new opportunities by the private sector. Further, the development of product markets is found to favour private enterprise that is more efficient than TVEs, but this has been counterbalanced where there has been a strong state sector mainly because of its contractual linkages to TVEs. The gradual and currently planned reduction in SOE participation and the "corporatisation" of SOEs may impact negatively on the position of TVEs relative to the private sector.

17 The study shows that a high degree of urbanisation favours private enterprise. PRC’s recently announced plans to accelerate the rate of urban development will have this effect. The work also demonstrates that the higher the level of collective asset ownership before the reforms, the more prominent is TVE economic participation. Finally, it is shown that although TVEs increase per capita incomes through non-farm employment creation, they do not generate higher per capita income than private enterprises and because they have high capital-labour ratios they are less efficient than private enterprises.

18 In summary, the legacy of central planning favours TVE development, but market reforms and other liberalisation encourage private ownership and TVEs advantages will diminish with market reforms. This implies the need for the continuation and probably the acceleration of corporate restructuring in the TVE sector as well as the SOE sector to maintain the competitive position of these enterprises. At the firm level, this is necessary to preserve the benefits to the stakeholders and at the macroeconomic level it is essential in order to maintain rural non-farm employment.


\textsuperscript{35} Jin H and Y Qian, 1997, ibid
By 1996 there were an estimated 819,000 enterprises (not including individuals) with 11.71 million employees and assets of RMB 321 billion. These enterprises are small on average with 14-15 employees. It is clear that unless reforms are reversed the private sector will play an increasing role in the economy and indeed offers the prospect of creating employment for what will eventually and inevitably be large numbers of unemployed former SOE workers. A market-driven non-state sector including TVEs, private firms and foreign joint ventures is now the dominant force in PRC’s economy. More than 70 percent of industrial output is produced outside the state sector.

Restructuring TVEs and continuing to encourage TVE growth has important implications for poverty reduction because more viable TVEs will:

- create employment opportunities for the expanding labour force and lay-offs from the state sector, reducing potential unemployment;
- help to maintain economic growth in the face of an overall decline in the growth rate and a declining state sector; and
- free-up local budgetary resources for alternative investment, including poverty reduction activities.

Interventions that also encourage the rural enterprise private sector are also highly desirable because in general they will have positive budgetary and economic growth impacts.

The Limited Role of TVEs in Agroindustry

It is important to note that agroindustry is not the leading rural processing industry even though TVEs are located in the countryside. Other types of industry create most non-farm employment. In the 1980s, scholars noted that TVEs are not industry that directly serves agriculture, such as maintenance and production of agricultural tools and machinery or processing of agricultural products. Rather, TVEs are a secondary industrial system, having almost the same basic subsectoral structure as that of the whole national economy. In PRC’s official statistics, TVEs are classified into agriculture, industry, construction, transportation, and business and catering trade. The structure of employment in TVEs, illustrated in Figure 1, shows the relatively minor importance of agroindustry to other rural enterprise.

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38 Since 1994, “business and the catering trade” have divided into: business (wholesale, retail), food and beverage industry, travel and service industry, and others.
The figure illustrates a relatively static employment structure since the late 1980s. Since the 1980s, employees working in industrial enterprises have accounted for approximately 60 percent of the total employees working in TVEs, with industrial value accounting for over 70 percent of the total output value of TVEs. The employment structure for TVEs in 1996 was: agriculture accounting for 2.6 percent, industry 59.9 percent, construction 14.8 percent, transportation 8.1 percent, and business and catering trade 14.7 percent.

This pattern is repeated in the output statistics shown in Figure 2. The structure of output in 1996 was: agriculture 2.0 percent, industry 71.5 percent, construction 8.1 percent, transportation 6.5 percent, and business and catering trade 11.9 percent.

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Regional Differences and Trends

25 Figure 3 shows the composition of agroindustry by enterprise numbers in eastern, central and western PRC. It shows in total terms the relative number of enterprises in eastern PRC is increasing.

Figure 3 Proportionate Shares of Agroindustrial TVEs by Region (Number of Enterprises)

26 Figure 4 in contrast illustrates the total numbers of agroindustrial TVEs
27 The trend shows that while the eastern region has had an increasing share of TVE agroindustrial enterprises in total, mainly at the expense of the central region, the overall numbers of enterprises have been declining rapidly in the central region and more moderately in the eastern and western regions. The total number of agroindustrial TVEs falling from about 452,000 in 1987 to about 259,000 in 1997.

28 Figure 5 shows the total direct employment in agroindustrial TVEs over the same time period.

Figure 5 Employment in Agroindustry by Region (Millions)\textsuperscript{42}

29 The trend is increasing in the eastern region (from 6 million employees in 1987 to 6.9 in 1997 at an average annual rate of about 1.3 percent) in the central region (with a slight increase from 2.2 million in 1987 to 2.6 million in 1997 at an average annual rate of about 1.7 percent) and in the western region (from 273,000 in 1987 to 454,000 in 1997 at an average annual rate of about 5.1 percent). This illustrates that on average, agroindustrial TVEs have been growing larger so that the reduction in enterprise numbers has generally been compensated for by increases in the average number of employees per enterprise.

30 Figure 6 shows the regional shares in agroindustrial output for TVEs.

Figure 6 Regional Shares of Total Agroindustrial TVE Output (\%)\textsuperscript{43}

\textsuperscript{41} RED, 1978-97, ibid and SSB, 1999, ibid
\textsuperscript{42} RED, 1978-97, ibid and SSB, 1999, ibid

Figure 4 Total Number of Agroindustrial TVEs by Region\textsuperscript{41}
31 The central and western regions have a greater share of TVE agroindustrial output in 1997 (28 percent) than in 1987 (20 percent). This illustrates a small degree of "catch-up" which is an expected phenomenon as growth in the eastern PRC slows.

32 Figure 7 shows the growth in real terms (1997 RMB) in TVE agroindustrial output by region.

**Figure 7 Growth in TVE Agroindustrial Output by Region (Billion 1997 RMB)**

33 This shows strong overall growth in real output averaging 22 percent per year in the western region, 19 percent in the central region and 14 percent in the eastern region, again illustrating a degree of "catch-up".

**Subsectoral Types of Enterprise**

34 Table 2 summarises the employment and value added figures for different types of agroindustry in the western region of PRC for 1998.

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RED, 1978-97, ibid and SSB, 1999, ibid
RED, 1978-97, ibid and SSB, 1999, ibid
Table 2  Agroindustry in Western PRC Employment and Value Added in 1998 45

<table>
<thead>
<tr>
<th>Subsector</th>
<th>Employment</th>
<th>Value Added</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>persons</td>
<td>percent</td>
</tr>
<tr>
<td>Food processing industry</td>
<td>172,879</td>
<td>32.2</td>
</tr>
<tr>
<td>Food manufacturing industry</td>
<td>61,849</td>
<td>11.5</td>
</tr>
<tr>
<td>Beverage manufacturing industry</td>
<td>97,528</td>
<td>18.1</td>
</tr>
<tr>
<td>Textile industry</td>
<td>139,272</td>
<td>25.9</td>
</tr>
<tr>
<td>Garment and other fabric industry</td>
<td>37,315</td>
<td>6.9</td>
</tr>
<tr>
<td>Leather, fur and feather products</td>
<td>28,756</td>
<td>5.4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>537,599</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

| Share of domestic total (%)       | 51.5       | 30.0        |

35  The table provides a few insights into agroindustry in western PRC. More than three-quarters of the employment is in food processing, beverage manufacture and textiles. Food processing is more efficient in value added per employee than any of the other industries by a significant margin. The textile industry is the least efficient in terms of value added per employee, by a significant margin.

36  Agroindustry in western PRC accounted for more than half of the national employment in these sub-sectors, but only 30 percent of value added. Even when the textile industry is removed, employment accounts for about 45 percent of the national total but value added about 28 percent. This may suggest that agroindustry in western PRC is more labour intensive, or uses less efficient technology, or suffers adverse terms of trade relative to agroindustry in the east or a combination of these.

Issues of Governance

37  Local governments together with other stakeholders generally establish TVEs. There are four main types:46:

- the 'Sunan' model of Wuxi County, southern Jiangsu, where capital formation relies on surpluses from agricultural production and growth is dependent on internal funding;

- the 'Wenzhou' model of Zhejiang province, where private capital is predominant;

- the 'Jinjian' model of Guandong and Fujian provinces, where there is a high level of foreign investment, particularly from overseas Chinese; and

- the 'suburban' model where there are strong links to SOEs as subcontractors.

38  TVEs are often sponsored by local government for bank loans. Loans come from the state-owned commercial banks and from RCCs. RCCs account for two-thirds of TVE loan finance. Most larger TVEs use the "Director Responsibility System" introduced in 1984 whereby individuals or groups contract to manage a firm,

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retaining a portion of the profits and remitting the rest as taxes. Smaller TVEs tend to be leased from their sponsors.

39 Overall, TVE managers enjoy more day-to-day autonomy than SOE managers. Although TVEs are subject to some control from community level government, they are not generally subject to intervention from higher levels of government in matters of investment, production, pricing, employment and wages. Equally, TVEs have no guaranteed material supply, have relatively limited access to credit through ABC and RCCs which have less resources than the Bank of Construction and the Bank of Industry and Commerce which service the SOE sector. TVEs are also early victims of credit tightening.

40 Recent cutting-edge econometric research that tests the extent to which external factors have been responsible for SOE poor performance demonstrates that overall TVEs have been subjected to a much more stringent external policy environment and that the potential for TVE growth would have been even more dramatic if TVEs had operated in a less stringent environment.

41 Ownership structures have had an impact on economic reform and on equality. During the early part of the decentralisation process, SOEs formerly centrally controlled were placed under provincial control. The speed of reforming ownership structure has differed markedly between regions. In 1981, the structure of SOEs and non-SOEs was relatively uniform across all provinces. By 1994, it was very uneven. The fastest growing provinces, including Zhejiang, Jiangsu, Guandong, Fujian and Shandong are those where the share of SOEs in total industrial output has fallen most rapidly. From 1981 to 1994, the share of SOEs in these five provinces dropped by more than 40 percent to create economic structures dominated by TVEs and private firms. In the same period, the remoter provinces in Western PRC experienced a much slower transformation. Qinghai, Guizhou, Ningxia, Inner Mongolia and Yunnan had less than 20 percent change in the share of SOEs, which remained dominant.

42 By 1994, 65 percent of the total revenue of TVEs was concentrated in the twelve coastal provinces and municipalities. Only 10 percent were in the nine western provinces and autonomous regions. In the same year, for private firms that had emerged since 1979, 63 percent of their total output was accounted for in the coastal provinces and municipalities and only 12.5 percent in western provinces and autonomous regions. In western PRC there is still a lack of incentives for TVEs, private sector development and foreign investment, while traditional management styles prevail in SOEs and have often been applied to TVEs.

43 Recent econometric research has investigated various hypotheses about the differentials in economic growth between regions. This quantitative analysis is important because it provides indicators for policies that will help western regions to "catch-up" with the economic growth of the coastal regions, and in turn the rate of economic growth in western regions has an impact on poverty reduction. The

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47 For example, about 1 million TVEs were shut down in 1989-90.
48 Ma J, 1997, "China's Economic Reform in the 1990s", IMF
49 Ma J, 1997, ibid, Chapter 8
50 Ma J, 1997, ibid, Chapter 8
analysis is also important in the light of the Government's intention to focus on regional development as a central pillar of its poverty reduction strategy for after 2000. The main hypotheses tested are:

- the share of state ownership in industrial production is negatively correlated to the growth of the provinces;
- the degree of government intervention, such as control through production planning, price setting and sales restriction are negatively correlated with provinces performance reflected in the share of light industry (which is generally free from intervention compared to heavy industry);
- the central-provincial fiscal relationship plays an important role in provinces growth performance so that provinces that retain a higher share of revenues show stronger growth; and
- the degree of openness of the provincial economy reflected in foreign capital utilisation positively affects its growth\(^{51}\).

44 The research shows that these four institutional variables: the share of state ownership, the share of light industry, the share of retained revenues and the share of foreign fixed investment explains 40 percent of the growth performance of provinces.

45 Other research\(^ {52} \) has examined the taxation environment. Prior to 1994 the marginal tax rate for TVEs was 21 percent in a progressive system that ranged from 10 to 55 percent. This reflected their relatively small size as business entities. After 1994, it was a flat rate 33 percent. This raised the average TVE tax rate above the 24 percent applied in coastal development areas. This may have discouraged some investment in inland provinces. Certainly, given that growth is linked with TVE development and there has been economic divergence since 1990 \(^ {53} \), revisiting the idea of a tiered tax system should be a policy consideration for PRC\(^ {54} \).

46 The macro policy and budgetary environments are therefore important determinants of the future economic growth of provinces in western PRC and of its impact on poverty, and are very important in the context of achieving economic convergence (that is reducing the relative gap between per capita incomes in richer and poorer regions).

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\(^ {51} \) While it is true that geographical location has had an influence on foreign investment, favourable policies including the delegation to provincial government of rights to decide on major investment projects and tax incentives on foreign investment in coastal provinces have also steered the investment in this direction.


\(^ {54} \) Many countries, for example Britain, have a two tiered tax system based on profits. This taxes smaller firms at a lower rate than larger ones though does not make any distinction about ownership. The policy encourages investment in smaller firms.
Dragonhead Agroindustry in PRC

Models and Risk Factors

47 The “dragonhead” mechanism has been used to support the regional development of agroindustry in PRC. Under this mechanism, a larger well established enterprise will provide assistance with the establishment of a smaller new enterprise in a different area or region. The new enterprises may or may not be in poor areas. The new enterprise may be a private sector “subsidiary”, but the relationship may also be a more complex one because of the non-transparent nature of TVE ownership and governance. Nevertheless “dragonheads” provide a useful means of nurturing new enterprise in poor areas.

48 Within this generic approach there are many variants. There are three main approaches to dragonhead development that have been used in PRC, though these are not mutually exclusive and may apply at different times to the development of a particular enterprise. Specifically, “dragonhead” enterprises may:

- establish their own raw materials bases under their own management.

Some animal products processors have established their own animal husbandry bases, feed bases and feed processing bases. Other companies have opted to rent uncultivated lands for large-scale cultivation. The former usually exist in suburban areas of large and medium-sized cities while the latter are common in Shaanxi, Inner Mongolia and Xinjiang where uncultivated land is available.

- form an association with local farmers.

Loose relationships are established by the dragonhead enterprise with local farmers to purchase their products at current prices. These may be direct relationships or through middlemen. The dragonhead enterprise may recommend new technology to farmers but the recommendations are not binding. This method is usually used during the early life of a processing enterprise.

- establish a joint venture with local farmers.

A “joint venture” is established by the dragonhead with local farmers. Terms and conditions in connection with technology used, the quality of products purchased from farmers, the farm level and infrastructure investments made by the dragonhead and the farmers, and the distribution of profits are specified in contracts.

49 In all cases, the "dragonhead" approach is characterised by vertical integration in the production, processing and marketing chain, with the "dragonhead" enterprise involved in all aspects. Table 3 summarises the advantages and disadvantages of these approaches.

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See paras 37 to 45.
Table 3 Advantages and Disadvantages of Different Dragonhead Approaches

<table>
<thead>
<tr>
<th>Approach</th>
<th>Main Advantages</th>
<th>Main Disadvantages</th>
<th>Potential for Rural Poverty Reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Development of own raw materials bases</td>
<td>Assured quality and production volumes through standardised technology, production systems and management; Overhead costs associated with outreach to farmers are eliminated</td>
<td>High investment costs; No risk sharing.</td>
<td>Low and limited to the impact of direct incremental employment creation on raw materials base and in processing factories</td>
</tr>
<tr>
<td>Association with local farmers</td>
<td>Low investment costs; Some risk sharing.</td>
<td>Quality and production volumes cannot be assured; Raw material supply may be volatile.</td>
<td>Moderate provided there is incremental product marketed</td>
</tr>
<tr>
<td>Joint venture</td>
<td>The quality of raw materials can be contractually specified; Supply can be adjusted to demand; Farmer income or partial can be assured; Farmer commitment is strengthened through profit participation.</td>
<td>Moderate investment and operating costs in extension; Moderate risk if guaranteed prices are offered.</td>
<td>High</td>
</tr>
</tbody>
</table>

50 This simplified analysis provides three important insights:

- there is a trade-off between risk and the level of investment for the "dragonhead" enterprise;
- the greater the degree of farmer participation, the greater the potential for poverty reduction; and
- joint ventures that involve the highest degree of farmer participation are not the least risky for the "dragonhead" enterprise.

These factors are important in the consideration of how to promote linkages with poor farmers, because promoting associations may well be more effective than promoting joint ventures.

The Contrast with Other Approaches

51 "Dragonheads" are not the only means to develop agroindustry with linkages to poor farmers. They are advocated in PRC because they address many of the constraints associated with production in poor areas. The linkage to a larger enterprise provides market orientation, branding and ease of market entry; while the enterprise's involvement in the organisation of production helps to offset the effects of low levels of farmer education and to assure supplies in an imperfect information market.

52 In developed economies, vertical integration is less common for many reasons including: the existence of alternative outlets for farm produce, farmers have good access to information on markets and prices, farm technology levels and levels
of farmer education are high, raw material quality is regulated, and quality attracts a price premium encouraging quality production.

53 In most other developed and developing economies co-operative structures are found. These are much less common in transitional economies, perhaps because in some ways they resemble the collectives of the past. Co-operatives are generally formed by farmers for purchasing and marketing and give farmers extra power in the market place. However, effective co-operatives also need access to good information on markets and prices and the high quality production associated with advanced technology and good farmer education in order to have that power in the marketplace. Co-operatives also need certain policy and operational conditions for success. These include clear and visible benefits for farmers to act as a group rather than as individuals; no government involvement in management; a benign policy view regarding co-operatives as private professional organisations and not "against government"; high levels of farmer equity; transparency and accountability in operations. Few of these conditions can be found in PRC, and the government's tendency to use "co-operatives" (as with other enterprise forms such as SOEs and TVEs) as a policy instrument rather than a market institution essentially prohibits their effective development. The recent closure of Rural Credit Foundations and the current insistence on the use of Rural Credit Co-operatives as the only vehicle for microfinance are illustrative of a policy environment that is inconducive to the development of self-sustaining farmer organisations.

54 Because the preconditions for the success of farmer driven linkages do not yet widely exist in the poor areas of PRC, "dragonheads" or vertical integration are the preferred development route. There are examples of mature "dragonheads" spinning-off the ownership of local production and processing entities once they are established, and so in one sense "dragonheads" can be regarded as the means for creating the preconditions for other types of enterprise relationships.

The Case Studies

55 Two case studies were carried out to consult with beneficiaries and to identify some of the characteristics of successful TVE "dragonheads". The findings generally bear out the research findings about the factors affecting TVE success. The following general observations were drawn from the case studies:

- there are location specific opportunities for production for agroprocessing (of which pineapples, passion fruit, mangoes and potatoes were the examples studied), but a wider range of crop and livestock products, particularly high value added products like herbs and medicinal plants provide viable opportunities for improving farm income;

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57 UN, 1998, "UN Report of the Secretary General on Co-operatives", (A/54/57)
58 See the second case study para 98 as a case in point.
59 See paras 71 to 112 for details.
60 See para 13 for details.
• processing plants need to be located in areas where there is good infrastructure. This generally means nearby cities and location at the county township level will be the exception rather than rule;

• government support, often through initial ownership and financing has been a pillar of the start-up of many such enterprises along with preferential access to loans and in some instances the use of poverty reduction funds to support enterprise development;

• advanced, often imported, technology and trained and experienced management are characteristics of successful enterprises;

• the enterprises were market sensitive in terms of both price and quality, and were assisted in this through the “dragonhead” relationship;

• the enterprises studied aimed to reduce risk through employing their own agricultural technicians to encourage good husbandry and develop high quality, though some reliance was also placed on government to provide extension support; and

• the enterprises studied were prepared to pay market prices for produce and used a combination of their own raw material bases and relatively loose associations with farmers. Profit sharing with farmers was not a feature.

The Effectiveness of Agroindustry and Rural Enterprise in Poverty Reduction

The Potential of Agroindustry

Employment and Income Generation

56 The analysis shows that agroindustry accounts for a small part of rural industry. In 1996 it comprised only 2.6 percent of such industry in terms of employment and 2 percent in terms of output61. In terms of direct employment the numbers employed in agroindustry nationally did not increase in the decade from 1987 to 199762 while the number of enterprises going out of business or merging with others was substantial, the total number of agroindustrial TVEs falling from about 452,000 in 1987 to about 259,000 in 199763.

57 TVE agroindustry as a direct employment creator appears to have limited potential. For example, if the growth rate of direct employment in western PRC does not accelerate in the sector, applying the 5.1 percent annual rate of the last decade to the employee number of 454,000 in 1997 results in the total new direct employment by 2010 of about 414,000.

58 No studies have been found on the indirect employment creation effects of agroindustry. In the case studies, which may or may not be representative, in one

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61 See paras 21 to 23.
62 See para 28.
63 See paras 25 to 26.
case 38 farmers benefited for each employee and in the other 47. If figures in the range 35 to 50 were indicative for the relatively high technology plants that will be needed to survive in a market economy, then 414,000 direct jobs would be linked to between 14.5 and 20.7 million indirect beneficiary farm families. However, further research, beyond the scope of the present TA, is needed to analyse the likely employment creation rates scientifically. The Leading Group of Poverty Alleviation and Development (LGOP) could undertake this research in the future.

The Comparative Advantages and Disadvantages of Poor Areas

Poor areas may have some natural comparative advantages, though these will always be site specific. Examples include:

- larger per capita land areas in western PRC with potential for the development of higher value (non-grain) crops for processing and extensive animal husbandry;
- some unique natural resource or climatic environments, particularly in mountainous areas that give rise to opportunities for particular commodities that cannot be grown elsewhere;
- relatively low labour costs; and hitherto
- some relatively low market entry costs for "dragonheads" which have generally enjoyed the patronage of local government as a potential taxpayer together with the other factors that have accounted for TVE success.

There are also disadvantages. Examples include:

- poor regions have poor infrastructure, and the conditions for successful enterprise operation which include good utilities, transport and communications facilities are not available in the remote areas;
- an increasing market sophistication regarding end products that requires a higher level of capital investment than was necessary during the rapid development of TVEs in eastern regions;
- an increasingly competitive market place in which profit motive increasingly prevails over other considerations in determining the deployment of capital amply demonstrated by the comparatively rapid growth of non-agroindustry and the private sector in rural areas;
- a shortage of professional, skilled management willing to work in rural areas;

It is stressed that this is an illustrative example not an estimate.


See para 13 for details.

• traditional cultivation practices and cropping patterns and low levels of farmer education that it takes time to change resulting in prolonged "start-up" phases and low initial returns.

61 This analysis demonstrates that generalisation about the advantages of agroindustry for poverty reduction is inappropriate and a case by case approach is needed. This can be readily accommodated within the framework of the traditional credit line approach that uses borrower and enterprise eligibility criteria to determine if a specific enterprise qualifies for support. It is considered that this is the most appropriate approach to foster in the future development of agroindustry for poverty reduction.

**Future Developments**

**The Policy Environment**

62 Historically, the policy environment has favoured SOEs over TVEs, and TVEs over the private sector. Changes in taxation in 1994 helped to create more even competition, but directed credit and subsidies continue to assist SOEs, and to a lesser extent TVEs. At the same time a better enabling environment for more formal operation of the private sector is emerging through new legislation, the rural private sector itself is growing rapidly, and many of the traditional advantages of TVEs will be eroded in the near future. Specifically:

• PRC's WTO accession will result in better access to capital for the private sector and intensify competition;

• as property rights and market institutions strengthen and the state sector declines further, TVEs close connections to local government will be less and less of an advantage and may turn to disadvantage where there is heavy dependence on them for revenue and ownership is not distinct from management; and

• SOE "corporatisation" will result in increasingly "commercial" relationships with TVEs and increased competition with the private sector for subcontracting.

63 In this new environment, policies that do not discriminate against either TVEs or private sector enterprise are desirable, and in particular clarity about the relationships between ownership and management is required, barriers to market entry for private sector firms need to be removed, and the general enabling environment for small and medium-scale enterprises (TVEs and the private sector) progressively improved.

64 In parallel, the development of support services to equip all SMEs to compete in a market environment and to foster SME establishment and growth in rural areas is desirable, because neither TVE management nor private sector entrepreneurs have access to market oriented support services. This will involve the development of new institutions. Continued rapid SME growth will also provide new opportunities for employment including for workers laid-off from the state sector.
Further, accelerating the process of SOE reform will have positive effects on a market oriented SME sector because it will free-up investment resources and provide a more sustainable basis for subcontract relations.

Addressing the Systemic Constraints

There are systemic constraints at the firm level which are characteristic of transitional economies. They arise because planned production does not require: a firm to compete for capital; market information or demand responsive production; technological advance to maintain competitiveness; or business development and management skills that are focused on providing sustained and superior rewards to shareholders. Consequently most SOEs and many TVEs are ill equipped to compete, while private sector entrepreneurs do not have access to the management training or the capital that will help them to grow their businesses.

To address these constraints generally, PRC policy makers can consider the establishment of "business development centres". In other countries these have evolved as multifaceted agencies providing a wide range of information and advice, management training, facilitating access to credit, and "signposting" linkages of all kinds between enterprises, financiers, investors and other stakeholders. The specialisation of such agencies in agroindustry would be possible, but it is probably more desirable for such agencies to adapt themselves to the overall economic growth potential of the regions in which they operate, with emphasis on agroindustry where it is a major component of the local economy.

In the absence of a fully reformed banking system and while state-owned banks continue to be obliged to carry out policy lending and to bear the non-performing loan burden of SOEs, policy makers can also consider the provision of special financing facilities for SMEs. Such facilities would be available at market rates and would provide both long-term capital for investment and short-term working capital. Where appropriate, and depending on the source, such facilities could be targeted at SMEs that have direct or indirect poverty reduction impact.

Effective Linkages for Rural Poverty Reduction

A good enabling policy environment, support services for SME development and SOE reform, and ready availability of capital investment and working capital credit will make major contributions to maintaining economic growth. Within this framework effective linkages for poverty reduction can be created through incentives to "dragonhead" type development. The incentives need not be subsidies on the investment in the enterprise itself. Indeed, it is desirable that this is not the case because the enterprise should be financially viable and able to withstand market rates of interest on borrowed funds. Rather, incentives should be tailored to removing barriers to market entry. Where there are high start-up costs, then consideration can be given to financial incentives, but it is preferable and more transparent for these to take the form of limited tax concessions (as has been done to encourage investment in coastal areas) or a two tier tax system that favours SMEs rather than interest rate subsidies.
To link such support and concessions to sustainable rural poverty reduction, the case studies carried out under the TA and the available research suggest that the basic criteria to be met are:

- viability of the enterprise, meaning that the enterprise business plan clearly demonstrates its access to markets, the responsiveness of its products to market demand, adequate overall market size and its ability to obtain market share, the competence of management, a satisfactory useful life for the technology chosen, and adequate financing;

- independence of the enterprise, meaning that even if government participates in the ownership, the relationship between ownership and management is that which would normally be found in a commercial enterprise where the shareholders appoint the managers, the managers are free to manage and are judged on their performance, and returns to shareholders are balanced by the need for retained earnings to support corporate growth;

- equitable arrangements with farmers, meaning that farmers receive at least market prices for their produce, are not exploited or put in a position where they could be exploited by monopoly power of single buyer, receive an adequate return on their investment, and where that investment is long-term have a reasonable expectation of a sustained market over the life of the investment;

- adequate technical extension arrangements, meaning that the enterprise provides or can cause to be provided technical information, support and training to farmers sufficient for them to be able to realise expectations in terms of yield and quality of produce and hence income;

- clarity of contractual arrangements, meaning that any rights and obligations of the enterprise and the farmers in connection with production, purchasing, prices, quality, loans or any other matter is clearly explained to farmers in advance and that farmers understanding of the arrangements is independently verified;

- no negative environmental impact, meaning that the natural resources used for production are used on a sustainable basis and that the enterprise itself is compliant with prevailing environmental regulations.
Case Study 1: Processing of Tropical Fruits in Xishuangbanna, Yunnan Province

Introduction

Provincial Priorities

71 The Government of Yunnan Province, in which Xishuangbanna Prefecture is situated, aims to reduce the poverty by increasing agroprocessing since the processing sector accounts for 25% of the light industry output in the province, and uses a considerable amount of raw material from poor areas. The food-processing industry in Yunnan Province is small-scale at present and consequently the impact on poverty is limited. The Provincial Government wants to speed-up development but is reportedly short of funding. The Provincial Government also puts priority on tourism, and aims not to have its sensitive environment polluted by mining or chemical processing plants.

72 The priorities set by the Yunnan Government to reduce poverty are:

• adjust the production structure in the poor rural areas to more profitable crops; and

• increase the income to farmers through non-farm activities.

73 Key factors for successful agroprocessing development, according to the Provincial Government, are:

• availability of funds, to finance relatively larger-scale enterprises for greater impact on the poverty;

• availability of technology and assistance in the design stage to get the right type of technology and equipment;

• linkages to successful enterprises, domestically or abroad; and

• a focus on “green and healthy products with no pollution”.

74 Since 1996 the Yunnan Government has invested RMB 700 million to reduce poverty into:

• animal husbandry,

• Chinese medicine,

• kiwi fruit production,

• medicine, healthy fruits and dietary products (moyju), and

• gingko leaf production and primary processing.
Prefecture Characteristics

75 The Prefecture, bordering Lao People’s Democratic Republic (Lao PDR) and Myanmar, has some 727 villages. The area attracts many tourists, since the region has natural scenery and several of the locations are well developed for visitors. The climate is tropical. The area of 6,969 square km is 95% mountainous with a total cropping area of only some 550,000 mu, or 5%. Most of the cropped area in the Prefecture is used for rubber and tea plantations. Some 47,000 mu is used for fruit crops including pineapple, passion, litchi, longan, mango, oranges and bananas.

76 The total population is 360,000 of whom some 260,000 live in rural areas. There are seven ethnic groups in the population, of which the Dai people are the biggest, accounting for about one third of the population. The prefecture has 166 villages below the poverty line, containing some 4,400 households and about 25,000 persons. There are 34 very inaccessible and very poor villages in the Prefecture.

77 The 1998 Decree by the PRC Government banning all logging of natural forests has caused many small enterprises in the Prefecture to close. The focus at present is to develop fruit trees in areas that need to be replanted. The price of latex is low and makes rubber tree plantation financially unattractive.

The Dragonhead Enterprise Studied

78 A plant and farmers producing passion fruits and pineapple were visited in August 1999. The objective of the case study is to analyse and identify the strengths and weaknesses of the enterprise concerning its linkages with poor farmers in the surrounding counties, how the experience gained can be used to guide the development of other dragonhead enterprises, and how the enterprise could develop further co-operation with its contracted farmers, whose cash income is dependant on the sale of their fruits.

79 The modern processing plant for tropical fruits is located close to Jinghong City along the main road to Kunming in Xishuangbanna Prefecture. It is called Xishuangbanna Baiguo Zhou Natural Food Company Limited. It was established in 1994 and started to process tropical fruits in 1995. The enterprise is financed and owned 70% by the Ministry of Foreign Trade and Economic Co-operation (MOFTEC) and 30% by the Prefecture Government. The total investment in the processing plant came to about RMB 40 million and the plant employs 85 persons. Plant management is professionally qualified and experienced. Investment per job created is high, at RMB 470,000 or US$57,000. The equipment is mainly from Sweden and Italy.

80 Jinghong City has infrastructure and secure supply of water, electricity and coal. The area where the raw material is produced has very poor infrastructure and roads. Consequently, the success of the enterprise would not have been possible if the plant would have been placed in the poor county.

81 The objective of the enterprise is to produce juice and concentrate as a semi-finished product to be sold to bottling plants in PRC or to be exported. Its position as one of the best processors and exporter of high quality concentrate is now well known in the trade in Europe and USA. It exports at world market prices.
82 The plant produces concentrated passion fruit and pineapple juices of high quality, of which about 80% of the passion fruit and 60% of the pineapple fruit concentrate is exported. Mango juice (with a high level of pulp) is not concentrated, has a good domestic market, and is not exported. The plant can process, at full capacity, some 10 tons of pineapple per hour, or somewhat less passion fruit. The concentrate is aseptically packed and stored in 200 litre steel drums, which are kept in a 500-ton cold store. The enterprise will continue to expand its production base to enable the plant to process more tropical fruits.

83 The plant obtains its raw material within a radius of 50 kilometres. In 1996 it handled some 2,500 tons of fruits. Production has increased steadily and in 1999 the planned processed amount will be about 18,000 tons fruits, mainly pineapple and passion fruits, amounting to the raw material requirements for about 50% of the plant’s maximum processing capacity. To produce one ton of pineapple concentrate (60 Bx) the plant needs nine tons of fruit (16 Bx). To produce one ton of passion fruit concentrate (50 Bx) the plant needs 11 tons of fresh fruits.

84 The production area for fruits covers some 30,000 mu, of which a relatively large part is still under development and is not producing at full yield. The enterprise itself operates some 6,000 mu as demonstration and testing lots. The area directly under the enterprise is divided up into three farms, employing 300 farm workers. They are mainly producing passion fruit (30% of the need for the processing). The target for the enterprise is to contract farmers producing from some 100,000 mu, which would involve some 10,000 families. The enterprise benefits from little competition with regard to the production and supply of raw material.

85 The yield of pineapple is about 2.5 ton per mu, and the fruit is grown in rotation. Yield drops after three to four years and the area is replanted. Since almost all of the pineapple plantation (Kajenne variety) are on the hillsides, all replanting and harvest is done manually. It is estimated that for one mu some 45 man-days for replanting and about three to four days for operation per year are needed. The harvest takes place from February to May and from June to August.

86 The yield of passion fruit is about 1.0 ton per mu. The fruit is grown as a vine on steel wire, similar to a vineyard. The plants start to yield after one year. Yield drops after five years and the area is replanted. The enterprise provides the steel wire and technical assistance to the farmers. Seedlings are easy to multiply and most villages do this themselves. The harvest takes place from August to January, and due to the resistant variety grown (thick skin but somewhat lower juice yield) the area has no major problems with any diseases or viruses.

Linkages with Poor Farmers

87 The technicians from the Bureau of Agriculture in the County have supported the development, but the main promotion of and support for growing tropical fruits comes from the enterprise itself. The enterprise employs 15 agricultural technicians with their own vehicles, who supervise and help the farmers with their crops. Within the 50 km radius, the plant has established its own collection centres and advises in advance through its own agricultural technicians and village leaders when purchase

Assuming 200 working days per year and 18 hours operation per day.
and collection will take place. The farmers do not only grow fruits for sale to the plant. Some fruit is sold directly to the fresh market. Additionally, maize is intercropped with passion fruit, and farmers would not normally allocate more than one third of their area for pineapple. The enterprise obtains about 80% of its all pineapple from one township some 40 kilometres from the plant. Passion fruit production is scattered over some 13 townships and two other sites.

Mr Bai La Xian of the Jinou Minority in Bapu Village (77 families and 343 persons)

Mr Bai started to grow passion fruits in 1996 and he combines his fruit growing with some oranges, litchi and nuts, as well as corn for the family and his animals. All the work in the orchards is done by himself and his family, on some 20 mu in the hilly tracts outside Jinghong City. Production of passion fruit in the village is still expanding, and some families started as late as 1999. Mr Bai grows seven mu of passion fruits. He finds the plants need a limited amount of attention, but they need a good fence around them to keep the cattle away. The fruits need a little spraying with insecticide, and some fertiliser. He does some inter-cropping with pineapple. He is happy at being able to sell some four to five tons of passion fruits per year. At the time of the visit, the market price and the enterprise price were the same: RMB 1.2 per kilo. He sometimes has buyers from the city who buy the fruits to sell in the city market.

88 Through the agricultural technicians and the technical support they provide the enterprise has established good relationships with the farmers that produce for it. The enterprise has opted to involve more small farmers the production, rather than expanding its own plantations. In 1999 the enterprise needs some 18,000 tons of pineapple and passion fruits. This will involve some 4,000 farmers. Since there is limited competition for the purchase of fruits, the farmers have no comparison, but since the income per mu is higher growing tropical fruits compared to grains, the farmers continue to expand the production area.

Mr Yai Kong of the Dai Minority in Bangsha Village (69 families and 345 persons)

The village is growing 2,000 mu pineapple, out of total area of 3,000 mu. The pineapple is grown on the hillsides. The plantation was started in 1995. The farmers at present get RMB 0.4 per kilo during the wet season and up to RMB 0.6 per kilo during the dry season. The yields are around 1.0-1.6 ton per mu. The village has given up some of its rubber tree plantation for pineapple, but still grows rice as the second most important crop. The production cost for pineapple is about RMB 100 per mu, during the first year, then drops. The enterprise has specified the floor price for pineapple to be RMB 400 per ton, and Mr. Yai is satisfied with the security of market and the prices paid. The enterprise works with the local village leaders to collect and buy pineapple.

89 The enterprise will expand its processing capacity up to about 30,000 tons within the next few years. To obtain this amount from the production bases, the enterprise is planning to expand its direct contact with the farmers, by:

- hiring another 15 agricultural technicians who can directly supervise the farmers;
- financing the establishment of for passion fruit; and
- expanding the system of collection and transport.
Observations from the Case Study

The following observations are made from this case study:

- part of the success of the enterprise can be attributed to the support concerning financial matters and export by MOFERT;

- pricing (ex-factory price) of the concentrate is following world market prices (pineapple concentrate during the case study was US$1,200 per ton, relatively low due to surplus production in Thailand);

- the selection of modern and advanced equipment from Europe ensures the capability to produce high quality tropical fruit concentrate which will find an export market;

- good management (from Beijing) at the processing plant controls the costs, and ensures high quality of final products;

- the enterprise pays the same price as the local market for the fruits, which makes farmers interested to expand production. The enterprise also buys all fruit with a floor price all year around; and

- the engagement of 15 agricultural technicians by the enterprise to keep contact with the farmers helps to ensure raw material supplies and maintain quality.
Case Study 2: Production of Potato Chips in Lupanshui, Guizhou Province

Introduction

Provincial Priorities

Between 1986 and 1999 Guizhou Province has received some RMB 10.2 billion from Central Government for the poverty reduction. Out of these funds, RMB 6.0 billion has been disbursed as low interest poverty reduction loans through the Agricultural Bank of China (ABC), RMB 1.4 billion has been given as grants, and RMB 2.8 billion has been used under the food for work programme. Some 5.5 million people have been lifted above the poverty line poverty during the period, but the Province still has some 2.7 million people in poverty and 1.1 million old and sick: in total 3.8 million people in need of support and assistance.

The main problem about the residual poverty is that the pockets of poor people are remotely located in mountainous areas with poor roads and infrastructure and are difficult to reach. Typical of these are the potato growing communities at high altitudes. The difficulties facing the Provincial Government are that the infrastructure is weak and the population graduating from poverty has little ability to withstand disaster and can easily slip back into poverty again.

County Characteristics

Shuicheng County, consisting of 36,000 square km, has a population of 680,000, of which 98.4% are engaged in agriculture. Of the county population, some 250,000 belong to 26 different minorities. Most of these people are located in 556 villages scattered through the county. The county has some 100,000 persons with incomes below the poverty line. The average net income of the county is RMB 1,120 per capita, and the grain production (including potato) is only, on average, 286 kilos per person. The county government has declared the following strategy for poverty reduction:

- develop rural infrastructure, roads, water supply and electricity;
- train farmers in different practical skills and support labour mobility; and
- develop local natural resources, such as for growing potato, ginger and tea.

Potato is grown on 330,000 mu (22,000 hectare) in the County and this is the second largest area in the Province.

The Dragonhead Enterprise Studied

The modern production plant of potato chips located in Lupanshui City, is a good example how the co-operation with poor farmers can be implemented to the benefit of both parties. The plant and farmers in the poor counties producing
potatoes were visited in July 1999. The objective of this evaluation is to analyse and identify the strengths and weaknesses in the enterprise concerning its linkages with the poor farmers in a poverty county, how the experience gained can be used, and how the enterprise possibly could develop further co-operation with those farmers, who’s cash income is dependant on the sale of potatoes to the enterprise.

96 The Angel Food Plant is located on a 22 mu site close to the centre of Lupanshui City. The municipality includes two counties, of which Shuicheng is one. The county is one of the 48 Central Government listed poor counties of the Province. Farmers in Shuicheng are the producers of potatoes supplying the plant. The enterprise is located in Lupanshui City because the city has infrastructure and reliable supplies of water, electricity and coal. The area where the raw material is produced has very poor infrastructure and roads. Consequently, the enterprise could not have been located in the poor county.

97 By constructing the enterprise in the city, the county did not get the tax revenue from the operation or the employment of some 130 workers. However, the enterprise creates a secure market for some 5,000 poor farmers with an average increase of cash income by some RMB 700 when the plant is in full production.

98 The enterprise will expand its processing capacity to enable the plant to process more potatoes and expand its distribution and marketing of potato chips. The Angel Food Factory is owned by the Municipality of Lupanshui City jointly with a parent enterprise that is located in Kunming: Kunming Angel Food Factory. Negotiation is going for the enterprise to be changed into a shareholding company with the county having 70% of the shares and the staff the remaining 30%. The implementation of the project stated in 1993 and the plant started production in October 1995.

99 The processing line was imported from Japan in 1995, and is working without any problems. Additional equipment was imported in 1998 to facilitate better weighing and packing of the final products (total cost RMB 0.8 million). Total investment in the enterprise was RMB 4.55 million in 1995, and the plant employs 113 persons (RMB 40,000 per job created). The estimated value of the plant at present is RMB 12.16 million.

100 Recent years’ production has been:

- 1996 204 tons chips, Profit and Taxes RMB 560,000
- 1997 187 tons chips, Profit and Taxes RMB 630,000
- 1998 450 tons chips, Profit and Taxes RMB 1,010,000
- 1999 (Jan-June) 470 tons chips, Profit and Taxes RMB 988,000

101 To produce one kilo of potato chips, four kilo of raw potato are needed. The quality of the potato processed during the visit was rather poor, but the chips came out with a good quality.
The plant is operating three shifts per day and can manufacture 1,000 tons per year of potato chips, flavoured with local red pepper and packed into plastic bags, each containing 40 grams (60 in a box) and selling ex-factory for RMB 0.92 per bag. The company demands high quality and makes its own flavours and spices. The retail price is about RMB 1.50 per bag (63% margin to wholesalers and retailers).

The sale of the potato chips is done through the distribution network of the main company in Kunming. The two production units use the same type of bags and same logos. The enterprise will expand its production by buying an additional chip line, with an annual capacity of 2,000 tons (RMB 5.8 million), to be installed at the end of 1999. In addition, a separate sales company will be created responsible for the distribution and sale of the planned output of 3,000 tons of chips per year (75 million bags).

The company buys its main raw material, potatoes, from farmers growing them in the mountains at an altitude of about 2,300 metres above sea level. At this altitude, virus infections affecting potatoes are limited. The yield of the main variety potato is about 1,000 kilos per mu (equivalent to 15 tons per hectare). The soil quality on the hillsides is rather poor and the farmers can only grow corn and barley as alternatives or can inter-crop.

Farmers in the producing area have on average some 20 mu of different types of land. No area is irrigated. All farmers in the village grow potatoes for their own household (about one third of output), potato for pig fodder (one third), and potato for cash sale (one third). The quality of the potato is good and the taste is considered as the best in the Province. The potato are sold along the streets in the city, and also baked for on the spot consumption.

New varieties of potato are being introduced by the technicians from the Bureau of Agriculture. The new types of potatoes have a better yield than the traditional crop, but are considered to have less taste and flavour. Yields of the new types of potato are about 2,000 kilo per mu.

**Linkages with Poor Farmers**

The Angel Food Enterprise buys nearly all its potatoes from middlemen, who arrange for the collection and transport of the potato to the processing plant in Lupanshui. The factory has a small potato store to hold raw materials for a few days processing, but depends on a steady flow of potatoes from farmers. The production area is about two hours drive, into the mountains, and since no telephone contact exists, the middlemen normally come to the plant twice or three times per week, to find out the demand for potato processing.

In 1999, the enterprise needs some 5,400 tons of potato to produce the planned 1,350 tons of chips. It has organised three production areas, and will expand the production system. At present, some 3,000 poor farmers are involved in the production of potato for the factory, and these farmers will slowly emerge from poverty, especially if the new varieties are introduced, which give a higher yield, without adding much more fertiliser or other inputs.
109 The enterprise has contracts with middlemen to collect the potato for a fee of RMB 20 per ton. The middlemen keep good contact with the small individual farmers and know about the situation regarding each farmer in their collection areas.

110 The technicians from the Bureau of Agriculture in the county are the main contact with the poor farmers to develop new varieties and to advise on other matters about production. Since the processing plant is mainly owned by the county government, it is ensuring that the potato growers get sufficient support to develop their production. The introduction of better varieties, mainly virus free, has taken relatively long time, due to the limited capacity of the seed production system in Weining County.

Mr He Guanyou of the Li minority from Xing Nong Village (300 families)

Mr He is growing five mu of potato, of which three mu is of the new variety. He has a family of six and a good part of his potato goes to his own family and for feeding his two pigs. The grown up pigs need four kilos of corn and 10 kilos of potatoes per day, but he is also using the potato ballast for pig feed (which his wife collects). He and his wife both work in the fields. Mr He plants potato twice a year, seeding in February for harvest in August, and seeding in October/November for harvest in March/April. Mr He uses mainly natural manure from the pigs on the fields, and his cows to pull the plow.

Mr He sells about 2,000 kilos of potato per year to a middleman who organises the collection of the potato and pays in cash. At present, Mr He gets RMB 0.5 per kilo for his potato and he feels that this is a reasonable price, and it is the same price he will get at the local market. If the price were to drop to RMB 0.3 per kilo, he will not sell his potato, he will feed his livestock better.

The yield of potato varies some 20-30% over the years depending on weather and rainfall. When the yields are lower, the price goes up a bit.

Mr He has good relationship with the middleman and the agricultural experts from the County Bureau. Mr He has not any formal contact with the processing plant, but he knows that he can sell his potatoes when he wants. The middleman advises him about the quantity of potatoes he is interested to buy, and Mr He will then harvest the amount directly from the fields. He has no storage for potatoes, he simply leaves the potatoes in the field and pulls them up at the time of consumption or sale. New varieties of potato have been introduced from Weining County, but since it takes time to develop the seed potatoes, he has not yet got enough potato to change his entire five mu. Mr He says it is very important that the potato chip factory buys his surplus of potato, since the local market is at least three hours away, and he cannot be sure if he can sell his potato in that market, anyway. The secure outlet is very important. Mr He calculates that he earns about RMB 200 per mu by selling his potatoes. The main the inputs are his own labour and the seed potato that costs about RMB 150 per mu.

111 The enterprise will expand its processing capacity from about 1,000 tons in 1999, to 3,000 tons of finished products: potato chips packed in plastic bags. The planned increase in the processing and marketing of chips will need an additional 8,000 tons of potatoes. To obtain this amount from the production bases, the enterprise is planning to expand its direct contact with the farmers, by:

- hiring about 10 agricultural technicians who could directly supervise the farmers;
- financing the introduction of new varieties of seed potatoes;
- expanding the system of potato collection and transport;
• ensuring that the planting of potatoes is done in such a schedule that potatoes are available to the plant all year around;

• using more of the allocated poverty reduction funds to support farmers and to finance part of the production of improved seed potatoes.

Observations from the Case Study

The following observations are made:

• the success of the enterprise can be partly attributed to the support and market distribution of the parent company Kunming Angel Food, including market campaigns;

• pricing (ex-factory price) of the potato chips is such that the margin for the wholesalers and retailers are large enough to maximise sales volumes;

• the selection of modern and advanced equipment from Japan ensures the possibility to produce high quality potato chips;

• good management at the processing plant in Lupanshui controls the costs, and ensure a good and high quality of final products;

• involvement of the local Government and the Bureau of Agriculture ensures that the farmers get sufficient technical assistance to expand its production;

• the enterprise is paying the same price as the local market for the potatoes, which makes the farmers interested to expand production;

• the introduction, with the support of the enterprise, of virus free and high yielding potatoes increases the profit and engagement by the farmers;

• the engagement of three permanent buyers (middlemen) by the enterprise, who get a fixed fee per ton of potato handled, keeps a steady presence of the enterprise in the production area; and

• it takes considerably time, several years, to develop the production base and the relations with the poor farmers in poor remote areas. Consequently, the financing of these types of enterprises needs long term loans.
Case Study 3: Xingfa Group Livestock Production

Introduction

113 Most agricultural production in PRC recently has been in a situation of oversupply and prices have been falling. Unprocessed raw materials of poor quality are over supplied while processed quality products are in short supply. Since the existing lack of variety and low quality cannot satisfy the improving living standards in PRC the present market for agricultural products can be described as one where both surplus and deficiency exist at the same time.

114 The millions of small land plots of the farmers are the source of agricultural products, while the tables of millions of Chinese families are the destination of these products. Therefore, the actual means of linking the two ends together are the key point that determines agriculture production. It is impossible for small and unorganized farmers to know the changing demand of millions of Chinese consumers. So there must be an actual "market" between the field and consumer for farmers to see and to feel. It can guide the farmers' production, knowing who they are producing for. In the command economy period of the past this "market" used to be planned by the government and farmers engaged in their production only according to government plans. But this type of structure only suits a period of deficiency, such as the backward production phase of “grain is the key food”. Nowadays, under the market economy, agriculture product supply is relatively good. Who can offer a market for farmers? In recent years, the so called “dragon head enterprise” (DHE) has appeared. This might create a proper market for farmers to see and to feel.

115 Firstly, a DHE is an industrial and commercial firm for agricultural production and marketing, it can guide agriculture production, make adjustments in agricultural production structure and improve it. The entry of industry and commerce into the agricultural sector is guided by the market itself, aimed at achieving a financial return. Agriculture product collection by a DHE is just an intermediate requirement, its purpose is not for immediate resale but for the production of value-added products then sold for more profit. So processing and marketing of agricultural products is simply the means of DHE to make profits. Aiming for this goal, a DHE must discover what the market needs and guide farmers to meet the demand. Furthermore it must ensure that its purchased product can be sold efficiently after processing and transformation. Generally speaking, it plays a role in linking farmers' production and market demand.

116 Secondly, a DHE which has the ability to manage agricultural production as an integrated business package has four characteristics. It has a strong ability to understand the market. The Company has a profound knowledge and understanding of certain agro-products as far as their processing and marketing at the domestic and export levels respectively, including the main competitors and other factors that may affect supply and prices etc. They are able to collect information and pass it to farmers in a timely fashion. It has a strong capability to develop a new and popular
product with advanced techniques to meet changing demand, so as to stabilise and enlarge its own market share continually. Besides it also creates reliable conditions for farmers. It can provide all-round services to its farmers. Many of the companies can supply farmers with selected quality seedlings and advanced production techniques which not only allays farmers’ fears of unexpected consequences, but more importantly ensures that enterprises produce a good quality product. DHEs can deal with farmers from a long-term point of view. They can see whether they have a reliable raw material production base and whether the enterprise can continuously develop to provide farmers with real profits.

117 Thirdly, the DHE’s guidance in production adjustment is market-orientated, which effectively avoids the administrative interference of mandatory government orders. The enterprise and farmers are legally equal although they are greatly different in size and both of them are independent business components. Their economic relationship is based on contracts. Both have to perform their duty in light of the contract. DHE can only attract farmers by fair dealing and equitable profit distribution. With careful selection of both partners production risks can be effectively minimised.

118 DHEs are in a leading position at present, and this is satisfactory in the overall development of township enterprises in agricultural product processing for the future. The reasons are as follows: in the early phases of township business, long-term planning of the economy caused a deficiency in light industrial products for a long time. This resulted in the average profitability of non-agricultural products outstripping that of agricultural and animal products. At the same time, the planned purchasing system for agricultural and animal products and small-scale farm household production systems also greatly restricted development. In poverty areas, there might be other specific problems limiting the development of the agro-product processing industry.

119 Concerning poverty relief and the development of agricultural and animal product processing the following factors should be clearly understood:

- How does an enterprise accumulate its capital from zero? Where do they get the capital, obtain technological and professional support etc.
- How to build a production base and help the poor including the determination of the size of a processing business and how many farmers are the beneficiaries.
- The economic relationship between the companies, farmers, government and collectives.
- How to use international commercial loans to establish agricultural by-product processing operations.

120 What should be discussed further is the following:

- Under what conditions can a DHE be set up in poverty areas?
What kind of system and organisational structure as well as management should be adopted to ensure the success of a production base?

Under what circumstances can farmers join in the production chain of a processing business?

The TA made an investigation of these factors as they affect the Inner Mongolia Grasslands Xingfa Group (IMGXG).

The Dragonhead Enterprise Studied

Inner Mongolia Grasslands Xingfa Group

IMGXG is located in Chifeng City of Inner Mongolia Autonomous Region. Chifeng consists of 12 districts and counties, of which eight are national level poverty counties and two are autonomous level poverty counties. The economy of this area is generally rather backward.

Set up in 1988 and taking advantage of local resources, IMGXG developed a specific green food grassland production programme with no contamination or pollution for livestock such as broilers and sheep and goats. This has become the biggest grassland meat processing enterprise in PRC. It is a dragonhead enterprise with an integrated production package in agriculture and animal husbandry in the Inner Mongolia Autonomous Region. The company started from 300 breeding chicks, a RMB2,000 loan and a two-room single-storey house and has developed into a sizeable company today with RMB1 billion fixed assets and more than 5,000 staff. IMGXG has over 10 branch companies, either as subsidiaries or as a minority shareholder. In 1997 total turnover of the company was RMB570 million, and paid RMB59 million in profits tax, which was double that of 1996. In 1998 the turnover was RMB804 million and paid RMB88 million in profit tax, increasing more than 60% over that of the previous year. It is planned that turnover will be RMB1.2 billion and profit tax RMB130 million in 1999. Up to now, the company has built 86 chicken raising operations with 20 million broilers (each area averages about 20,000 - 25,000 broilers). It covers 10 counties and up to 6,800 farm households have benefitted, out of which about 30,000 people were classified as living in poverty. There are 10 main products in over 1,000 varieties produced now by the Group, such as hot-pot mutton of Grassland brand, dressed frozen chicken of Xingfa brand, ready-made wild animal food products and roasted meat products, pickled wild vegetables, buckwheat food and bread fortified with Calcium and Iron etc. Its products are exported to Japan, Germany, France, the Middle East and Hong Kong and there is also a sales agency in Saudi Arabia. There are also many sales agencies in over 20 large and middle sized cities such as Beijing, Tianjin, Dalian, Shenyang, Harbin, Jingzhou, Shanghai, Nanjing, Hangzhou, Yantai, Guangzhou, Wuhan, Shijiazhuang, Xi'an and Zhengzhou etc.

1998 was an important year as the Company made an adjustment to its industrial structure, product, organisation, personnel and investment, that is, the company definitely decided to make mutton production its core business and started to develop quality mutton production in Inner Mongolia. Seven local food companies (meat processing combined plants) were incorporated or leased by IMGXG in 1998. A mutton production company was founded at the production base. After renovation,
500,000 sheep were slaughtered in that year, producing 9,400 tons of good quality grassland mutton, making RMB12 million profit. In 1999, it is planned to merge 14-16 slaughterhouses at Hulunbeier grassland, Ke’erqin Grassland and Xilingele Grassland. Now five of them have been purchased. The mutton production business has a close connection with the chicken business, many resources can be shared between the two. IMGXG has formed a stable relationship with local farmers and gained their trust by applying the proven management pattern of “company+base+farm households” for mutton production base development. Meanwhile, the company paid attention to lamb fattening and grassland establishment in order to ensure its continuous development.

125 In 1998, the company developed “chicken strings” as a main high added value product. At the same time, they began to raise the breed of yellow feather broiler to replace white feather broiler. 500,000 yellow feather broilers were processed in that year. Besides, IMGXG took over the Kangsi Food Co Ltd, thus combining two large local companies in agricultural product processing. Food grains other than wheat and rice were made into fortified functional food that has become another main industrial business, examples are buckwheat, maize, pearl millet and red grain with Calcium and Iron additives. 1,100 tonnes of this type of product were produced in the same year, making RMB350,000 profit.

126 The group also established a Technical Research and Development Centre that has been joined by the Green Food Development Institute, the Research Institute of Animal Nutrition and the Poultry Disease Control Research Institute. The High-tech Food General Plant of IMGXG has successfully developed some blood and calcium tonics, making a new contribution to this sector in PRC.

127 IMGXG obtained an export permit in 1997 and trading volume increasing greatly. In 1998, the company achieved exports of 8,000 tonnes. Meanwhile, an expanding domestic market created a turnover of nearly RMB1 billion in 1998. They have set up numerous trading companies in 20 target cities, for example, Beijing, Tianjin, Harbin etc. and over 1,000 chain stores.

Boiler Feeding, Processing and the Establishment of Xinfa Group and Its Development

Boiler Feeding and Processing in 1988 - 1992

128 When Xingfa Group started in July 1988, the main industries of Baoyuan District, Chifeng City were mining, transportation, building construction and catering. But Mr. Zhang Zhengwu, the former deputy head of Wujia Town who was responsible for the agriculture sector, had seen the constraints in making the vast majority of people rich by simply relying on the four existing business lines. A new way had to be found. After a survey to local resources, he focussed on poultry farming because as people’s income and living standard increased, broiler products would have a large market. Chifeng is within the maize production area in PRC and so they could make use of maize to develop chicken farming. Thus, he co-operated with some of his colleagues who shared the same ideas and started a broiler breeding farm with RMB2,000 in loans.
129 Wujia Town Daxing Broiler Company, the predecessor of present Xingfa Group, was established at Fangsheng Village of Wujia Town on July 22, 1988. A complete broiler producing system was set up in January 1989 jointly between the township government, Fangsheng Village and the Grain Station of Wujia Town. Total investment was 1.5 million yuan, including a 4,000 tonne chicken feed mill, a 10,000 head/year parent stock breeding enterprise hatching 1 million commercial chickens per year and a 1 million chicken slaughtering and processing plant. From the very beginning, they adopted a pattern of company + farm household, namely, both company and farmers must sign a contract, within which the company is responsible to provided farmers with services such as breeding chicks, mixed feed, technical service and disease prevention. Farmers would raise the chickens and sell their entire production back to the company when they were ready. The company was in charge of processing and selling. Since then, a complete production and service system was created. The aim of the company from the very beginning was made clear that and was “to develop farmers and to develop the company, farmers and the company sharing all the risks”.

130 In 1990, broiler production enterprises comprised 203 farm households with 298,000 broilers. This year the group had a turnover of RMB7 million and RMB100,000 profit. Farm households made RMB350,000 net profit. Thus the pattern of company + farm households was confirmed. In September of the same year, they obtained an export permit from the Inner Mongolia Commercial Goods Import & Export Bureau as their broiler product reached the national hygiene standard and export hygiene standards. The Company exported their products to Japan through Jingzhou Foreign Trading Cold Storage Plant and Dalian Foreign Trading Company. Hence they established a stable relationship with Japanese clients.

Supporting Policy to Farmers in the Past

Local farmers had suffered losses in the past. Government foreign trading companies once encouraged farmers to raise broilers for export. On the one hand they had very restrictive requirements on broiler feeding and were responsible for breed supply and collection, but on the other hand they could not discharge their contractual obligations due to the fluctuation of the market, besides there were other reasons such as poor service and many losses of chickens so farmers ran a big loss. Local chicken farming had always experienced up and downs in history.

Xingfa Corporation had experienced similar serious problems before. To allay farmers fears, the company changed their policy on profit making. They started to take responsibility for farmers risks in chicken farming meanwhile allowing more profit to go to the farmers. They sold chickens and feed to farmers on credit, agreed to pay RMB7 per chicken on mortality as a subsidy and awarded 5% chicks FOC on purchase.

131 In May, 1991, Wujia Town Daxing Broiler Company was renamed as Yuanbaoshan District Daxing Broiler Company, forming a integrated enterprise joined by Yuanbaoshan District government, Wujia township government and Fangsheng village of Wujiazheng, The Company was managed according to a modern management system. The Board of Directors is responsible for policy making. The General Manager is in charge of daily operations under the leadership of the Board. The result was fruitful in terms of market development, and seven selling points were set up in Hongshan District and Yuanbaoshan District in that year.
Meanwhile, the company developed itself greatly by various means. In 1992, they merged another seven companies, the Pingzhuang Feed Mill, Pingzhang Food Company, Yuanbaoshang Food Company, Pingzhuang Xingfangsheng Pig Farm and Xingguangyuan Food Plant. Hence, RMB150 million of idle assets were put into use again. Chifeng Daxing Company reregistered their capital as RMB125.60 million this year.

Further Development and Assets Expanding in 1993-1997

Being a main sponsor, Chifeng Daxing Company united Wujia Town Business Company and Fangsheng Village Business Company of Wujia Town and founded Chifeng Xingfa Shareholding Group Company Limited by raising funds in March 1993. When the Shareholding Company was founded, it had a capital stock 63.2099 million shares. Out of this the Chifeng Daxing Company made up of 52.5286 million shares (including RMB52.5286 million of its net asset value through estimation on their equipment, building and land etc.); another two sponsors purchased 3.8813 million shares in cash and their staff purchased 6.8 million shares.

In 1996, Chifeng Xingfa Group Co.Ltd. expanded its shares to 100 million, Chifeng Food Product Company brought 36.7901 million shares with its production assets RMB58.7866 million (5,000 t cold storage, attached processing workshop, special railway and right for land use, it was valued RMB58.7866 million ). In that year the company was renamed as Chifeng Xingfa Shareholding Group Co. Lit. and it become a main profit source for all the shareholders and the company.

Set up of an Internal Marketing System

The company found that its subsidy policy did not allow them to make profits anymore as the expansion of the chicken farming went on so they adjusted their internal market system to ensure multi-benefit through a close profit effect on both company and farmers:

On the one hand the Company was continuously installing more high-tech solutions to increase the survival rate of chicks. They found out through calculation that when survival rate reached 94%, they can achieve the breakeven point. On the other hand, they managed to reduce the feed conversion ratio from 2.8 kg of feed for 0.5 kg of meat to 2.5:0.5 or 2.1:0.5. This greatly decreased the production cost.

The Company also paid attention to market changes so as to develop new products to meet the demand and to enlarge its market share. Besides, the company took a few other measures conducting a closed internal price system:

- Provided high price chicks to farmers above market price (RMB4.2 / chick).
- Provided farmers with high price feed produced by its own feed mill (RMB2.7/kg of chick starter for chicks before 21 days; RMB2.64/kg for chicks in 22-42 days; RMB2.6/kg for chicken in 43-56 days;
- It collected mature chicken with a price over market price (RMB9/kg).

Under this internal price system, both farmers and the company avoided many risks. The company will not collect chickens if the farmer does not buy the chicks from the company; if the farmer cannot reach a certain conversion ratio he cannot make a profit; if he does not sell his chickens to the company, he must run a loss.

According to present price, if the farmer can raise his chicken to 2.5 kg of gross weight with 5.5 kg of feed, then he can make 1.5 yuan/chicken of net profit. Otherwise if the farm does not use feed of the
The company in total or if he used more feed, his production cost will go up.

The Company also encourages large sized operations. Those who raise more than 100,000 chickens in the feeding lot (each lot is about 20,000 – 25,000 chickens) in about 56 days, four lots in a year, will get 1 yuan subsidy per chicken by the company allocated from the profit of its processing.

The company aimed to develop its broiler feeding and processing size first of all. In 1994, a second phase chicken slaughterhouse (5 million capacity) project started and they reached the goal in 1995. The Research Institute of Animal Husbandry and Veterinary Medicine was founded. To provide a better service to farmers, the group also set up a Chicken Feeding Service Company and created a policy of so-called “services to the door in five sectors”, including professional advisers touring around their responsible areas to offer free services. The group also built a broiler farming base, bringing it up to optimum size and standard. The policy is that farmers raised the funds, the Township or village provided land, uniform supply of water and electricity, and Xinfa group offered farm design, technical guidance, equipment selection etc. In 1995, there were 38 chicken farming ventures with a capacity of more than 100,000 chickens. Chicken farming business covered seven counties, a district and 43 towns around Yuanbaoshan region. There were 1,286 specialised broiler farming households.

Beside broiler farming and processing, they also built a feed plant, instant frozen food plant and industrialised pig farm. The group obtained a national “Green Food Certificate” for their Xingfa Brand Frozen Chicken, instant frozen dumplings and cooked food.

**Animal Breeding Department of the Company**

The Animal Breeding Department is responsible for all the technical services on chicken breeding. It has 570 staff, of which over 200 are university or collage graduates. Annual expenditure is about RMB2 million. The Department has 10 units under it, they are: breeding chicken farm, feed mill, technical service company (including 103 service centre and 110 professional staff), piggery, drug plant, green bird project department, poultry disease research institute, feed research institute and feed sales department. The company provided chicken raising farmers with "service to the door in five sectors": 1) delivery of chicks to door; 2) delivery of feed to the door free of charge with only two days notice to the feed company; 3) deliver service to door. Every 56 days the service staff must visit to the farm no less than 8 times. 4) provide vaccination to door; 5) collect chickens.

Meanwhile the group is taking every opportunity to develop markets and is starting to find markets beyond the Autonomous Region. They have not only set up chain stores and founded trading companies in Huhehot, Manzhouli, Dalian, Tianjin but also exported products to Japan, Rassia and the Middle East. In 1996, they exported chicken meat and pork 3,000 tons. In this year, the Group had total assets of RMB500 million and over 3,000 staff.

**Chicken Farming Enterprises and Chicken Feeding Farmers**

Henan Village, Xizi Town, Ningcheng County with a land area of 920 ha. in total, has 564 families of 2,047 people. In 1996, 24 chicken units were set up in the village, covering 3.7 ha. of land and with total investment of RMB350,000, consisting of RMB150,000 in loans from credit co-operatives, RMB50,000 in poverty-relief funds, and the balance RMB150,000 was raised by farmers. By 1998, their annual capacity was 100,000 chickens and net income amounted to RMB350,000-RMB400,000. On top of this, they could get 0.5 million kg of chicken manure using it for pig farming, (wet manure price: RMB120/m³, for a 2,000 chicken farm, he could earn RMB2,400-2,800 more from
chicken manure sales), so all the chicken feeding farmers recovered their investment in one year. Before chicken farming, average annual income per capita in the village was around RMB800-900, in 1998, it was up to RMB1,550/capita.

Mr Liu Zhengwen, a villager, who has a family of four, was once a bricklayer and served in the army. In 1978, he returned to his hometown to do field work without a stable income. He began chicken farming with RMB14,000 (incl. RMB2,000 of his own, RMB6,000 from credit co-operative and the balance borrowed from his friends). He recovered his investment in total in 1997 and earned RMB10,000 of net profit in 1998.

All the feed, chicks and animal drugs were offered on credit, monthly interest was 3 fen in the past and now it is 2 fen/month.

Annual income from chicken farming is around RMB12,000-16,000, while it is merely RMB2000 if working on land. Besides, chicken manure can be used for pig farming. At the same time it can also reduce about RMB1,000 in the cost of fertilizer.

138 The year of 1997 was a turning point in the history of the Grassland Xingfa Group. Inner Mongolia Xingfa Shareholding Co.Ltd. issued RMB40 million in one RMB normal shares to the public on May 19 and started trading on Shengzheng Stock Market on June 6. In September, 1998, Inner Mongolia Xingfa Shareholding Co.Ltd. changed its name to Inner Mongolia Grassland Xingfa Shareholding Co.Ltd.

139 The Shareholding Company raised RMB216.8 million funds with which they purchased 14 poorly-operated enterprises by merger, purchasing, leasing or trust managing from former Northern High-tech Industrial Zone of Ankang Group and Baoyuanshan Forest Farm etc. The re-organised assets amounted to RMB300 million. According to the policy of poverty-relief of Inner Mongolia, it was decided that the agricultural and animal product processing in light-textile industry would be taken as No.1 main stay industry in the Autonomous Region. Thus the broiler and pig feeding and processing package of Grassland Xingfa Group became the most successful poverty-relief project in this Region.

140 To implement the poverty relief project, Grassland Xingfa Group turned their eye beyond areas of north and west. 20 poverty-stricken areas and counties rich in maize production were selected. They made use of local poverty-relief funds and existing breeding farms, feed mills and meat processing plants, reactivating these assets and renovating them. Following the pattern of "company+production base+farmers", Grassland Xingfa Group set up an integrated production system for chicken, pig farming to processing-marketing-service in one chain. The Group invested in management modelling and software operation, management, technology, brand and marketing (providing parent chicken stock, breeding pigs, feed additives and drugs) to the base banners and counties. All the processed products must use their brand "Grassland Xingfa Brand".

141 With the opportunity of stock sales to the public, the company speeded up their progress. In 1997, the third phase enlargement project was under way. They renovated and built a broiler processing plant with a capacity of 20 million broilers, a 72,000 grandparent chicken breeding farm, a 150,000 tonne feed mill. Besides, they also built a new pickled vegetable plant, an organic food plant, a hot-pot mutton processing plant.
A New Processing Industry: Mutton Processing

Background of Grassland Development

142 Being the biggest animal farming base in the border area of PRC, Inner Mongolia covers 1.18 million square kilometres of land. Xiling Gele Grassland, Ke'erqing Grassland and Hulun Beier Grasslands are rich in water and grass for cows and sheep/goats. On the grassland of Inner Mongolia, there are 55 million head of livestock, most of them are sheep/goats.

143 In recent years, as people's living standard has risen, demand for mutton has increased due to its high protein content, low fat and tonic effect. The Sunit and Wuzhumuqin sheep/goat breeds in Inner Mongolia are very popular on the market. But most of the sheep/goats were sold live to other provinces, and prices and market were unstable. The herdsmen's life showed no big improvement. The advantage of good resources could not be converted into money.

144 From production point of view, traditional farming is grazing. A herdsman can only increase their meat production by enlarging the number of sheep/goats, in the long run this would cause an excessive stocking rate on the grassland and ultimately degrade it. Being a dragonhead firm, IMGXG decided to start a grassland mutton industry depending on its own resources, extending its industrial chains and supporting poor herdsmen.

Building Production Bases

145 Traditionally cows and sheep/goats had been kept by individual herdsman in extensive systems and consumption for mutton is very small. Most of it was sold out of the region. But some meat companies went bankrupt due to poor operation and financial problems. How then was it possible to make good use of the rich resources, converting these into value-added products through processing and establishing a No.1 mutton brand in PRC? IMGXG merged the meat food companies on the grasslands beyond its area in 1998 and 1999.

In 1998:


2) Xiwuqi Haiyinhua Food Product Plant: built in 1992 and was put into operation in 1993. Total assets RMB14 million, storage capacity: 500t.

3) Grassland Meat Processing Plant of ZhengLan Banner: Total assets RMB14.6 million. It is a 500 t cold storehouse.

4) Sunite Zuo Banner Food Product Plant: Total assets: RMB118 million, storage capacity: 750 t.

5) Chifeng Linxi County Food Plant: built in 1998. It was Linxi County Food plant in the past. Total assets RMB8.99 million, storage capacity: 500t.
6) Aohan Grassland Meat Product Plant: the former Aohan Banner Food Product Company. Total assets RMB12 million, storage capacity: 500t. It is the first state-owned company purchased at low cost by the Group beyond the area.


In 1999:

1) Dongwu Banner Muslim Food Plant: total assets: RMB21 million, storage capacity: 1050 t.

2) Arbaga Food Product Processing Plant: total assets: RMB8.34 million, storage capacity: 350 t.

3) Chifeng City Balin Zuo Banner Food Plant: total assets: RMB12 million, storage capacity: 500 t.

4) Zhelimumeng Huolin River Food Plant: total assets: RMB11 million, storage capacity: 500 t.

5) Ximeng Duolun County Food company: total assets: RMB10 million, storage capacity: 300 t.

**Asset Status and Means of Procurement (or lease) of Mutton Sheep Bases before Merging.**

At present, the group has 11 meat sheep production bases distributing in Xilin Gele League (an administrative division of Inner Mongolia Autonomous Region, Corresponding to a prefecture), where there are 6 bases, Chifeng City (having 4 bases) and Zhelimu League (having 1 base). Their asset status and means of procurement before merging were as follows:

**Xilin Gele League:**

1) Xilin Gele Meat Sheep Base: Located in Xilin Haote City. It was a cold storehouse of Xilin Haote City. Total assets: RMB15 million, net asset: RMB12 million. Leasing period: 20 years. Paid RMB2.38 million at one lot for leasing fee.

2) Dongwuzu Muqin Banner Meat Sheep Base: located in Wuliyasitai Town of Dongwuzu Muqin Banner. It was once a cold storehouse of Dongwuzhu Muqin Banner Food Company. Total assets: RMB21 million, Leasing period: 20 years, paid RMB2.58 million at one lot.

3) Xiwuzu Muqin Banner Meat Sheep Base: located in Bayanhua Town of Xiwuzu Muqin Banner. It was once a cold storehouse of Xiwuzhu Muqin Banner Food Company. Total assets: RMB14 million, net assets: 10.9 million. Leasing period: 20 years, paid RMB1.8 million at one lot.

4) Zhenglan Banner Meat Sheep Base: Located in Dundahaote Town. It was former Zhenglan Banner Food Product Company. Total assets: RMB14.6 million, net assets: 11.67 million. Leasing period: 20 years, paid RMB1.58 million at one lot.

5) Arbagar Banner Base: Located at Xinhaote Town of Arbagar Banner. Its former was Arbagar Banner Feed Product Company. Total assets: RMB8.34 million, net assets: 3.9 million. Leasing period: 20 years, paid RMB1.3 million at one lot.

6) Sunitezuo Banner Meat Sheep Base: Located at Mandulatu Town of Sunitezuo Banner. It was once a food product company. Total assets: RMB11.8 million, net assets: 8.7 million. Leasing period: 20 years, paid RMB1.8 million at one lot.
Chifeng City:

1) Arlu Kerqin Banner Meat Sheep Base: Located at Tianshan Town, Arlu Kerqin banner. It was a former banner food company. Total assets: RMB14.9 million, Way of collection: paid RMB0.2 million each year, leasing period: 20 years,

2) Baqizuo Banner Base: Located at Lindong Town of Balinzuo banner.

Former banner food company had total assets RMB13 million, The company brought by RMB1.18 million at one lot for permanent ownership,

3) Linxi Meat Sheep Base: Located in Linxi County. Former food company had total assets RMB8.99 million, net assets: RMB3.67 million. Paid by RMB2 million at one lot for permanent ownership,

4) Aohan Banner Meat Sheep Base: Located at Xinhui Town. The former banner food company had total assets RMB12 million. It was paid by RMB1.5 million at one lot for a permanent ownership.

Zhelimu League:

Huolingele City Meat Sheep Base: It was once the cold storehouse of the city: Total assets were RMB11 million. Paid by RMB1.18 million at one lot for permanent ownership.

146 Purchases of some other food companies such as Arbagar Meat processing Plant, Hailar State Farm Food Processing Plant are under negotiation. It is expected that 14 - 16 food processing plants will be merged or purchased in 1999. The group basically covers the best resources on animal husbandry of Inner Mongolia Grassland. In 1998, it collected 0.5 million live sheep and processed these into mutton products of 30 kinds such as common mutton rolls, fine mutton rolls, mutton slices, tail meat slices etc. They achieved popularity among consumers. Especially its newly developed sauce for hot-pot meat became well known. They sold 9,400 t of mutton and mutton products in the whole year.

147 For the purpose of their market, their brand fame and improving their sales network, they have set up over 20 branch companies recently to conduct sales promotion in cities such as Beijing, Tianjin, Harbin, Shanghai, Guangzhou Xi'an etc. Meanwhile, they also cooperated with restaurants over PRC, founding "Xinfa Hot-pot Garden of Grassland" to promote their lamb meat.

Technical Improvement

148 Since traditional ways blocked the development of animal husbandry in Inner Mongolia, IMGXG has made a great effort to introduce and extend practical techniques on seed use, cattle and sheep fattening, artificial grassland establishment, disease prevention and treatment, water saving and animal product processing. They also paid attention to technical services including advising and training.

Production Base Improvement

149 There are 86.7 million ha.(1.3 billion mu) grassland in Inner Mongolia, that are desertified and deteriorating seriously due to human influence and natural factors.
Being the dragonhead firm for fattening sheep integrated production, IMGXG not only made use of the natural resources, but also improved the quality of production bases, that is one of their main aims of developing sheep farming. This has resulted in good development in both grassland construction and environmental ecological improvement.

**Lamb Fattening**

**Demonstration on Lamb Fattening**

Mr. Hao Zhizhong is a herdsman of Huangqi Brigade in Xilinguole League. He was chosen to build a private demonstration farm. He has 1,400 sheep so far and 150 cattle, in which 10 are black and white cows and 14 horses. It is expected that he will have about 400 young animals born. He has 233 ha of grassland with two net fences, covering 120 ha of pastures, including over 30 ha of artificial pastures. On top of this, he was allocated another 67 ha, of land for feed and grain production. So every year he can make 125,000 kg of green hay and 75,000 kg of grass silage. He also has 5 plastic green houses covering 480 m² and 240 m² of ordinary green house; 2 grass storage circled fences amounting to 600 m², 1 silage pit, 5 feeding and exercise yards amounting to 1,800 m². 1 small sized tractor, 2 grass choppers, 1 feed grinding machine and a set of grass collecting equipment. Information on his brothers and sisters:

<table>
<thead>
<tr>
<th>Name</th>
<th>Sheep</th>
<th>Cow</th>
<th>Horse</th>
<th>Agro-Equipment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hao Zhigang (elder brother)</td>
<td>420</td>
<td>0</td>
<td>16</td>
<td>1 big track, a set tractor</td>
</tr>
<tr>
<td>Hao zhiqiang (second)</td>
<td>530</td>
<td>76</td>
<td>40</td>
<td>1 small tractor, 1 set of grass collecting equipment</td>
</tr>
<tr>
<td>Hao Zhizhong (third)</td>
<td>560</td>
<td>52</td>
<td>10</td>
<td>1 small tractor, a car and a set of grass collecting equipment</td>
</tr>
<tr>
<td>Hao Zhijun (fourth)</td>
<td>560</td>
<td>42</td>
<td>80</td>
<td></td>
</tr>
<tr>
<td>Hao Fengxia (elder sister)</td>
<td>560</td>
<td>72</td>
<td>40</td>
<td>1 small tractor, 1 set of grass collect equipment</td>
</tr>
<tr>
<td>Second sister</td>
<td>360</td>
<td>82</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>Third sister</td>
<td>300</td>
<td>30</td>
<td>65</td>
<td>a combine (jointly with second sister)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>3,210</strong></td>
<td><strong>384</strong></td>
<td><strong>261</strong></td>
<td></td>
</tr>
</tbody>
</table>

Grassland: 896 ha. 467 ha (fenced)
The herdsman consciously cooperate with their relatives. They began to carry out investment in different sectors avoiding duplicate purchase of the same equipment.

The foundation of production bases has given more opportunity for employment and the industry has prospered. Inner Mongolia has 86.7 million ha. of pastures and over 55 million head of livestock, the largest portion is of sheep. To convert these resources into economic units, industrialisation is the right way to go. Being the dragonhead firm of the sheep fattening project, IMGXG plays a leading role in bringing animal husbandry development into a modern state. They provide all kinds of services and techniques to the herdsman, for example, lamb fattening, disease prevention and control, feed mixing, breeding.

To supply the market with lamb meat all year round and to keep the company more dynamic, the Group greatly promote lamb fattening skills to herdsman. This project selected 1,200 common households, 2,000 large sized farm households, 375 poverty farmers and 500 breeding stock farms. A certain amount of money will be invested in it and support will be given to them in pasture and animal shed construction and breeding stock. After the project, lamb fattening farmers and big sized farm household had 366,700 more animals. Their profit per animal averages RMB84. The poverty households will be out of poverty within 2 years if each is given 40 lambs. The project will take 1,625 households out of poverty. Up to now, there are two banners and one county having signed contracts with herdsman in a sum of
RMB0.6 million investment totally. Outside the project, there are 20,000 fattening lambs in 200 households in Zhenlan Banner, 40,000 lambs in 150 households in Suzhuo Banner, 25,000 lambs in 250 households in Xiwu Banner. In total 85,000 lambs in 600 households.

**Fund Issued to Sheep Fattening Project in 1998: Zhenglan Banner**

<table>
<thead>
<tr>
<th>Name</th>
<th>Unit Price (RMB/lamb)</th>
<th>Fattened Lamb Value</th>
<th>Place</th>
<th>Issued</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hu Yage</td>
<td>100</td>
<td>20</td>
<td>2,000</td>
<td>Shangduhe Sumu</td>
</tr>
<tr>
<td>Wurijin</td>
<td>100</td>
<td>30</td>
<td>3,000</td>
<td>Shangduhe Sumu</td>
</tr>
<tr>
<td>Buhe</td>
<td>100</td>
<td>20</td>
<td>2,000</td>
<td>Shangduhe Sumu</td>
</tr>
<tr>
<td>Wang Hailiang</td>
<td>100</td>
<td>15</td>
<td>1,500</td>
<td>Shangduhe Sumu</td>
</tr>
<tr>
<td>Burenzhaoketu</td>
<td>100</td>
<td>30</td>
<td>3,000</td>
<td>Shangduhe Sumu</td>
</tr>
<tr>
<td>Qiao Jiancai</td>
<td>100</td>
<td>100</td>
<td>10,000</td>
<td>Shangduhe Sumu</td>
</tr>
<tr>
<td>Hao Zhizhong</td>
<td>100</td>
<td>500</td>
<td>50,000</td>
<td>Shangduhe Sumu</td>
</tr>
<tr>
<td>Hu Richa</td>
<td>100</td>
<td>40</td>
<td>4,000</td>
<td>Zhuolunhe Sumu</td>
</tr>
<tr>
<td>Du Lijun</td>
<td>40</td>
<td>130</td>
<td>5,200</td>
<td>Hangkela Sumu</td>
</tr>
<tr>
<td>Geriletu</td>
<td>100</td>
<td>20</td>
<td>2,000</td>
<td>Shangduhe Sumu</td>
</tr>
</tbody>
</table>

In total: RMB82,700 fund, 905 fattening lambs, 10 households. There are more herdsmen intending to sign contract.

**Fund Issued to Lamb Fattening Project in 1999: Sunitezuo Banner**

<table>
<thead>
<tr>
<th>Name</th>
<th>Fattened Lamb</th>
<th>Assisted Fund</th>
<th>Place (at Sumu)</th>
<th>Issued</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sujilatu</td>
<td>400</td>
<td>20,000</td>
<td>Bayanbaolidao</td>
<td>14/05/99</td>
</tr>
<tr>
<td>Hadaraooqier</td>
<td>200</td>
<td>10,000</td>
<td>Bayanbaolidao</td>
<td>14/05/99</td>
</tr>
<tr>
<td>Chaganchaolu</td>
<td>800</td>
<td>40,000</td>
<td>Bayanbaolidao</td>
<td>14/05/99</td>
</tr>
<tr>
<td>Wang Dianping</td>
<td>600</td>
<td>30,000</td>
<td>Bayanbaolidao</td>
<td>14/05/99</td>
</tr>
<tr>
<td>Daoerji</td>
<td>1,000</td>
<td>50,000</td>
<td>Changtuxile</td>
<td>17/05/99</td>
</tr>
<tr>
<td>Suylatu</td>
<td>80</td>
<td>4,000</td>
<td>Changtuxile</td>
<td>17/05/99</td>
</tr>
<tr>
<td>Gerilechaogetu</td>
<td>80</td>
<td>4,000</td>
<td>Changtuxile</td>
<td>17/05/99</td>
</tr>
<tr>
<td>Wurigarxiliartu</td>
<td>80</td>
<td>4,000</td>
<td>Changtuxile</td>
<td>17/05/99</td>
</tr>
<tr>
<td>Li Baoer</td>
<td>60</td>
<td>3,000</td>
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In total: assisted fund: RMB200,000, fattening lamb: 4,000, households: 15.

**Fund Issued to Lamb Fattening Project: Xiwuzhumuqin Banner**
Special fund for lamb fattening: RMB200,000
No. of households in the project: 25
No. of fattened lamb by each farm: 80
Fund allocated to each lamb: RMB40
Location of the project: Yigazhar Village, Harrigentai Sumu
Issued Time: May

**Targets in Future**

153 As a dragonhead firm, Grassland Xingfa Group will continue to carry out the integrated production programme. In 1999, 25 more food processing plants are due to be taken over. The purpose of the plan is to increase company capability in resource control and unified management. Besides, it is planned to collect 0.6 million fattened sheep and produce 15,000 t of mutton products.

154 To reach the set target, the firm must promote pasture development and lamb fattening programmes at the same time, since desertification of the grassland has been very serious in recent years. IMGXG is set to become the biggest meat processing and exporting company in PRC in the near future.
Summary

This paper reviews international approaches to rural infrastructure development and the impact of different rural infrastructure types on poverty. In its introductory section it considers the impacts in terms of their broad effects on quality of life (QOL). It then reviews the emerging trends in rural infrastructure development covering the increasing role of the private sector, institutional reform, the development of smaller projects and the need for participation. Subsequent sections consider the issues associated with poverty reduction for electricity, roads, irrigation, water supply and telecommunications and discuss a range of policy issues. Lessons that are of value in the PRC context are derived.

The importance of developing infrastructure has long been recognised as central in promoting economic growth. In rural areas it has wide ranging impacts on individuals, households and communities both in terms of income and other quality of life indicators. There are both direct and indirect benefits from infrastructure development and it is important to consider the indirect benefits in decision-making about infrastructure projects. Education, for example, can affect income and health both of that in turn affect quality of life. There are also strong social benefits from infrastructure that need to be taken into account. Economic benefits such as increased income, employment, productivity gain, better income distribution and opportunity for diversification are obvious. Social benefits such as time savings, school enrolment levels, access to health services, environmental improvement, skill development, capacity building, improved information and gender impacts are less transparent, but in the longer term may be as or more effective in poverty reduction because they lead to sustained improvements in quality of life independent of income sources.

Four trends are noticeable in the development and implementation of infrastructure projects: the increasing incorporation of incentives to involve the private sector in the provision of infrastructure financing; a greater concentration on institutional and regulatory reform; an increasing focus on smaller scale projects; and increasing stakeholder involvement in design and maintenance of projects.

Governments have often performed poorly in the provision and maintenance of infrastructure and interest in private sector involvement is increasing. Governments also do not have the resources and annual private capital investment in infrastructure in developing countries increased from $100 million in 1988 to $20.3 billion in 1996. Private sector investment now accounts for about 15 percent of total investment, focused on power, telecommunications and roads. Development assistance also substantially makes up for government’s own lack of resources with between 25 and 40 percent of funding going to infrastructure projects. Although the private sector faces risks in infrastructure investment, governments should not assume these risks on its behalf because it encourages inefficient investment, and the guarantees that have been provided have often been to compensate for structural problems such as low user fees, macroeconomic mismanagement and inefficient state enterprise. A better approach is to bring about regulatory reform. This at once improves efficiency and makes the environment for private investment more attractive. In Latin America for example, the introduction of formal bidding procedures and tariffs that reflect costs of services have encouraged private investment. Technological advances, for example in the case of small power plants and solar energy, have meant that small
scale projects, more suited to less densely populated rural areas can be made profitable. However, in the donor sector, although this apparently receives support, small-scale rural projects are not yet common. This in part stems from the major donor’s need for large overall loan sizes, a lack of mechanisms for implementing a large number of small projects using one large loan, and perceptions about the lack of profitability of such investments. Decentralisation of responsibility for local level infrastructure, past poor performance, global democratisation, and delays arising from public protest are factors contributing to greater participation by beneficiaries in infrastructure design. Creating participation also creates ownership and can contribute to more effective operation and maintenance as a result. However, decentralisation needs balancing by oversight to ensure an equitable distribution of funding and that the benefits are not captured by the non-poor. Participation may also promote new approaches that make small-scale infrastructure economically viable where it might not have been before. For example, working with the poor and microfinance organisations to establish schemes for infrastructure access (the relatively large capital payments for electricity connection and water supply installation may be prohibitive if paid at one time) or flexible timing of payments to fit household cash flows (for example prepayment at harvest when there is cash available) may create viability.

Electricity seems to be most beneficial in terms of QOL gains (extended working hours, opportunities for evening study, introduction of labour saving appliances) and has differential gender impacts. Businesses can also benefit and new business opportunities (using different tools or opening at different hours) become available. However, electricity on its own does not push ahead development and growth in the absence of other infrastructure (or other assets for the poor) and it is concluded that it should only form part of a package or bundle of infrastructure investment, and then only where there are roads, growth potential in agriculture, population concentrations, generally improving living standards because of other factors, plans for regional development and proximity to the power grid. The latter condition is modified where solar power can be used. The need for complementarity must be taken into account in the design. Tariff policy is also important because subsidies are unsustainable and result in misallocation of resources. Where there is a need for welfare because of extreme poverty, discounted “lifeline” rates can be charged, but the full costs should be recovered through the tariff structure for other consumers, not from the government budget.

Roads have generally been viewed as the most important economic infrastructural development. Benefits for poor rural areas include lower transport costs, lower prices, expanded extension services, and greater free time because of substitution of goods (for example kerosene for firewood resulting in less time spent collecting the latter). However, the research shows that the prior social and economic context of where roads are located matters in their eventual impact on development and the need for complementarity of investment is also demonstrated in this sector. The policy environment is also important. Road development can create landlessness, and can result in larger landowners gaining a greater share of the benefits because of their greater access to other resources such as credit. However, in the right context roads bring better access to markets, higher prices for produce, and better

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1 This conclusion from elsewhere is being tested under the pilot project for this TA in PRC.
access to health and education facilities. Upkeep has been a persistent problem with rural road development. ILO argues for a labour intensive approach to construction and maintenance, but while voluntary labour can be used for construction it has not proven a good approach to maintenance. Project design must include clearly identified funding for maintenance, which can be contracted to the private sector if appropriate and can have further poverty reduction impact by creating on-going employment.

Irrigation projects have also suffered from a lack of operation and maintenance funding and have been biased towards larger farms and high cost solutions. Other common problems with irrigation have related to water management and user fees. Research suggests that participation at all stages in irrigation projects is the best means to ensure on-going maintenance and adequate cost recovery. There are also advantages to involving users directly in management of irrigation projects. Water has many uses, and there are common and potentially conflicting interests among users. Water availability and quality are potential sources of conflict. However, few countries have involved stakeholders in this way, and where they are involved they have mainly been farmers using water for crop irrigation rather than drawn from the wider community of water users. Research also shows that community water management works better where there is a high level of social capital and social and economic homogeneity. The income benefits of irrigation accrue through increased yields for those who have land. Benefits for the land poor also accrue, because water can be used for livestock and domestic purposes, they can gain from employment created through the intensification of agriculture. They can also temporarily gain from employment in construction. Innovative schemes have also found ways to further capitalise on irrigation development for the land poor. In India and Nepal for example, water rights have been allocated on a household basis, and land poor households have been able to sell this asset to those with more land. In Bangladesh, microcredit has provided groups of land poor with the means of drilling wells and pumping to supply water to other users.

Safe domestic water supply is central to poverty reduction. It can reduce disease and morbidity, and raise productivity because of timesavings in collecting water. However, there has been less successful financing of water supply by private capital than for other types of infrastructure. Reasons advanced are that water services are normally under the control of local government which may be less accountable than national government; the condition of infrastructure is difficult to assess because it is often below ground; and perceptions that water is a right for all encourage its supply even to those who cannot pay. Researchers suggest that independent regulatory bodies and increased competition are the way to encourage the private sector, but this does not address supply to the poorest. Sustaining water supply projects also requires similar stakeholder participation to that of irrigation projects.

Telecommunications are an increasingly important contributor to poverty reduction. Information about prices for outputs and raw materials can be made more accessible to farmers. Radio, TV and Internet can enhance the learning of rural schoolchildren and can make up for deficiencies in teachers. Rural medical and relief workers can get assistance and advice. Communications can be used to reduce the impact of natural disasters and the spread of disease. Competition to bring costs down needs to flourish for successful telecom development and to attract private sector capital. World Bank research suggests various organisational models for private sector
participation: revenue sharing concessions, joint ventures, and rural co-operatives. Some concessions in terms of costs: for example tax relief or finer interest rates may be appropriate where there are barriers to market entry or markets will take time to yield satisfactory returns on investment.

In drawing lessons for PRC from the international experience, it is concluded that: institutions matter and good governance at all levels effects the poverty reduction outcome of infrastructure projects; sustainability depends critically on planning for maintenance and repairs and setting tariffs sufficiently high; viability can be greatly increased through user participation and management of projects, most effectively where there is a high degree of social capital and homogeneity among stakeholders; oversight is necessary to prevent the poor being excluded from the gains; and access to other types of soft infrastructure such as extension and credit can enhance the impact.
Introduction

1 Policy makers and donors have long understood the linkage between infrastructure and enhanced quality of life (QOL) outcomes in developing countries. Since the publication of the 1994 World Development Report that focused on infrastructure, it has been a priority of the international policy community2. Without investments in infrastructure, poor countries are likely to fall further behind. At the same time, however, there is a recognition that the results of many infrastructure projects have failed to live up to expectations3 4. Problems include inappropriate design, poor maintenance and deteriorating infrastructure5.

2 The impact of infrastructure provision in rural areas is potentially enormous and related to improving individual, household and community welfare and quality of life. As an indicator and goal of development, quality of life is increasingly replacing an earlier focus on income. The work of economist Amartya Sen6 and others has shown that social indicators such as health or education do not always go hand in hand with per capita GDP; China and Sri Lanka, for example, have better social outcomes than some countries with higher incomes. This suggests that development is a much broader concept than simply income growth and measures such as the UNDP’s Human Development Index attempt to capture this complexity.

3 From a policy point of view, it is not simply that a broader set of indicators for assessing development is warranted, but rather that there may be important interlinkages among different factors as shown in Figure 1 7. In particular, there may indirect benefits and links associated with investments in the different factors that policy makers need to take into account. While standard cost-benefit analyses look at the direct effects of policies, viewing the determinants of QOL as an interlinked system means that there may be social multiplier effects associated with investments. In the case of infrastructure, there may be direct improvements to quality of life or income, but there may be indirect ones as well.

5 World Bank, 1994, ibid
7 Bloom D E, P H Craig and P N Malaney, Forthcoming, “The Quality of Life in Rural Asia: Peril and Promise”
4 For example, there are direct economic effects. Poverty reduction is an especially important aspect of rural infrastructure. At the macro level, the stock of infrastructure is linked to a country's competitive position and thus to jobs, investment and export earnings. Labour intensive construction of infrastructure projects may also have a poverty reducing impact, provided the poor are paid for their labour. Rural roads allow farmers better access to agricultural inputs like fertiliser and allow them to better market their surpluses. Irrigation can permit farmers to cultivate their land more intensively and sometimes increase the number of crop cycles, which may allow them to move out of subsistence production and into cash production.

5 In addition, infrastructure such as roads may offer indirect benefits on rural quality of life by allowing people greater access to social services such as health clinics or schools. Health benefits in terms of reducing mortality and morbidity are outcomes associated with the provision of safe drinking water and sanitation. This is an example of a social multiplier, because better health is not simply a good in and of itself, but is also linked to higher incomes because, as many authors have shown, healthier individuals have higher productivity and are more likely to be in the labour force. Similarly, if infrastructure investments allow children better access to

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11 World Bank, 1994, ibid

schooling, improve their attendance or allow them to study more, this may lead to indirect, long run benefits in terms of higher productivity or income.

6 The gendered nature of the impact of infrastructure is another area that is receiving increasing attention. Women (and also children) often spend a great deal of time in activities related to basic subsistence such as getting water or fuel. Thus the introduction of wells or electricity for household use may have significant labour savings which can then be put to productive uses (or in the case of children, may allow families to send them to school) such as farming more land or tending to diversified crops.

7 There are also environmental impacts from infrastructure projects. These may be positive, for example, in reducing deforestation by providing alternatives to firewood such as biogas for domestic use, or negative in the form of increased pollution with projects like coal mining.

8 Infrastructure investments have the potential to have positive impacts on the life quality of poor rural inhabitants. Policy makers concerned with poverty reduction tend to focus on the economic effects, such as changes in household income as the result of infrastructure projects but from a quality of life perspective, there are a number of other potential benefits. Because these may be related to further income gains, they should not be dismissed, even by those policy makers whose main concern is the bottom line. Here, the economic and social benefits from infrastructure that together can mean an enhanced quality of life are specified:

**Infrastructure Impacts on Quality of Life**

<table>
<thead>
<tr>
<th>Economic</th>
<th>Social</th>
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<tr>
<td>Increased income</td>
<td>Time savings</td>
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<td>Employment creation</td>
<td>Education (enrolment)</td>
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<td>Productivity gains</td>
<td>Health (access, reduced costs)</td>
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<tr>
<td>Distribution of income</td>
<td>Environmental</td>
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<td>Diversification (micro-enterprise,</td>
<td>Skill development</td>
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<td>natural resource development)</td>
<td>Capacity building</td>
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<td>Increased information</td>
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<td>Gender impacts</td>
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**Experience and Evolving Approaches**

9 While most development specialists agree that infrastructure investments are essential for raising household and national income, the fact that many infrastructure projects have failed to realise the expected benefits has led funders to focus on ways to improve the development and implementation of infrastructure projects. Four trends are notable in the financing of rural infrastructure:

- the increasing incorporation of incentives to involve the private sector in provision and financing of infrastructure;
- a larger focus on the need for institutional and regulatory reform;
- an increasing focus on smaller infrastructure projects; and
• increasing stakeholder involvement in design and maintenance of projects.

**Private Sector Financing**

10 Because of the often poor performance of governments in extending, providing and maintaining infrastructure, many are now looking to the private sector as an important actor in both financing and delivering infrastructure services. In addition, the investment needs in infrastructure exceed what many third world governments are capable of providing. The participation of the private sector has risen enormously in the past decade, with foreign investments in financing infrastructure projects in developing nations growing from only $100 million in 1988 to $20.3 billion in 1996 and the expectation that private sector investment will account for about 15% of infrastructure spending in developing countries by the year 2000. Power is the most important sector to attract private finance, followed by telecommunication and transportation.

11 In addition to private finance, infrastructure has been a major focus of development assistance and loans. For example, 31% of the World Bank's loans in 1996 and 25% of OECD aid went to finance infrastructure projects. In some regions, these figures have been higher, as in Africa where 40% of World Bank loans in the last thirty years have gone to transportation, communications, water and power.

12 Despite the rapid increase of private investment in infrastructure, the overall rise has been lower than the increase of private capital flows to developing regions in general. This is the result of political pressures to keep prices of infrastructure goods such as electricity or water below the cost of producing them and because the typical time horizon of infrastructure investments is long (ten to thirty years) and during that time, investors are exposed to huge risks. These risks include currency fluctuations and the ability of governments to sustain the original conditions of contracts.

13 Generally, the riskier the perceived conditions in a country, the greater the guarantees the government will be expected to assume by private investors. The question of what risks governments should be held accountable for is a matter of some debate. While governmental assumption of risk is a way to attract investment, most economists believe that it creates higher costs and negative incentives for sound management. While risks such as expropriation or currency convertibility...

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16 Anayiotos A, N.D. "Infrastructure Investment Funds" in Public Policy for the Private sector series, Private Sector Development Department, World Bank
17 Dailami and Klein, 1997, ibid
18 Overseas Development Institute, 1998, "Mainstreaming Public Participation in Economic Infrastructure Projects", Briefing Paper
19 H H Farah, 1998, ibid
20 Dailami and Klein, 1997, ibid
make sense for the government to assume since those are directly under its control, aspects such as construction cost or future demand and even currency depreciation should be borne by investors. Having the government shield against these risks encourages investors to make unsound investments for which the taxpayers in developing countries often wind up paying 21. Often, such guarantees are a way of dealing with fundamental structural problems of low user fees, macroeconomic mismanagement and inefficient state enterprises 22.

Institutional and Regulatory Reform

A better strategy than relying on a host of government guarantees is to undertake institutional and regulatory reform 23. Indeed, such reform to make the environment amenable to infrastructure investors and entrepreneurs is a major goal of the economic adjustments pursued by lenders such as the Inter-American Development Bank in Latin America 24. There are a number of steps governments can take to encourage private investment in infrastructure projects. These include:

- having formal, competitive bidding processes for projects;
- creating a stable macroeconomic environment;
- allowing tariff increases that reflect costs of services;
- improving project management, including considering privatising the management of projects;
- dialoguing with project developers throughout the project to reduce risks; and
- improving information flows about projects.

New Financial Tools for Infrastructure

Equity funds are an increasingly popular means of attracting international investments for infrastructure in developing countries. Through these, institutional investors in the developed world can create a diversified portfolio of infrastructure investments in growth sectors such as power, telecommunications and transportation. There are a variety of mechanisms for this. Local companies can issue equity or bonds in international capital markets or multinational corporations may issue securities and then invest the funds raised in global infrastructure projects. By investing in a variety of projects and working with countries and firms with a sound history of financial management, these equity funds can lower the risks associated with infrastructure investments.

From: Anayiotos A, N.D. "Infrastructure Investment Funds" in Public Policy for the Private Sector series, Private Sector Development Department, World Bank

Project Scale

21 Thobani, 1999, ibid
22 Dailami and Klein, 1997, ibid
At the same time that better management and regulation is advocated to reduce costs of projects, there is a trend, at least at the rhetorical level, to focus on smaller projects. Technological advances, as in the case of electricity, may facilitate this where small power plants of 50 megawatts can be profitable. Yet, it is also the case that large, complex infrastructure projects may raise costs because they drive up legal and financial expenses involved in protecting against risk. While there has been a public commitment on the part of agencies such as the World Bank to finance more small and medium sized projects, some critics point out that there has been little increase in lending for smaller infrastructure projects to date.

Stakeholder Participation

Another extremely important trend in infrastructure development and provision is finding ways to involve the public, or stakeholders in projects. There are several reasons for this trend. In part, it is related to issues of decentralisation, accountability and community empowerment that are currently on the agenda of national and international policy makers. Because the state is no longer regarded as capable or particularly efficient at providing good and services, there is a move to shift provision either to the private sector or to lower administrative levels (regional or local) in order to better respond to citizen demands and preferences. The poor performance of many state enterprises in providing infrastructure is one of the common arguments for more consumer involvement. Global trends towards greater democratisation are also impelling these changes.

Another reason for the focus on participation is that doing so can cut down on costs associated with projects. Delays that may result from the protests of those affected by projects have resulted in increased costs and embarrassment to funders. Also, beneficiary consultation and involvement in projects may improve performance of projects in the long run. Programmes where the community is involved and coordinated by local officials or NGOs are generally more successful than where such participation is lacking. In addition, cost-recovery may be easier when consumers feel that services are meeting their needs or that they have some recourse in case of dissatisfaction. There is also some evidence that labour relations in projects with public consultation may be better. For all of these reasons, many donor and lending agencies as well as some private corporations now insist on the prior and continuous consultation with project beneficiaries.

There is scope for beneficiary involvement in both large-scale and small infrastructure projects. For large projects, there appear to be five models of participation currently in effect.
• Crisis Management: the public is called in when protests about on-going projects put them off-schedule; this may involve public relations or conflict resolution techniques.

• Conventional Participation: currently the most common model, where consultation with representatives of the public (often NGOs) is undertaken at the project drafting stage when terms of reference are in development; because this is to satisfy agency rules and get government consent for planning, this type of participation often breaks down at the implementation and construction phases.

• Project-Cycle Participation: donors are increasingly giving thought to this model based on deficiencies of the above model. Such consultation includes continuous updating of participation strategy throughout life of a project, monitoring, developing mechanisms for information dissemination during project, and creating grievance procedures.

• Concurrent Participation: where the timing of participation coincides with independent assessments of project impacts and the project sponsor negotiates acceptable packages of compensation for impact with those affected.

• Dedicated Participation: this model is the most radical and built on three pillars of incentives, process and safeguards; it entails a more proactive approach by sponsors and tries to create good relations and democratic accountability towards stakeholders in every phase of the project. Where the projects are largely commercial, a key role for aid agencies and governments is the creation and oversight of safeguards to ensure participation.

19 Public participation also may lead to better results in terms of providing access to infrastructure for the poor and thereby aid in the reduction of poverty. One of the drawbacks to private provision of infrastructure often cited is that the poor are not a profitable market and so they are likely to be under-served in terms of infrastructure. However, a number of arguments work against this position. First, competition in some areas may actually bring the costs of services down, making them more accessible to the poor. Even where that is not the case, public dialogue and information exchange can be beneficial for the poor's access to infrastructure. By representing the interests of stakeholders, a better mix of the infrastructure provided may be achieved. For example, because men and women often have different priorities in terms of their infrastructure needs, the fact that women's interests are frequently not represented means that the services most crucial to them are given short shrift.  

Empowering the poor may also mean that more appropriate, affordable infrastructure is provided. Means to allow the poor to become consumers of private infrastructure services include:

- providing information about low cost alternative services may allow for the development of market niches serving the poor;
- working with the poor and private groups such as NGOs to develop micro-credit arrangements that will allow the poor to finance their connection to infrastructure or the purchase of infrastructure inputs;
- using innovative payment systems because household ability of the poor to pay for services may differ drastically from a standard schedule of monthly billing. Daily or weekly payments may suit their needs better or pre-payments at harvest time may be a solution. By adjusting payment schedules to household needs, poor consumers can be brought on line.

**Participation and Local Infrastructure in El Salvador**

In order to encourage community participation in decision making and aid the post-war reconstruction effort, USAID in El Salvador made the disbursement of funds for local infrastructure construction contingent upon holding open town meetings (cabildos abiertos) to identify local needs and priorities for the funds. Community members suggested and commented upon projects that were then discussed and prioritised by the local councils. Not only did this process strengthen the fledgling democracy in post-civil war El Salvador but it also created greater local capacity for project development and management. Municipal governments were responsible for over 10,000 infrastructure projects between 1987 and 1994, and were especially engaged in building transport, electricity, water and schools. Such projects also saw tremendous cost-savings (45%) over centrally funded projects, particularly due to lower construction costs and hiring of local labour.


While participation, decentralisation and dialogue can be important factors in developing and maintaining infrastructure for the rural poor, it is not a panacea. The small scale of NGOs and their locally based position may work against the dissemination of innovations. Also, participation and decentralisation together may exacerbate regional inequalities as wealthier areas capture the lion’s share of services. An evaluation of infrastructure development programs in Bangladesh highlights another caveat about decentralisation. Without sufficient oversight, entrenched local power structures may take over projects, allowing the gains to be distributed among the better-off, well-connected segments rather than to the poor.

**Infrastructure Sectors**

In this section, an in-depth discussion of the international experience with different forms of infrastructure is presented. Because the characteristics and

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32 H Farah, 1998, ibid
33 P Streeten, 1997, ibid
34 Lein, H, 1987 "Infrastructure Development and the Rural Poor in Bangladesh", The Chr. Michelsen Institute, DERAP Publication no.231
practices vary across infrastructure types, it is important to treat them separately. The discussion here focuses on electricity, roads, irrigation, drinking water and telecommunications.

**Electricity**

23 There has been debate over the benefits delivered by rural electrification (RE) as well as its role as an engine of rural development. In theory, having access to electric power brings both quality of life improvements for agricultural communities as well as economic gains by allowing for productivity increases. However, most analysts now agree that earlier expectations have not been completely realised.

24 It is in quality of life gains that rural electrification seems to be most successful. Electricity brings with it possibilities for entertainment, as well as an extended day that allows for new activities, the prolongation of daytime work and improved conditions. Many rural inhabitants list the fact that children are able to study in the evening by electric light as one of the primary benefits of power. When electricity means public lighting, there may be improvements in community security. There is also evidence that electricity has especially positive effects of the quality of women's lives. For example, studies from rural India and Colombia showing that housework had become somewhat easier as a result of appliances and that women have more evening leisure time as a result. Evidence from Peru suggests that women's evening work such as sewing and spinning became much less onerous by electric light compared with carrying out such chores by candlelight or kerosene. Results such as these highlight the fact that issues of energy and the priorities individuals assign to them vary by gender.

25 For businesses, electricity can allow them to stay open later, offer a wider range of services and products, and potentially cut costs if electricity is cheaper than the diesel or kerosene they previously used.

26 However, many of the expected gains from electrification have failed to materialise. In particular, the notion that electricity alone can push ahead development and growth in the absence of other factors and forms of infrastructure has been discredited. Evidence shows that RE investments have been more expensive and yielded fewer benefits than expected. The older optimism has been replaced by the view that within the context of an on-going development process, electrification can play a significant role in supporting continued growth. Poverty reduction, for example, will only come about through RE if incomes rise because

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37 Barnes D F, 1988, ibid
38 Foley G, 1990, ibid
39 Davis, 1998
electricity allows people to be more productive, but this only happens when other factors are also at work, such as gaining greater access to markets.\textsuperscript{41}

27 Conclusions about when it is appropriate to invest in RE can be drawn from this. One is that RE must be undertaken as part of an overall rural development strategy. Electricity infrastructure inputs should be concentrated in selected areas rather than spreading them out widely,\textsuperscript{42} even if this means that some areas do not get access to electricity as soon as they might have. In the context of overall development, the World Bank’s 1975 criteria for areas where RE investment makes sense continue to hold in many circumstances. These are that there should also be:

- good quality infrastructure, especially roads;
- growth of agricultural output;
- large villages that are not too scattered;
- improving living standards;
- plans for regional development; and
- proximity to the main power grid.

28 However, technological changes in the field of power offer new policy wisdom. The advances in photovoltaic technology in the last decade mean that it is now possible to economically extend the coverage of electric power beyond the economic limits of a traditional grid. In addition, solar technology can be an important part of the policy maker’s tool kit because it can fill precisely the niche where it is uneconomical for the extension of traditional electrical service: remote areas where load and load density are low. According to a recent World Bank study of best practices for solar household energy,\textsuperscript{43} a number of design elements should be present when developing a well-functioning solar energy policy. Fee structures should cover all associated costs, but also include payment schedules geared to cash streams of households. Also, financing mechanisms, either by utilities or the private banking system need to be developed in order to overcome hurdles associated with initial costs; evidence from many countries shows that for rural households, a large down payment is a greater barrier than even substantial monthly payments. The study also points out the importance of local participation and outreach: not only does it find that NGOs or other local organisations are better able to administer and maintain solar programmes but prior consultation with beneficiaries is crucial to their later satisfaction with the programme.

29 In terms of RE financing, the fact that electrification does not automatically generate positive development outcomes suggests that policy makers must consider

\textsuperscript{41} World Bank, 1995, "Rural Electrification: A Hard Look at Costs and Benefits", World Bank: Operations Evaluation Department, OED Précis No 90
\textsuperscript{42} Ranganathan V, 1993, "Rural Electrification Revisited” Energy Policy 21: 142-151
the benefits of RE investment carefully. Many authors have noted the fundamental fact that it is more expensive to provide electricity in rural areas than in urban settings because rural population density is lower. In addition, the shift to electricity by consumers appears to be less complete in rural areas than in urban areas, making it risky to project rural usage based on urban consumption patterns.\textsuperscript{44} Certain areas make much more sense as RE investment sites than others do and thorough prior assessment is important.\textsuperscript{45} Sparsely populated rural areas with little potential for productive use of the power are poor candidates for RE and should be avoided (although as noted above, these may be ideal candidates for solar technology). Areas where there are potentially large, complementary loads stemming from agricultural, domestic and industrial uses should be a priority because by co-ordinating loads (usage at different times of the day and year), the costs of electricity can be brought down.

30 Tariff policy is also critical. In many countries, there are heavy subsidies to rural electricity provision, though the subsidies do not usually approach the true costs of providing service. Such a situation is neither stable nor feasible in the long run. The public sector in most countries simply does not have the financial resources to continue subsidising RE. Tariffs have to rise if the system of RE provision is not to collapse.\textsuperscript{46} If the price paid for service does not exceed the long run marginal cost, there is no incentive for the private sector to engage in electrifying the rural areas.\textsuperscript{47}

\begin{center}
\textbf{Rural Energy Use Following the Introduction of Electricity - The Case of South Africa}
\end{center}

Income is a primary determinant of electricity use in the developing world. Not only are higher income rural households more likely than poorer ones to have a connection but they are more likely to substitute electricity for other fuels compared with poor, electrified households. Evidence from South Africa shows that rather than the occurrence of a fuel transition, rural households continue to use a variety of fuel sources for lighting, cooking and heating after gaining access to electricity. This is most pronounced among the poorest households, especially for cooking and heating. Poor households with electricity appear similar to unelectrified households in their choices of cooking and heating fuels and they also continue to rely to a large degree on candles for lighting. Some of the reasons for these choices are the inability of the poor to afford electric appliances, payment structures that require large, front-end expenses, and a sporadic power supply. These findings highlight important policy implications: utilities should not base revenue projections on the assumption of a rapid energy transition, particularly for low income households who are likely to make relatively limited use of electricity for some time. In addition, consistent with what a number of other studies have found, electricity may not have the environmental benefits, particularly in terms of slowing deforestation, often attributed to it if people continue to use wood for cooking and heating.

\begin{quote}
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31 In addition, the structure of tariffs in many countries is such that the more well off are subsidised, since the poorest rural inhabitants can often not afford any service at all.\textsuperscript{48} Subsidies work against the interests of rural consumers in the long-term since they encourage utilities to reduce both the quality and quantity of service.
provided and the economic misallocation of resources. There is certainly little reason to subsidise productive uses of electricity in agriculture, industry or the service sector. This is classically demonstrated, for example, throughout the whole of the former Soviet Union. Farmers and shopkeepers can generally afford the costs of electricity. Poor consumers can be offered a 'lifeline' rate, which is an absolute minimal level of consumption that allows households, for example, a few hours of light per day. Consumption is low but so are the costs, which can be recovered from better off consumers without much difficulty.

32 In part, mechanisms such as lifeline rates can help offset the inevitable hardships and discontent that will come about as subsidies are removed, especially in populations that have come to see cheap electricity as an entitlement. Removing subsidies has proved politically difficult in many countries. Other possible forms of assistance are helping with initial connection costs, which are often prohibitive for the poor, rather than subsidising service. This can be done either through a direct subsidy or though micro-credit to allow people to borrow money for the connection fees and then pay it back over time.

Roads

33 Like electricity, rural roads are viewed as a crucial infrastructure investment for promoting growth and well being. A superficial examination of some successful road projects shows how Lord Lugard's maxim that "the prospects for development can be summed up in one word -- transport" once rang so true. A recent World Bank impact evaluation of rural roads in Morocco, for example, notes a vast number of improvements such as lower vehicle operating costs leading to lower transport costs, lower prices of agricultural inputs, expanded government extension service, a more profitable agrarian economy, more free time for women as a result of delivered butane that substituted for firewood that needed to be collected, and higher school enrolment especially among girls. Though roads and other facilities related to transportation are an important facilitator of progress in rural communities, to see them as a magic bullet for development is erroneous and overly simplistic.

34 Current thinking about the role of transportation and roads in rural development focuses on three related areas: the social and economic benefits of roads; the construction and financing; and long-term maintenance or viability. An important shift away from the view that roads alone could guarantee development began in the 1980's. Overly optimistic results from successful case studies gave way to attempts to find factors associated with better and worse outcomes. Review of the impact and outcomes of road construction projects around the world between the 1960s and 1980s showed the prior social and economic context of where roads

49 Ranganathan V, 1993, ibid
50 Foley G, 1992, ibid
52 World Bank, 1996, "From Foodline to Lifeline: Rural Roads in Morocco." World Bank: Operations Evaluation Department, OED Précis No 119
were located mattered to their success or failure in spurring development. The important conclusion is that because context is so crucial, it is hard to predict similar outcomes to road investment when conditions are different. The evidence does not support a claim that road construction necessarily has ameliorating effects on poverty. Indeed land concentration and increased landlessness may ensue. In some cases, improving existing roads brings fewer benefits than opening new roads, especially in terms of reducing transport costs, which is an important impetus for development. Road quality may be a less important factor than is often assumed by policy makers. If sound regulatory policies are not in place, that is: if there is over-regulation and restrictions to entry in the transport market, there are unlikely to be major changes. Similarly, if transportation costs only make up a small percentage of the final price of agricultural goods, major changes will be less likely. Small-scale farmers need to be the target of public policies if they are also to benefit. This includes things like extension services, access to credit, and information about markets. Without these complementary activities, it is likely that most of the benefits stemming from new roads will go to the most advantaged rural sectors. Land ownership patterns are an important determinant of benefits and the more skewed towards the better off those are, the less even distribution of benefits from roads is likely to be.

35 More recent, detailed studies seek to assess the impact of roads, though the results are not always consistent. In a recent paper looking at the distributional aspects of road construction, data from Nepal show that rural road construction does not tend to reduce income inequality, but rather leads to overall benefits from which the poorest households gain, but do not do so disproportionately. A comparison of villages with and without developed roads in Bangladesh found economic benefits in the former that can be attributed to the presence of infrastructure such as lower fertiliser prices and higher wages. In addition, in Bangladesh it has been found that household income rises a great deal as a result of transportation infrastructure and there is a large distributional effect. For farmers, income from crops, wages and livestock rises more for the poorest and landless than for wealthy landowners. The situation is reversed for the effect of transport on rural workers in business and industry. Not only is the effect small, but it tends to be captured by wealthier households because of their superior access to credit. The conclusion is that policy must be used if the gains from infrastructure are to achieve reductions in poverty, specifically ensuring that the poor can obtain credit.

36 In addition to purely economic or income effects, roads potentially bring social benefits such as access to better (or any) health facilities and schools. It has been found that villagers with roads in Bangladesh had improved health conditions and more acceptance of family planning than those in non-infrastructure villages. In terms of rural attitudes, a series of focus groups that examined quality of life issues in India, Thailand and China found that infrastructure improvements, particularly the

55 Ahmed and Hossain, 1990
56 Ahmed and Hossain, 1990, ibid
57 D E Bloom, P H Craig and P N Malaney Forthcoming, ibid
construction of new roads, were seen as having brought the most significant gains to quality of life. Both economic and social benefits were noted: better access to markets, less reliance or middlemen and thus obtaining higher prices for their products, greater ability to move to higher-paying short term jobs outside the village, access to better health facilities and easier commutes for school children (in some cases, roads meant the difference between sending girls to school or keeping them home).

37 Another current concern is the notion of rural transport itself. Out of a concern that the promised benefits of rural roads and transportation had as often as not failed to develop, researchers in the 1990s have begun to question underlying assumptions regarding the purpose of transportation. The rural poor, particularly women, spend vast amounts of time in activities related to basic survival such as fetching water or fuel and that they have little access to even non-mechanised forms of transportation such as wheelbarrows\(^58\). The result is that much effort could be used more productively. The focus on market-oriented transportation has changed to an emphasis on "access". What this implies is that policy makers need to look at roads as part of an entire system of transport. For example, it might often make more sense to put facilities such as water closer to users, rather than build road networks, but these considerations under an access framework become transportation issues\(^59\).

38 This focus also implies a more user-oriented approach in the design of projects. Because much time is spent unproductively, for households to be able to move away from subsistence to producer status, they have to be able to meet basic needs which is an argument for policy makers to "concentrate on rural producers rather than on rural production when designing programmes of rural development"\(^60\). This means understanding the time usage and productivity constraints faced by inhabitants of particular areas needs to be an important part of the design of integrated rural transport infrastructure projects.

39 In addition to failing to live up to many expectations about its impact on growth, rural transport infrastructure has also raised concerns about its long-run feasibility in terms of maintenance. The experience of many countries suggests that the lack of attention to recurrent costs in the design of road projects dooms many of them to a much shorter than expected useful life span. One solution proposed to both the economic impact and maintenance problems is to use a labour-based approach to construction and upkeep. The ILO argues for a participatory, labour-intensive strategy to rural transportation\(^61\). Communities for whom subsistence is a persistent problem may have little interest in infrastructure investments (or their later upkeep), and increased emphasis on community participation in the planning process in terms of stating real needs may allow policy makers to better target transportation interventions.

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59 Edmonds G, 1998, ibid
60 Edmonds G, 1998, ibid
Although labour-intensive means of construction are widely accepted as one of the best ways that roads can have a poverty reduction impact, there are recent issues and developments that ought to be examined by policy makers. First, the private sector must adopt labour-intensive methods since that is where most construction is likely to occur in the future. This is not always straightforward since ensuring the cost-effectiveness (a *sine qua non* for private firms) may be hard. ILO experiences in Ghana, the Philippines and Madagascar, show that difficulties stem from problems contractors have in obtaining credit, ensuring that there is sufficient cash-flow to keep workers paid and willing to show up and complying with complicated contractual requirements. To assist small contractors in this (and foster the labour-intensive approach), policy makers need to develop better contracting mechanisms, make sure contractors have cash flow throughout the project and help small contractors deal with getting credit both from banks and foreign lenders.

A second area that project designers need to take into account is how to use appropriate light machinery. Labour-intensive does not mean labour-only and equipment such as tractors and draught animals for hauling and compacting can be used to supplement manual labour.

Road maintenance has been a major flaw in rural infrastructure programmes. In the absence of incentives, maintenance is unlikely to occur, even when communities demonstrably benefit from the presence of a good road. Voluntary labour has sometimes been a good strategy for construction, but is unlikely to be a solution to maintenance. When local funds are in short supply, food aid may be a solution and has been successfully used in India. This stimulates local agricultural production and needs to establish good delivery mechanisms as well as a political commitment to keep it ongoing in order to be maintained. Projects must take into account recurrent costs in the design. Many nationally and internationally funded projects fail to ensure that sufficient funds will exist for future maintenance of roads. For example, in half of the World Bank rural road projects examined, the sources of maintenance funds were not spelled out and only in a quarter of projects did a reasonable plan for future road preservation exist.

The Financing and Governance of Road Systems

The lack of attention to road maintenance and the inability to do budgetary planning for it implies large costs to developing countries in terms of growth and productivity. However, there is a great deal of debate over the best way to finance road systems. While Road Funds were at one time a common policy prescription, there is a plethora of evidence that many developing countries are unable to institute the governance structures that are necessary for Road Funds to function. The funds, whether from user fees or gas taxes, must be shielded from being diverted to other sources; are often poorly managed and may not provide all the needed monies for continued maintenance and construction. Although analysts are less sanguine than previously about such funds, one common lesson is that their governance structures can be enhanced by participation by

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62 Edmonds G and J J de Veen, 1992, ibid
64 Riverson, Gaviria and Thriscott, 1991
65 Edmonds G and JJ de Veen, 1992, ibid
66 Riverson, Gaviria and Thriscott, 1991, ibid
stakeholders. In Zambia, for example, a National Roads Board made up of members from the
government (non-voting) and the private sector (voting) has had a major effect on making roads
financially sustainable by attracting both government and donor money for investment in the road
system.

Observer 14:159-185
Newbery D M and G Santos, 1999, “Road Taxes, Road User Charges and Earmarking” Fiscal
Studies 20:103-132

43 One of the primary causes of road maintenance collapse is that it is typically
the responsibility of rural communities or local governing bodies who have neither
the management nor the technical skills to carry it out. Because political and
administrative decentralisation is the current direction for many countries, road
maintenance will increasingly be ignored by central governments so that it is
imperative to find solutions to overcome problems at the local level. Contractual
solutions can be individual agreements where local workers have renewable
contracts and are responsible for the maintenance of a specific length of road;
agreements between governments and communities where communities are
compensated for doing upkeep; petty contracts which are workable so long as
contracts to small local groups are simple and specific; and using small-scale private
contractors, which demands supervision and measurable expected outcomes. In all
cases funds for maintenance need to be available on a continuous basis, which
implies establishing the funding as part of the initial project.

Irrigation

44 The vast and growing number of individual world-wide who still lack access to
water is evidence of the under-investment in water projects by donor agencies and
governments67. Compounding this problem is the failure of so many water and
irrigation programmes68. As in the case of roads, long-term maintenance issues are
central to sustainable projects. Again, a common criticism of programmes is that
donor focus and funds are heavily weighted towards the construction phase and tend
to neglect the operations phase69. The distortions are not just associated with foreign
donors. Projects of the PRC Government, for example, have suffered from an
excessive focus on construction and have shown too little concern with the later
operation and maintenance of facilities70.

45 Other distortions in public financing of water projects also occurs, sometimes
as the result of domestic political pressures. Water programmes are often biased
towards big projects that benefit large farms rather than much more cost effective,
smaller solutions such as “improving existing systems, developing smaller
community controlled facilities and improving rain-fed methods”71. In addition to the
obvious costs of the failure of projects such as wasted investments and costly

67  Jimenez E, 1988, ibid
68  Howe C W and J A Dixon, 1993, ibid
69  Easter K W, 1993, “Economic Failure Plagues Developing Countries’ Public Irrigation: An Assurance
    Problem” in Water Resources Research 29:1913-1922
70  Howe C W and J A Dixon, 1993, ibid
71  Jimenez E, 1988, ibid
rehabilitation, there is a hidden cost which may prove more damaging in the long run to achieving successful project goals: the loss of confidence and cynicism that participants and beneficiaries will carry with them to subsequent projects\textsuperscript{72}.

46 Because water may have relatively low economic value, there are few incentives to invest in it. Also, the high cost of setting up systems of farmer participation or taking the appropriate legal and regulatory steps to ensure property rights may lead to poor performance. Because water is often a public good, it is difficult for people to organise its efficient distribution. A model has been developed to take into account the various collective action and free-rider problems that can arise in irrigation projects. It offers policy makers performance indicators that can be used to evaluate programmes as well as suggesting normative criteria for project implementation\textsuperscript{73}.

47 The model assumes that successfully implemented and maintained projects must contain: internal and external assurances to farmers that their peers (internal assurance) and the authorities (external) will actually comply with their maintenance responsibilities, that there is a commitment on the part of beneficiaries to the project, which as many\textsuperscript{74} have noted often depends on their participation in the planning process, and there needs to be a perception of fairness. Fairness is the degree to which farmers feel that water delivery and management is just. Table 1 summarises the performance indications corresponding to each component, though it should be noted that the indicators may overlap.

Table 1 Easter's Performance Indicators for the Operation and Management of Irrigation Projects

<table>
<thead>
<tr>
<th>Internal Assurance</th>
<th>External Assurance</th>
<th>Commitment</th>
<th>Fairness</th>
</tr>
</thead>
<tbody>
<tr>
<td>Penalties for non-payment of fees</td>
<td>Assurance that fees are used for operations and maintenance on payer’s projects</td>
<td>Government gives priority to efficient water use</td>
<td>Rules for fees reflect farmer’s ability to pay</td>
</tr>
<tr>
<td>Financial incentives for collecting fees</td>
<td>Penalties for poor government management</td>
<td>Government priority to project maintenance</td>
<td>Allowance for non-payment of fees when there is natural disaster</td>
</tr>
<tr>
<td>High levels of fee collection from farmers</td>
<td>Communication and information flows between farmers and officials</td>
<td>Adequate government resources for operation and maintenance</td>
<td></td>
</tr>
<tr>
<td>Large contribution from farmers to operations and maintenance</td>
<td>Clear division of duties between farmers and officials</td>
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<tr>
<td></td>
<td>Dependable delivery (timing and amount) of water</td>
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\textsuperscript{73} Easter K W, 1993, ibid


Jimenez E, 1998, ibid

Webb P, 1991, ibid
A review of irrigation projects in four Asian countries (India, Nepal, Philippines and Sri Lanka)\textsuperscript{75} suggests that there are often only limited attempts to follow these sorts of guidelines, though they are essential for ensuring successful projects and improved water delivery and management. One of the conclusions is the importance of stakeholder (farmers in this case) participation in all components of the model. How to bring that about is not always obvious but one step is to have their input from the beginning in planning and construction phases. Doing so helps cut down on the difficulties associated with trying to develop participation after the fact when beneficiaries may have come to consider it 'the government's project' and hence the government's responsibility.

Stakeholder involvement in the management of irrigation projects can also involve an expanded beneficiary base, focused on the multiple uses of irrigation systems, not simply water for crops\textsuperscript{76}. Because water is supplied for fisheries, kitchen gardens, micro-enterprise and domestic uses, there are numerous different interests that need to be taken into account in order to most efficiently and fairly manage projects. While there may be many common interests, there are also potentially conflicts among the different uses of irrigation water. By organising the different interests together in governing bodies of water projects, it is more likely that some of the differences can be managed. This is particularly important in terms of water quality issues such as pollution or salinity levels, concerns towards which some water users are particularly sensitive. If as much value as possible is to be derived from irrigation projects, then it is necessary to represent the different interests in their management. However, in most countries, even where user representatives form parts of governing or advisory boards, these are usually limited to farmers who do crop-irrigation. In order to involve all interested parties, changes in regulatory structures are likely to be necessary.

Getting stakeholders to work together, even when they are all in the same community, is not always easy. A review of the literature suggests that community water management works better when groups are characterised by high levels of social capital, that is, where there are dense social and economic networks that facilitate co-operation and trust among members. The importance of social capital is highlighted by the fact that where there are existing associations where people have experience working together, there tend to be better water management practices\textsuperscript{77}. Social (ethnic, linguistic, caste, etc.) and economic homogeneity of those participating in common irrigation schemes also appears to lead to more co-operative outcomes\textsuperscript{78}. Such work suggests that where there is little social capital, much more attention must be paid by those designing the organisation of

\begin{itemize}
\item \textsuperscript{75} Easter K W, 1993, ibid
\item \textsuperscript{76} Meinzen-Dick R and M Bakker, 1998, "Irrigation Systems as Multiple-use Commons: Experience from Kirindi Oya, Sri Lanka", Paper presented at International Association for the Study of Common Property Meeting, Vancouver, Canada
\item \textsuperscript{78} Kähkönen, 1999, ibid
\end{itemize}
stakeholder participation to overcoming suspicions and reservations about other community members or potential water system users.

51 A different set of concerns about stakeholder involvement in the design and implementation of irrigation projects is found with respect to the role such projects can play in the reduction of poverty. The inclusion of all those whose economic fortunes are tied to the outcomes of irrigation project 79 becomes important. These include not just farmers with plots to irrigate, but the landless or land-poor who stand to benefit from the employment generation potential of increased yields and the cultivation of new lands. In addition, they may gain from non-agricultural uses of irrigation (for example: water for livestock, bathing, washing) and from lower food prices. A review of the evidence 80 concludes that while the full mechanisms of irrigation’s role in employment generation have not been fully disaggregated, the greatest gains in job creation and poverty reduction for the land-poor are through the intensification of agriculture. This is related to good water management as well as the use of high yield seed varieties (which may under some circumstances, increase the demand for female labour). Also larger irrigation projects can be an important source of job creation during the building phase so that labour-intensive methods of construction should be used and may even save significant amounts of money in construction costs.

52 In addition to agricultural intensification and labour creating construction priorities, innovative design of irrigation projects can achieve poverty reduction goals. For example, pilot projects in India and Nepal have experimented with allocating water rights to all households rather than to landowners exclusively. Water rights can then be sold or exchanged by those without land, who in that way benefit from irrigation schemes 81. Other programmes have used micro-credit financing to allow the land poor to band together to buy and operate pumps and tube wells so that they can manage and sell irrigation water to those who need it. For example, Proshika, a Bangladesh NGO, encourages landless agricultural workers to manage irrigation services and it provides the technical training and monitoring such groups need to succeed 82.

79 Silliman J., 1987, ibid
80 Silliman J., 1987, ibid
81 Silliman J., 1987, ibid
The Failure of a Gambian Pump-irrigation Scheme

A World Bank project in Gambia between 1972 and 1977 that attempted to increase rice production using pump-irrigation highlights a number of design and implementation flaws that can doom water projects in the developing world. The project promoted double cropping in an area of 3,000 households. Diesel powered pumps provided irrigation; inhabitants could rent tillers and were provided seeds and other inputs on credit. In order to achieve the benefits of double cropping, a tight schedule of wet and dry season harvesting was adopted and since the two often overlapped, a labour shortage ensued. Outsiders were hired to help and in addition, farmers shifted some of their labour out of traditional harvesting of ground nuts (men) and swamp rice (women). Initially boom times meant rising incomes, greatly increased trade and extensive credit for inputs like donkey carts and other farm equipment. However, after a short period, the project faltered and eventually when farmers could not repay the loans, the pumps were removed and the project ended.

There were multiple reasons for the failure. First, the machinery broke down far more often than anticipated, in part because there were too many different types of equipment imported and few spare parts, partly because it was ill-suited to the Gambian terrain and partly because farmers were insufficiently careful with the equipment they did not own. This wrecked the ability of farmers to follow the tight schedule. Another problem lay in the design of canals so that there was both seepage in unlined canals meaning shortages in some spots and poor drainage in others that flooded seedlings. National fuel shortages compounded the problems. As yields declined as a result, farmers went back to traditional patterns which meant only one, but secure, harvest per year.

Some of the lessons learnt from this project are:

- Technical difficulties need to be anticipated and planned for. More thought should have gone into standardisation of appropriate machinery and a steady fuel supply assured.
- Management design that does not build sustainability is a problem. Because the design assumed state ownership rather than participant ownership, there was less incentive to care for equipment and to see failures as the fault and responsibility of the government.
- Lack of participant understanding and design input undermined goals. Double cropping played an important role in national food security policy. However, farmers’ perspective of their own food security saw double cropping as too risky given the technical problems and they reverted to traditional practices.


Household Water Supply

53 A central development challenge for the 21st century is how to get sufficient water to the vast and growing numbers of people worldwide, mostly rural, who lack access. The key, interrelated issues for household water supply (water for human and livestock consumption) are impact, financing and sustainability.

Impact

54 The existence of a safe, nearby water supply brings enormous benefits to households and communities in terms of quality of life. The impacts on health may be to reduce prevalent diseases and morbidity, and because it is linked to the presence of water for irrigation, better nutrition if a wider variety of food can be grown. Economic benefits include raising productivity by freeing up time spent in the
collection of water, doing laundry, etc. The benefits of water supply and sanitation have been particularly stressed for women and children.\textsuperscript{83}

55 A recent review of the available evidence on the health and economic benefits\textsuperscript{84} notes that little reliable work has been done on the link between water supply and productivity world-wide. Examining rural sub-Saharan Africa, some of the conclusions they reach are the following:

- the average per capita use in rural areas is far below what the World Health Organisation sees as necessary for good health.

- approximately 11 percent of deaths are due to poor water supply, sanitation and hygiene at the beginning of the current decade.

- household productivity seems not to be very affected by diseases such as diarrhoea or schistosomiasis; malaria, however, was associated with a significant number of days lost. In part, the authors found fewer productivity losses than expected because households engage in labour substitution. Often women and children step in to agricultural production when male family members fall ill. While production is thus not always negatively affected, the costs in terms of lost school time, housework, and caregiving are high.

- health benefits are much greater where optimal levels of service are present than where intermediate level exist and improvements in both water supply and sanitation lead to higher benefits than either one alone.

- investment decisions are likely to vary depending on whether a single benefit from water supply improvements such as a reduction in diarrhoea is calculated versus taking into account an array of expected benefits in terms of health and economic impacts.

**Financing**

56 Financing of large-scale water infrastructure projects present special challenges for private investors. The risks include the fact that water services are usually under the control of local authorities who may be less accountable than national governments; it is difficult to gauge the condition of water infrastructure since it lies below ground; because water is sometimes seen as a human right and because of its association with health and environmental outcomes, there is pressure to increase access to all, even those who can not afford to pay.\textsuperscript{85} In addition, there has been less successful financing with private capital in water projects than other forms of infrastructure and those that have been so financed usually involve assistance from governments or donors and export credit agencies. The solution to


\textsuperscript{85} Haarmeyer D and A Mody, N.D. "Financing Water and Sanitation Projects -- The Unique Risks" The World Bank Group, Finance, Private Sector, and Infrastructure Network
increasing the role of private finance in increased transparency and regulatory reform. In particular, they suggest the need for independent regulatory bodies and increased competition.

Assessing Sustainability: Willingness to Pay for Water in Rural Philippines

The possibilities for cost recovery in infrastructure projects are linked to their sustainability. The willingness to pay for the true costs of infrastructure services needs to be examined when considering the introduction of services. Researchers using contingent valuation methods asked villagers in the Philippines about what they would be willing to pay for different levels of water services. Their conclusions are important for the design of sustainable water projects. They found:

- Grants will be necessary to finance initial construction costs in order for projects to be sustainable
- Services are more sustainable in more densely populated areas
- Willingness to pay is higher when there is greater dissatisfaction with traditional water sources (because of long distances, very poor quality, etc.)
- Willingness to pay is higher for household taps rather than community taps
- Households with higher income have a greater willingness to pay for water systems
- Willingness to pay is associated with educational attainment suggesting that authorities can raise the willingness to pay though targeted education and information campaigns

While cost savings in projects could be achieved by reducing the quality or quantity of water delivered, or village taps could be installed, such options need to be considered very carefully in light of these findings. If the conclusions here are generalisable, then such measures could defeat the purpose if customers are unwilling to pay for lower quality services.


Sustainability

Because so many water and sanitation projects require donor funds, it is appropriate to judge sustainability in light of the experiences of such projects. In their review of donor-assisted rural water projects, the factors identified that are crucial for sustainability:

- Institutions: At the national governmental level, this requires leadership and co-ordination among agencies, especially a clear demarcation of responsibilities. At the regional level, extension services may play a crucial link in transmitting the needs to users to the government as well as developing capacity among the local population. Communities also need to be empowered because they are increasingly responsible for the management and on-going operation of projects
- Development Processes: project designs must have input from stakeholders in areas such as consensus of the problem to be solved, technology options, and assigning financial responsibilities. Beneficiaries also need education about the importance of sanitary and hygiene practices. Communication channels must be developed initially in the process of design.


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D Haarmeyer and A Mody, N.D. ibid

financing must be found and it is especially important to give consideration and responsibility for on-going costs. Operations and Management is the process of integrating the foregoing concerns

- Technologies: these must be suitable, responsive, acceptable to the users and beneficiaries, be relatively uncomplicated and inexpensive to service, standardised within the region and costs must reflect willingness to pay.

- Contextual Factors: here factors such as environmental sustainability, demographic profile of the area, socio-cultural factors, especially gender, political and economic issues must be taken into account.

- Project Organisation: during the life of the project, specific management factors come into play such as monitoring and evaluation procedures, integration with national institutions, contractor abilities, organisational style and effectiveness and all of these must be appropriate and continuously evaluated during the project.

- Donors: they need to engage in collaboration with the recipient, being especially attentive to local factors that may mean that what worked elsewhere may be inappropriate in another context and work with recipients to develop clear policy guidelines and plans; they must also show flexibility and adaptability during the distinct phases of the policy cycle; co-ordination with other donors is also essential.

Telecommunications

58 Telecommunications are an important type of infrastructure that will increasingly determine the quality of life and ability of rural areas around the world to escape poverty. Connectivity is important for farmers and rural businesses. Information about prices can help farmers determine where and when to market their goods as well as what commodities to produce. QOL can be achieved with information technology such as radio, TV or the Internet if it enhances the learning of rural schoolchildren and makes up for deficiencies in teacher training. Rural medical workers can get information and make better diagnoses if they are in contact with better-trained, urban colleagues. Technology also may mitigate the costs associated in rural areas with natural disasters and disease. For example, there is evidence that the impact of 1999’s floods in Bangladesh was to some extent mitigated compared with similar past floods because local leaders and NGO workers were in constant cellular telephone contact and were better able to predict the path of floods and engage early warning systems 88. Health officials will increasingly use IT to identify the early outbreak of communicable diseases and prevent or lessen epidemics.

59 A central issue in telecommunications policy in developing countries is regulatory reform and virtually all observers agree that competition must be allowed to flourish in order to bring down costs. Private finance will be essential for the development of telecommunications systems. A variety of financing mechanisms have been advanced. Researchers at the World Bank have recently completed a

88 D E Bloom, P H Craig and P N Malaney, forthcoming, ibid
study of rural telecommunications development with the following findings and suggestions:89

- revenue sharing concessions: these allow the investor who builds and then transfers ownership of the network to obtain a proportion of revenues in exchange for managing and operating the network.

- joint ventures: many Asian nations such as India and the Philippines are pioneering joint ventures where part of the concession involves obligations for rural service provision.

- rural co-operatives: these exist in parts of North and Latin America; rural communities provide capital and labour and have networks specifically geared towards their needs but they have limited ability to create new capital needed for investment and they tend to lack entrepreneurial skills. These are most successful where there is high demand.

- rural joint ventures: these are often financed by local business associations such as coffee and tea growers in different parts of the world who are willing and able to subsidise the high initial costs of services.

- Competition: the introduction of competition has significantly brought down costs in many rural areas of the world. Especially as the costs of wireless technology come down, this will be an increasingly important option.

60 The same authors suggest policy options that will be important in stimulating the provision of rural telecommunications services.90

- Funds availability: rural operators must have access to funds and credits from commercial and state banks as well as development assistance monies.

- Tax relief: especially because most equipment needs to be imported, the tariff rate on such equipment needs to fall.

- Loan rates: because providing rural service will continue to be less attractive to many investors, low cost loans should be made available to them as an incentive.

- Grants: as an option once commercial means have been exhausted, grants should be considered for rural service as a means of achieving broader development goals.

<table>
<thead>
<tr>
<th>Competition in Successfully Developing Rural Telecommunications: The Case of Chile</th>
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<tbody>
<tr>
<td>Although the costs of telecommunications technology are rapidly falling, some populations, particularly remote, poor rural areas remain difficult to serve because of cost-recovery issues. Faced with such a situation, the Chilean government set up a fund in 1994 to encourage service provision to rural areas without phone service. In consultation with local groups and governments, the national regulator</td>
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90 R Kayani and A Dymond, 1997, ibid
identified localities without phones. After grouping them according to the likelihood of needing subsidies, they separated out those that were not financially viable but with small subsidies could be made so. They solicited bids for service provision and defined terms of maximum subsidies and obligations; bids were awarded to entities that bid lowest for subsidies. Incentives for rapid provision of service were included, and the lump sum payment, not subject to inflation adjustments, would be given as soon as facilities were built. Virtually all of the 46 projects were bid on, many with no subsidies because carriers sought to expand their market share and break into local markets. Also, the bidding process gave carriers information about willingness to pay that they had been previously unaware of and this also meant they were often willing to bid without subsidies. According to analysts, the lessons drawn from the Chilean fund are the following:

- Competition is crucial to develop rural telecommunications
- With the suitable policy environment, very limited subsidies can make the rural telecommunications market take off
- The need for and cost of subsidies can be determined by market forces
- Errors of analysis only cause timing errors; where no bidders were found for the few markets included on the bid list, the Chilean government re-evaluated them, increased the subsidies being offered slightly and put them out to re-bid.

Wellinius, B, N.D. "Extending Telecommunications Service to Rural Areas -- The Chilean Experience" World Bank, Industry and Energy Department, Finance, Private Sector and Infrastructure Network, Note No. 105

The Lessons

61 Rural infrastructure continues to be viewed by policy makers and scholars as a crucial element of growth and development in impoverished rural areas. At the same time, however, there is awareness that many of the expected benefits of costly infrastructure investments made over the years have not been realised. The preceding review of experiences with rural infrastructure highlights some lessons for practitioners to consider when designing new programs and policies for infrastructure.

62 The first lesson is that institutions matter. The context in which specific programs are carried out has important implications for their success or failure. Particularly important here are governance issues. For example, clearly defined property rights are often an important requirement for well-functioning systems where collective action is an issue such as in irrigation. The continuous management and oversight of projects also requires good governance, not only in terms of financial responsibility and a lack of corruption but also technical competence.

63 The long-term viability of projects crucially depends on prior planning for their operations and maintenance. One of the key lessons the literature points to is that many projects fail not because of their initial design but rather their lack of sustainability over the long run. In part, this is related to the lack of consideration given to long-term financing for maintenance and repairs, a problem particularly associated with collective goods such as roads and irrigation systems where it is hard to charge individuals for use. While giving more local control over fee collections and maintenance may help with compliance and financing, this may not be the solution for very impoverished communities that do not have the financial resources to invest in infrastructure up-keep.

64 Many of the potential problems associated with infrastructure projects such as upkeep, willingness to continue to use and pay for services, appropriateness for the community, etc. can be made easier by promoting participation by beneficiaries.
and stakeholders. Not only is such participation linked to more suitable designs of projects but also is associated with better cost-recovery and sustainability. With respect to cost recovery and willingness to pay, there is often far greater willingness to pay on the part of rural peasants than often assumed. However, this also depends on the quality of services and the expected benefits. For this reason, dialogue with beneficiaries is important so that they know what to expect realistically from services. Some projects, for example, solar home systems have foundered when the unrealistic hopes of consumers were frustrated and they did not continue to use the systems. Another consideration is the definition of stakeholders. While the experience with local management boards such as for roads or water systems has often been positive, identifying a broad set of those affected by policies may be useful for avoiding problems of competing claims and satisfying many interest groups. Social capital, or the bonds of trust in a community and experience with acting in concert, is also linked to better outcomes of infrastructure systems. Where such ties do not exist, project designs that includes ways of building up community or user linkages and participation are important for policy makers to consider.

65 At the same time, participation is not a cure-all. One of the downside risks is that local élites or other vocal groups will capture projects and their benefits. Because political action and ‘voice’⁹¹ are often exercised by those who are politically well connected or have the skills and habit of engaging in such behaviour (usually the better educated), decentralisation and devolution of power to local levels may shut out the dispossessed. In this case, impoverished rural groups may not be the beneficiaries of infrastructure investments.

66 Soft infrastructure, particularly access to credit and agricultural extension services, appears to enhance the effectiveness of investments in hard infrastructure. Because peasants often are unable to afford the initial costs of infrastructure or the equipment it requires (such as connection fees, machines or appliances), credit can be an important tool for bringing new clients online. Also, where rural infrastructure can help increase productivity or access to markets, peasants may need training in areas like use of new seeds and the application of fertiliser or may require marketing advice. Developing these kinds of services or figuring out how to link existing ones with infrastructure projects needs to be considered when designing projects.

67 Finally, but not least, policy makers should increase their focus on the social impacts of infrastructure. While the evidence shows that timesavings, education, improved health, environmental improvement, skill development, capacity building, increased information and gender factors are all impacted on by infrastructure the research in this area remains weak. Greater investment in monitoring and evaluation of social impact is desirable because it will demonstrate scientifically a greater aggregate impact for infrastructure development than the simple economic impact. This in turn will influence decision-making more in favour of the disadvantaged and contribute to the justification for investment using commercially priced funds.

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Summary

This paper reviews PRC experience with rural infrastructure development as it relates to poverty reduction. Infrastructure includes economic and social infrastructure. This report focuses on economic infrastructure. The paper defines rural infrastructure and describes the development of infrastructure in PRC for the irrigation, rural hydropower, water supply, and road sectors. It identifies the economic and social impacts of rural infrastructure on poverty. It gives an overview of the situation with the development of infrastructure in poor regions of PRC and reviews the main government policies and their effectiveness. It describes the way in which infrastructure projects are managed in design, construction and operation and reviews funding sources and cost recovery. It provides a special review of the food for work (FFW) programme. It assesses the effectiveness of poverty reduction and infrastructure as a component and identifies future development opportunities for improving effectiveness.

Government authorities in PRC have attached priority to economic infrastructure development. Irrigation and drainage works, small-scale hydropower facilities, potable water supplies for people and animals, roads, electricity and telecommunications have all received substantial investment.

Irrigation has been developed extensively since 1949. The area covered has increased from 238 million mu in 1949 to 784 million mu at the end of 1997. Only about 20 percent of this area is in poorer western PRC. Hydropower resources have been extensively used over this period. In the 1950s, the installed capacity was small and mainly used for lighting. There are now more than 800 local power grids that supply more than 20 million kW to customers. However, there are still 11 counties and 70 million people in PRC without electricity supply. In the 50s and 60s drinking water shortages were not severe. Population growth and drought prompted more investment in the 1970s and 80s, but rapid economic development through the 90s has still left about 69 million people and about 51 million livestock without adequate water supply and about 22.5 million people with contaminated water supply. More than 20 percent of the population in western PRC do not have access to potable water. Road development has progressed from about 80,700 kms in 1949 to 847,900 km at the end of 1996. FFW has been instrumental in much of this since the mid 1980s. However, at the end of 1998 there were still 591 towns and 92,000 villages still not connected to the road network of which 457 towns and 28,210 villages were in western PRC. In general, infrastructure development in poor areas has lagged behind that in other areas, in some ways reinforcing their poverty.

During the 1990s the government has made efforts to improve the effectiveness and efficiency of infrastructure development. These policies have centred on trying to combine irrigation and hydropower developments effectively, progressively introducing market rates for electricity and water to make depreciation and operation and maintenance self-funding, raise funds from different sources including commercial funds to accelerate infrastructure development, and use the FFW programme as a means of developing infrastructure and having an impact on poverty reduction at the same time.

The FFW programme has been the most important small-scale rural infrastructure programme from a poverty reduction perspective because it is focused on poor
areas. By the end of 1998 the programme had created or renovated 300,000 km of rural roads, provided drinking water for 63 million people and 54 million livestock, developed 53 million mu of new agricultural land, newly irrigated or rehabilitated 73 million mu of irrigated land, planted 46 million mu of fruit trees and forest and contributed to hydropower and telecommunications development in rural areas.

Local Government is responsible for the management of infrastructure projects in poor rural areas. Engineering design is mostly, but not always, subcontracted to line agencies or institutes, and unified standards are not necessarily followed. Construction may be by force account (ie by the government department concerned) or use local labour, and private sector competitive tendering is not common. There has been limited attention to operation and maintenance funding at the design stage and it is widely recognised that there has been more emphasis on construction than maintenance.

Funds for investment in infrastructure come from a wide variety of sources: from the community (particularly in the form of labour), from local fiscal revenues, from government budgetary subsidies, from the FFW programme, from donations, from domestic bank loans and from international funding agencies. In general, the investment decisions for infrastructure development where there is no loan involved are not fully appraised from a financial standpoint because recovery of investment costs is treated as less significant. For investments that involve borrowing, there is more thorough analysis and recovery issues are covered.

Funds for operation and maintenance generally have to come from charging, but effective charging structures are not always in place. Capital costs may or may not be recovered by inclusion of a depreciation element in the fees. Electricity and water are relatively easy to charge for. Roads need to be paid for from the public purse, though local labour can be mobilised on a voluntary basis to carry out some repairs.

The provision of infrastructure in rural areas has been a component of poverty reduction programmes in PRC, but has typically not been viewed as the major factor in bringing about the dramatic reduction in poverty. Little work has been done on the impact of infrastructure development on poverty and its construction is widely perceived as a “relief” activity in poor areas rather than an economic one. Cost recovery has therefore received little attention, reinforcing the perception. Where there is cost recovery, it has often been at subsidised rates. This in turn has resulted in a preference for the development of other kinds of infrastructure by local government where revenues can be easily generated.

It is concluded that decisions about infrastructure in poor areas need to be better co-ordinated with poverty reduction efforts. This means first a better understanding of how infrastructure impacts on poverty. The pilot project under the TA and other research can contribute to this. Mechanisms that encourage investment in infrastructure that will reduce poverty also need to be developed. The present incentive system does not encourage such investments because of the pressures on local officials to make revenue-generating investments. Investments in hard infrastructure alone will have limited benefits and the development of soft

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Note that crowding in and parallel funding mechanism discussed in the overall strategy effect this.
infrastructure such as microfinance and technology and enterprise development is also important. More beneficiary consultation would be useful in enhancing the effectiveness of infrastructure development. If cost recovery programmes are to be effective, the development of infrastructure needs to be in response to demand (willingness and ability to pay). Participation is the only means through which local officials will be able to determine this. At the same time it will build greater ownership. Although FFW has been a very important component of infrastructure development, and its focus on agricultural land development has led to productive increases, its large-scale use of free-labour from the poorest households is inappropriate and has a negative effect on poverty reduction as well as being a potential source of discontent. Out-migration will continue to be an important means for poor households to supplement income. In establishing the priorities for infrastructure development consideration needs to be given to how infrastructure can facilitate this (for example better roads or better telecommunications).
Introduction

1 The meaning of infrastructure differs in different countries and at different stages of development. Generally speaking, the concept of infrastructure traditionally includes both economic and social infrastructure. Irrigation, water supply, electricity, transportation and telecommunication which serve as the prerequisite and condition for economic development constitute economic infrastructure, whereas education, occupational and technical training, basic medical services which are the basis of social development and human capital formation constitute social infrastructure. In addition, the growth of environmental consciousness means that pollution controls, waste disposal systems and natural habitat zones are increasingly considered part of the stock of infrastructure. In economic terms, major parts of infrastructure belong to the category of “public goods” or “semi-public goods”.

2 This report attempts to summarise the state of infrastructure development, and the management, implementation and impact of infrastructure projects in PRC as they relate to poverty reduction. It focuses on water, electricity, and roads that have the closest connection to poverty relief.

Development of Rural Infrastructure

3 Government authorities in PRC at different levels have attached great importance to the construction of infrastructure, especially economic infrastructure, in the countryside. Much work has been done with fruitful results in irrigation and drainage, small hydropower works, drinking water for human/livestock consumption, roads, energy, storage and telecommunications facilities.

Irrigation Works

4 The development of irrigation has been rapid since the founding of PRC. Five main stages in irrigation development can be identified:

• 1949 – 1957: The main feature of irrigation in this stage is the repair of irrigation works destroyed during the war or neglected for years. At the same time, farmers were also called on to build dams and small-scale drainage works. Through repair and construction of new irrigation facilities, the irrigated area in PRC increased from 238,930,000 mu in 1949 to 375,070,000 mu in 1957.

• 1957 – 1965: Collectivisation made the construction of large irrigation works possible. Most of the large and medium size reservoirs and large irrigation areas that are still used in PRC were built during this time. By 1965, the irrigated area reached 480,540,000 mu.

• 1966 – 1980: The construction of irrigation works stopped during the “Cultural Revolution”, and only resumed after 1971. From 1971 some conveyance systems were added to the existing reservoirs and in northern PRC extensive of groundwater development activities started. Motor-pumped wells increased from 1 million in 1972 to 2.29 million in 1980. The irrigated area reached 733,320,000 mu in 1980 in PRC.
In the 1980s: As a result of Deng’s reforms in agriculture and finance, irrigation investments were reduced. The lack of repairs to deteriorating facilities and absorption of irrigated areas and water sources into urban and industrial areas led to a slight reduction of irrigated area in to 725,840,000 mu by 1990.

In the 1990s: Government authorities again emphasised agriculture and irrigation by increasing investments. Irrigated areas rapidly increased and the irrigated area reached 784,030,000 mu by end of 1997.

There are 84,837 reservoirs, with total storage capacity of 458.3 billion m$^3$ in PRC. Four hundred of the largest reservoirs have 70 percent of storage capacity compared with the 82,000 small water storage facilities that together hold about 12.7 percent of total stored water. In addition, there are 6.7 million small water tanks built in mountainous areas.

**Small Rural Hydropower**

PRC has rich hydroelectric resources in the countryside, with an exploitable capacity of 142 million kW. By end of 1997, more than 45,000 small hydropower stations were operating, and there were more than 70,000 generating units. Their operating capacity is about 23.39 million kW, representing 16.5 percent of the total exploitable resources. Small hydropower stations are spread over more than 1,570 counties (towns). Nearly 800 counties are supplied with power by such stations and they have played an important role in the development of the national economy and improving rural living standards, especially in border areas, minority nationality regions and poor areas.

The development of small hydropower works in the countryside has undergone five stages:

1. 1950s: Small hydropower works with installed capacity under 500 kW started to be developed. The main purpose was for lighting.

2. 1960s: The installed capacity of power units increased to 3,000 kW. Besides lighting, they were also used for grain processing. Short-distance, high-voltage (10 kV) electricity delivery was started.

3. 1970s: Installed capacity increased to 12,000 kW, and power grids of 35 kV extended to the counties. These allowed not only lighting, processing, and drainage of flooded fields, but also promoted the development of local industries.

4. 1980s: Installed power unit capacities increased to 25,000 kW, and power grids of 110 kV were built. Some small hydropower station began to supply county level electrification.

5. 1990s: With the upgrading of local capacity, small- and medium-sized power stations were put into operation, power grids were extended and super high-voltage delivery of electricity of 220 kV also increased.
8 Currently, there are 800 local power grids supplied by small- and medium-sized hydropower stations and more than 40 grids extending across counties. These provide more than 20 million kW to rural customers bringing positive impacts on income and quality of life.

**Water Supply for People and Livestock**

9 With the exception of Shanghai, problematic access to drinking water is common for the more than 900 million people living in rural areas in PRC. In some areas, the shortage of water is a problem of very long standing.

10 Small and micro projects characterise most of the efforts to supply drinking water for people and livestock. They include surface storage (water storage pools, reservoirs), diversion (spring water, river water), and ground water (drawing water from wells, and pumping stations). Drinking water projects have high water quality standards that require selection of unpolluted watersheds or equipping them with water purification devices to meet state standards. Water project construction has occurred in four stages:

- **1950s – 60s**: Drinking water shortages were not severe and little state attention was given to water conservancy projects. To the extent that attention was paid, it was related to building irrigation works. At the same time, people living in areas short of water were organised to dig water pits, water-retention wells, and household water tanks. The scale of such works was small.

- **1970s**: At the beginning of 1970s, there was a drought for several years in northern PRC, drinking water shortages were common, and improvements became a priority. From 1973, motor-pumped well construction became widespread. In parallel with irrigation development, the state allocated special funds for drinking water projects. In addition, water contamination as a cause of endemic diseases was problematic in the mid-1970s. According to statistics collected in 1979, there were 80.1 million people and 51.5 million livestock with a shortage of drinking water.

- **1980s**: Between 1980 and 1984, total investments of 590 million yuan were made to tackle drinking water problems. By end of 1984, the problems of drinking water shortage had been solved for 76 million people and 43 million livestock. In spite of this, growing population meant that by end of 1985, there were still 159.8 million people (of whom 31.59 million lived in contaminated water areas) and 91.5 million livestock in urgent need of clean water supply. In order to meet this need, and taking into consideration the limited available state funds and limited local ability to raise funds, the central government decided to use the food for work (FFW) programme to help the poor areas build roads and implement water conservancy projects.

- **1990s**: With rapid rural economic development, there has been a huge increase in water demand. In those areas that lack a sufficient water supply, water shortages have severely hindered local economic development. During this stage, the state continued to outlay funds from the FFW programme for water projects, and the government also arranged domestic and international...
loans to tackle the problem. UNICEF and the World Bank participated, with the World Bank loaning 284 million yuan for a project to solve the rural drinking water problem. With the increased availability of funds, drinking water and water supply projects in the counties were greatly accelerated. By end of 1997, a total of 196.1 million people (22.3 million people with contaminated water) and 122.2 million livestock had the problems of drinking water shortage solved. However, the problem of insufficient drinking water continues to affect 68.8 million people (22.5 million with contaminated water) and 50.8 million livestock in PRC today.

Rural Road Construction

11 The development of road construction in PRC has undergone five stages:

- 1949 – 1952: At the end of the war, PRC began to restore and construct the national economy. At this stage, road construction mainly involved restoration of the main routes destroyed during the wars. In the countryside, work had been done to facilitate restoration of industry and agriculture and the exchange of goods between town and country. In addition to constructing and upgrading some main arteries, many country roads were built. By end of 1952, there were 126,700 km of roads in PRC, an increase of 46,000 km compared with the 80,700 km in 1949.

- 1953 – 1957: Collectivisation facilitated the rapid increase of the production of the main agricultural products such as cotton and grains. However, the means of transportation at this stage was mainly manpower and animal power, since there were few transport vehicles or roads. PRC government policy encouraged road construction by mobilising the labour force, emphasising the importance of building roads suitable for the local transportation through the joint efforts of local government and people. Large-scale road construction began in the countryside. Between 1956 and 1957 alone, 70,000 km of country roads were built.

- 1958 – 1965: Economic growth increased pressure on the transportation network both in terms of people and goods, leading the government to call on the public to help with road construction. In 1958, 160,000 km of new roads were finished, although they were low quality. 140,000 km of the roads were fairly rough, and could afford basic transportation. However, not many new roads were built in this period and attention focused on the technical renovation of the existing low quality roads. By 1965, the total network reached 514,455 km.

- 1966 – 1980: Road construction was mainly done with investments from the state and labour from the people. In this way, a relatively high speed of construction was guaranteed. During the 15 years, a total of 370,000 km of roads were constructed. By 1980, the total network in PRC had reached 888,000 km, of which 600,000 km were rural roads.

- 1980s and after: The economic reforms brought about rapid social and economic development, which included rural roads. This was due to: increased ability of some more developed rural areas to raise funds for road
construction; the FFW programme in poor areas; and international aid or soft World Bank loans for rural road development. According to statistics of the Ministry of Transport, in 1996, the total network of rural roads was 847,900 km, representing an increase of 250,000 km over 1980. The quality of these roads is still quite low, and they are mainly third or fourth grade roads.

**Other Rural Infrastructure**

12 Besides the infrastructure developments mentioned above, the PRC government has also invested extensively in: land improvement, rural telecommunication facilities, extending the broadcasting and television network coverage, schools, sanitary facilities, and environmental conservation.

**Impact of Rural Infrastructure on Poverty**

13 Rural infrastructure impacts on poverty. The following table summarises some of the identified impacts of different types of infrastructure in PRC.

<table>
<thead>
<tr>
<th>Infrastructure</th>
<th>Benefits and Effects</th>
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<tbody>
<tr>
<td>Irrigation works</td>
<td>Increases drought-resistance and crop yields</td>
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<tr>
<td></td>
<td>Increases multiple cropping potential</td>
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<td></td>
<td>Affords development of high yielding cash crops</td>
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<td></td>
<td>Improves farm income and food supply</td>
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<td></td>
<td>Improves soil and water conservation</td>
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<tr>
<td>Small rural hydropower works</td>
<td>Uses renewable resources</td>
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<td></td>
<td>Provides energy for agroprocessing and other industries allowing more rural value added</td>
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<td></td>
<td>Reduces incineration of straw and fuel wood contributing to reduction in pollution and tree conservation</td>
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<td></td>
<td>Creates new income opportunities</td>
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<td></td>
<td>Has significant other quality of life impacts</td>
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<tr>
<td>Clean water supply</td>
<td>Reduces disease and morbidity</td>
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<td></td>
<td>Reduces medical expenditure</td>
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<td></td>
<td>Reduce the time spent getting water by women and children</td>
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<td></td>
<td>Increases school entrance of female children</td>
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<td></td>
<td>Reduces disputes over water supply, raising social stability</td>
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<tr>
<td></td>
<td>Improves social and living environment</td>
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<tr>
<td>Rural roads</td>
<td>Facilitates access to inputs and markets for agricultural produce</td>
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<tr>
<td></td>
<td>Reduces transportation costs</td>
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<td></td>
<td>Facilitates labour migration</td>
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<td></td>
<td>Opens opportunities for new businesses and greater rural value added</td>
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**Infrastructure Development in Poor Areas**

14 In general, the level of infrastructure development in central and western PRC lags behind the average. This is the cause of the under-development of the economy of these areas, as well as its effect.

15 According to the statistics collected by the Ministry of Water Conservancy, in 1997 there were 55,952 million hectares of effective irrigated area in PRC, whereas the relatively eight poorer provinces in the west as Sichuan, Guizhou, Yunnan, Shaanxi, Gansu, Qinghai, Ningxia and Xinjiang had a total irrigated area of 10,984 hectares, representing only 19.6 percent of the total irrigated land.

16 According to the statistics collected by the Ministry of Construction, in 1996, the total network of rural roads was 3,091,696 km in PRC, whereas the eight
relatively poor provinces of Sichuan, Guizhou, Yunnan, Shaanxi, Gansu, Qinghai, Ningxia and Xinjiang had a total road network of 587,704 km, representing less than 20 percent of the total network in PRC. According to documents from the Ministry of Transportation, in 1998 there were 591 counties/towns and 92,000 villages not connected to roads, of which in the eight provinces there were 457 counties/towns and 28,210 villages not connected to roads, representing 77.3 percent and 30.7 percent respectively of the totals for PRC.

17 According to figures provided by the Ministry of Electric Power, by 1997 there were a total of 11 counties without power supply (of which there was one county in Qinghai and 10 counties in Tibet) and nearly 70 million people living without electricity. According to figures provided by the Ministry of Water Conservancy, there are still 3.6 percent of the counties, 4.7 percent of the villages and 6.95 percent of the families in the countryside in PRC that are not yet connected to a power supply, whereas for the eight poorer provinces, the comparative figures are 6.6 percent, 11.3 percent and 11.1 percent respectively. Among the 1,203 counties, 26,343 villages and 13,070,618 families who live without electricity, the majority are concentrated in western and central PRC, being 86.3 percent, 91.6 percent and 59.5 percent respectively of the national totals.

18 The majority of the population that continues to have problems with drinking water shortages live in the mid-west areas (especially the Loess Plateau). Some 42.6 percent of the population in the west region use tap water, which is lower than the 63.7 percent in the east and 42.6 percent in the central regions (the average in PRC being 50.42 percent). There is still more than 20 percent of the rural population in the western poverty regions who are drinking untreated water, and many have problems getting that for human and livestock consumption. Even among those who have the benefit of water improvement, the incidence of tap water is still low, and they are mainly using treated water from tanks.

19 The construction level of other infrastructure of the mid-west areas falls also far behind that of the average of PRC.

Main Government Policies and their Effectiveness

20 In recent years, the central government has emphasised irrigation and water conservancy as the main infrastructure development in rural areas. The "Decision on Key Issues of Agriculture and Rural Works" adopted during the Third Meeting of the 15th Congress of the Communist Party stated that: “Unremitting efforts should be made in irrigation and water conservancy construction to solve the problems of drought and water shortage. Restoration and completion of water conservancy facilities in large and medium irrigation areas should be accelerated. Building and management of small water conservancy facilities in different ways by groups and families in the countryside is encouraged. Policies on saving water should be made, and water-saving irrigation should be developed .... Water utilisation should greatly increase and efforts should be made to enlarge the irrigation areas."

21 Policies on hydropower works encourage the combination of hydropower development with irrigation and flood control; encourage local level funding and management; aim to foster sustainability through the reinvestment of profits from hydropower in further infrastructure development; will progressively deregulate the
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tariff structures; encourage linking of local grids to the national grid so that power sharing can be effected when necessary; and provide for medium- and small- scale county-level hydropower works to charge a reduced VAT rate of 6 percent to encourage demand.

22 With respect to drinking water projects, the policies are to: implement the “build, own and manage” policy and use locally donated labour; raise funds from different domestic and foreign sources and increase investment with a minimum reliance on subsidy; promote regulatory reform through the use of contracting systems and promoting charging for water supply.

23 For rural roads, there is currently no unified programme. The main policy of the state is combining state support with the labour input from local residents and local government funding.

24 In recent years, the central government has greatly increased infrastructure investment in the countryside. In 1998 especially, a major part of the additional national debt of 100 billion yuan was used on accelerating infrastructure construction in rural areas, including water conservancy construction, road construction, power grids renovation (see Annex 2) and building storage facilities and markets.

25 For the poor areas, ever since the beginning of the FFW in the mid 1980s, the state has always set infrastructure construction as a priority. The government has specific targets such as: solve the problem of drinking water by 2000; connect roads to each village; build market places in each village; connect electricity to most of the villages and to every county; provide telephone connections to almost every village in the mid-west under-developed areas and poor areas by 2000. With respect to agricultural production, the goal is have 0.5 mu/person of high yielding crops and 1 mu/person of wood/fruit or industrial crops in relatively better off areas.

26 FFW is one of the most important poverty reduction programmes. Starting in the mid 1980s, the state had allocated a total of 31.3 billion yuan (by end of 1998), in seven instalments, in the form of goods and funds, to provide food in exchange for work. The projects consisted mainly of infrastructure construction in the poor areas. According to statistics, by end of 1998, nearly 300,000 km of new roads or renovation of old roads were done in counties and villages; drinking water shortages were solved for 63 million people and 54 million livestock; an additional 55 million mu of farmland was added; new or transformed irrigation area of 73 million mu was added; 46 million mu of wood or fruit land was planted; 42,000 m² of soil erosion was controlled; 24 million mu of grassland was constructed or transformed using the FFW programme. It also contributed to the construction and building of small hydropower works, telephone works and power grid projects.

Management of Infrastructure Projects in Poor Areas

Responsible Organisations

27 As in other areas, infrastructure construction in the poor regions is managed by the relevant government departments. Depending on the type of infrastructure, the government departments are: Water Conservancy, Agriculture, Road Transportation, Medicine and Health, Post and Telecommunications, Power Supply,
Education, Broadcasting, Planning and Development, Environmental Protection, Urban and Rural Construction, Finance. All these departments are organised from the central government down to the village level. Since most of the infrastructure construction projects are within counties (though a small part of medium-large projects are done across counties), the organisational system at the county level has played a dominant role in the infrastructure projects.

28 Irrigation works, small hydropower works, drinking water for people and livestock are executed by the water conservancy departments. Medical and health departments are also responsible for the drinking water projects. Health departments and urban/rural construction departments are responsible for water improvement projects. Road and transportation departments are responsible for the road construction projects. Other specialised departments are responsible for infrastructure projects within their jurisdiction. Planning and development departments, as well as finance departments are responsible for selecting projects for the FFW programme, and the allocation, transfer, and supervision of funds. Generally they are not directly involved in execution of projects. Using the example of the department of water conservancy, Annex 1 illustrates the organisation of infrastructure construction in the countryside.

Project Engineering

29 All projects to be executed by the water conservancy department, including irrigation works, small hydropower works, drinking water, and projects relating to water, even those not executed by such departments, will have the engineering and design work done by the design institute that belongs to the same level (or higher) of the water conservancy department.

30 There are many problems with the engineering and design of the rural road projects. Since villages or communities themselves, without unified planning do a majority of the construction, generally there is seldom engineering or a design process before construction begins. If engineering is needed, design institutes at the county level or higher, or technicians working in the design institute, are invited to do the work.

31 Other infrastructure construction projects also seek out professional design institutes or technicians who belong to the responsible departments to do the engineering work. If there is no such design institute, normally the comprehensive design departments will take over the work. However, a majority of the projects are done without prior engineering.

Construction

32 Similar to the project engineering, specialised departments normally use construction teams that belong to these departments. However, in many instances social construction teams will be used because of the scope and quality requirements of projects or because limited (or sometimes no) specialised construction teams exist under the responsible departments. For large projects or where high quality is demanded, there is usually a tendering process to choose construction teams, but for most projects, the process of choosing construction
teams is still not standardised, and factors such as personal relations usually have a large influence on the final decision.

Management and Maintenance

33 The management and maintenance of infrastructure in the countryside differs depending on the kind and scale of infrastructure and the funding source. Take water conservancy as an example. After completion of the project:

- for small irrigation or drainage works built by community investment, the village will appoint a special unit or person responsible for the management or maintenance. However, due to unclear ownership of such works, the infrastructure is not usually properly maintained. To tackle the problem, methods like selling off infrastructure at reduced prices, leasing, and management by contract have been used during the recent years, and the results have been fairly good.

- irrigation or drainage works built by individual investors are managed and maintained by the investors.

- the management and maintenance of large water conservancy facilities built with state investments is done mainly by professional management, combined with the local community. Larger projects are managed by a combination of professionals and community, whereas the smaller projects are managed and maintained by the village and county that benefits. Normally, after the completion of small rural hydropower works or water supply works in the countryside, an enterprise is formed, which is responsible for management and maintenance. There are some small hydropower or water supply works whose management and maintenance responsibility lies with the department dedicated to water conservancy facilities, since these small projects depend on the irrigation facilities.

34 With regards to rural roads, there is hardly any special maintenance since mostly roads are unable to collect tolls for road maintenance. In general, the main problems with rural infrastructure construction is “more emphasis on construction, but less on maintenance”; or “only construction without maintenance”.

Participation and Roles

35 Local governments play a dominant role in infrastructure construction. They are responsible for the raising funds; drawing up policies for voluntary labour investment; mobilisation, organisation and consultation with the beneficiary population; assisting the department in charge of supervision of quality of construction; and the approval of projects.

36 The beneficiary population normally supplies funds and voluntary labour, as well as infrastructure maintenance. In the poor areas, because of the financial limitations, the population generally supplies only labour rather than funds.

37 The construction team takes responsibility for keeping the project on schedule, as well as quality control. In cases where the project is designed by an institute, this institute bears the joint responsibility for the quality of the project.
Financing parties are not normally directly involved in project construction. For projects using loans, the lenders will oversee the use of funds, and audit, supervise and control the construction progress.

Requisition of Land, Migration and Compensation

Since infrastructure construction in the countryside is normally small-scale, mainly within the village communities, they usually avoid problems like re-settlement as in the cases of reservoir-flooded areas. Small-scale projects also try to avoid taking land from farmers. When that cannot be avoided, compensation is made according to methods regulated by the government. If land is taken and structures dismantled, the local government will allocate new lands and compensate for the dismantling of buildings. The principle in doing this is to guarantee that output and standards of living after resettlement are not lower than before the migration.

Funding and Cost Recovery

Structure of Investment Funding

Funding sources for rural infrastructure construction mainly include the following:

- funds raised by people living in the community and their labour;
- local taxes;
- budgetary funds and subsidies from different governmental levels;
- FFW and special purpose funds allocated by the state;
- poverty relief funds from specialised state departments and from counterparts at the provincial level;
- donations by enterprises or organisations from the involved region (There are some examples of roads constructed using only money provided by enterprises, which benefit local farmers);
- loans from domestic banks; and
- donations or low cost loans from international organisations and international banking institutions.

The foregoing shows a variety of funding sources for infrastructure. Because of the long investment period of infrastructure, perceptions of low returns, and few beneficial policies from the state, loans are not typically used for small-scale rural infrastructure in PRC at present.

Funds for Operation and Maintenance

After the completion of rural infrastructure construction, the state will not generally give any further funds (or subsidy) for operation and maintenance of infrastructure, no matter how much as been invested or how high the subsidy may
have been. Typically fees are charged for water and electricity, but not for roads. Income from fees is the main source of funds for operating and management of irrigation and drainage works, as well as for maintenance, improvement and renovation. Charges for water are set separately according to usage and are in line with state economic policy and current reserves. Charges are fixed on the basis of the calculation of water supply costs that include: salaries, storage costs, energy costs, depreciation and overhaul costs, project maintenance costs, other direct costs and management fees.

43 The management and maintenance expenses for small hydropower works and drinking water works are handled by the management units of such projects or relevant level of government authorities. The source of funds is the income from the sale of water or electricity.

44 Generally, there are no special funds for managing or maintaining rural roads. In most cases, if there are serious problems with roads (such as damage by flooding) the local government will call for voluntary labour for simple repairs.

Cost Recovery of Projects

45 Since the main sources of funds for infrastructure construction in the countryside are the budget and government subsidies and funds raised locally, generally the issue of cost recovery does not arise. Only in some infrastructure projects, such as irrigation works, drinking water projects, hydropower works and road construction, where bank loans or other loans from international institutions are used, is there the question of cost recovery. In addition, there is usually a part of the fund raised from the local farmers or through their labour that will not be repaid.

46 User fees are appropriate for small irrigation works, meaning the benefited farmers or families using irrigated water should pay water charges. Detailed water charges are calculated and fixed according to the water management methods taking farmers’ ability to pay into consideration. Households can pay the water charges by cash or in an equivalent amount of grain. Drinking water projects and small hydropower works charge for water and electricity consumed.

47 Cost recovery is done by relevant managing departments through centralised collection and payment, into specific accounts. Procedures are needed to guarantee that the funds will be used in the operation, management, maintenance and renovation of infrastructure and that a portion of fees equal to the depreciation retained to repay capital investment.

Review of Food for Work Projects

48 Between 1984 and 1996, FFW projects were executed in seven phases, with different construction emphases. After 1996, this investment fund has been allocated each year into financial budgets, rather than through direct payouts, and the form of payment is cash instead of goods. From 1984 till 1996, 18.3 billion yuan were invested through the fund, 4 billion yuan both in 1996 and 1997, and 5 billion yuan both in 1998 and 1999.
49 Counties are the basic executing unit for the FFW programme. County Planning Committees make plans keeping in mind the number of projects needed and considering the effect on economic development of projects across infrastructure sectors. They report to the State Development Planning Committee (SDPC). SDPC decides, based on data provided by the State Statistics Bureau (SSB) for poverty incidence, the scale of investment in each province/region and the plan for fund allocation is made. Specific projects are selected at county level. Factors that influence SDPC’s allocations are:

- the number of poor;
- the distribution of poor counties;
- net income per capita of poor counties calculated by the state; and
- expenditure per capita of poor counties calculated by the state.

50 FFW projects mainly relate to infrastructure construction in the poor regions, including small hydropower works (including also electric grid renovation), drinking water, small water conservancy works, roads in counties and villages (normally roads below grade 4), telecommunications in the countryside (relay stations and lines), terracing (including upgrading on medium or low yield fields). Generally speaking these projects are not executed across counties.

51 Departments in county governments apply for FFW funds, while the engineering and execution is done by professional organisations. For bigger projects, special provincial level bureaux will take over the job. The relevant department will handle quality control and the local department will be responsible for maintenance after project completion, and no more funds will be available for such purpose. Recruiting a labour force and managing related funds is done by the local government (county or below county). Families maintain their own projects.

52 The planning committee system carries out work inspections each year on the FFW projects. Such inspection includes: financial supervision, auditing funds for helping the poor, oversight of whether or not projects are executed according to original programme, procedures followed in project decisions, lawfulness of investment of the funds, etc. Cross-provincial inspections are carried out to ensure the reliability of the inspections.

**Project Approval Decision Making**

53 Except for large-scale projects and those needing bank loans, the approval procedures for normal infrastructure construction projects are comparatively simple, and take into consideration the following factors: social utility of the project (including productivity and quality of life gains, governmental administrative requirements, realisation of governmental development goals in the countryside, etc.), economic utility, environmental impact, effectiveness for poverty reduction, financing capabilities, sectoral development plans designated by the supervising department of government, and the harmonious development of different facilities.
The approval procedures for projects using bank loans are much more complicated. Besides all the above factors, further criteria include: ability of repayment, economic evaluation of project, financial and economic internal rates of return, net value, indeterminacy of the project, period of investment recovery, and period of refund for the fixed asset investment, debt, etc.

Monitoring and Evaluation Systems

Generally speaking, not much emphasis is attached to the monitoring and evaluation of existing infrastructure construction projects in the countryside. More emphasis is given to the monitoring and evaluation to projects of bigger scale and those using borrowed funds from ODAs. Project execution is more effective where there is monitoring and evaluation.

The Effectiveness of Infrastructure in Rural Poverty Reduction in the PRC

The construction of infrastructure in rural areas is one component of an effective poverty reduction policy, although the provision of infrastructure has not typically been viewed as the major factor influencing the dramatic reduction in the poverty population in rural areas of the PRC over the last two decades. There are three notable trends in rural poverty that must be taken account of when designing future interventions. These are:

- a dramatic decline in the absolute numbers of people living in poverty since 1978;
- the changing nature and structure of rural poverty; and
- growing or persisting income gaps between rural and urban dwellers.

Following the reforms of Deng Xiaoping, PRC made rapid gains in the fight against rural poverty. It is estimated that between 1978 and 1985, absolute poverty in rural areas was reduced from about 270 to 100 million people, or from about one third to one tenth of the population. In the same period, the growth rate in rural areas was impressive and saw incomes rise from 150 yuan per capita in 1978 to 400 by 1985. Further strides were made during the 1990s.

Despite such an impressive performance, rural growth has been highly uneven and in ways that are crucial to understand the future prospects for poverty reduction and the institutional context in which decisions about infrastructure will be made. The central motor of rural growth following liberalisation was rural industry since the reforms allowed for the creation of non-state firms, the township and village enterprises (TVEs). This became the fastest growing sector of the economy and by

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1995 accounted for 30 percent of the PRC’s GDP\(^4\). For rural households, this meant that wages became a significantly larger proportion of overall household income as farmers left the land to take up jobs in industry, helping pull many out of poverty\(^5\). At the same time, it is true that reforms that promoted the development of agricultural markets also meant that yields increased and farmers began greater specialisation, which meant that income from agriculture also went up in many cases\(^6\). However, the move away from collective farming to household production was in a sense a one-time boost to agriculture and after initially high growth rates in the sector, growth has slowed\(^7\).

59 The TVE sector has been dynamic, but its benefits have been very unevenly distributed geographically in the PRC. Coastal areas in the east have disproportionately gained from the development of TVEs, while rural areas in central and western portions of the country have lagged far behind. Various explanations have been proffered for the lack of success of TVE development in remote rural areas of the PRC. Some explanations focus on the differences in initial starting position of the areas where TVEs took off. A number of authors view TVE-fuelled rural growth as essentially a suburban phenomenon, because of the proximity to urban centres of many TVEs\(^8\). TVEs take advantage of proximity to urban areas for their markets and in addition, the better soil quality of land in the eastern region meant that it was easier for many communities to build up surplus capital, which is essential for TVE start-up money\(^9\). The lack of initial local capital is one of the reasons that the poorest, remote regions have not participated in the TVE boom. Human capital is also essential for the functioning of TVEs and those close to cities can count on an inflow of technical expertise from urban residents. In addition, the level of education in eastern areas tends to be higher\(^10\).

60 Another set of explanations is essentially policy related, arguing that specific decisions either directly or inadvertently favoured better-off areas. In part, policies such as granting special incentives to development zones and a policy reversal that allows some to ‘get rich first’ have fostered the development of TVEs near the coastal areas\(^11\). Another aspect of the policy environment that has had an impact on the possibilities for poor rural areas is the highly fragmented nature of rural credit markets, making it difficult to fund projects in areas where there is a lack of capital, that tend to be the poorest areas\(^12\). The poor quality of infrastructure in the central

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6 Rozelle S 1996 Stagnation without Equity: Patterns of Growth and Inequality in China’s Rural Economy, China Journal 35:63-92
8 Peng, 1999
10 Peng, 1999
11 Yao and Liu, 1998
12 Yao and Liu, 1998
and western areas, particularly roads and telecommunications is also cited as a factor that has hampered the success of development in the interior of the country.\textsuperscript{13}

61 One of the key results of this pattern of rural growth has been a rapid and dramatic rise in regional inequality and especially inequality between urban and rural areas. After an initial reduction in rural-urban inequality following the Deng reforms, income differentials began rising again in 1985 and were historically high by 1992\textsuperscript{14}. It is not simply the pattern of industrialisation that has tended to skew the distribution of income in favour of urban dwellers. Rural fiscal policy is also a culprit according to many analyses. Governmental price subsidies are concentrated on urban residents\textsuperscript{15} and in rural areas, the system of taxation ensures that the poorest households bear the brunt of income transfers to the state\textsuperscript{16}. Not only does current fiscal policy hamper an effective poverty alleviation strategy, but numerous authors highlight the destabilising potential for the regime of growing regional and spatial inequality\textsuperscript{17}.

62 Partly as a result of this pattern of development and partly due to the risk of instability, in the mid-1980s the PRC began a targeted programme of poverty alleviation efforts for the rural poor that included subsidised loans, grants and the FFW policy mentioned above. Although little work has been done on evaluating the poverty reduction outcomes of these programmes, the accompanying Box suggests the need to have incentives for poverty reduction as part of the policy design.

\textbf{Evaluating Poverty Investments in Rural PRC\textsuperscript{18}}

\begin{quote}
Because the most remote rural areas have been slow to realise the gains from reforms that other areas have, authorities in the PRC have experimented with poor area policies with the intention of reducing poverty through economic growth. The realisation in the mid-1980s that decentralisation and generally favourable economic conditions were an insufficient stimulus for these areas led to a policy shift in favour of subsidised loans to households to promote growth. However, by the end of the decade, the fact that loans were mostly going to consumption rather than productive uses and the low repayment rate prompted authorities to shift focus again, this time to projects that would lead to development such as local enterprises. The FFW programme for rural infrastructure construction was enlarged to include agricultural infrastructure that would lead to increased output and productivity.

In one of the few attempts to evaluate anti-poverty programmes in rural PRC, sample data from Shaanxi was used to determine the effect of different types of policies on agricultural and industrial growth. Researchers found that loans to households, a policy that has at least partially been abandoned, were positively related to agricultural growth in poor counties. More surprisingly, investments in infrastructure were negatively related to agricultural growth possibly, the authors speculate, because the investments were concentrated in terracing and reforestation, rather than roads and telecommunications; the former have long time-horizons and use a lot of unpaid labour that could be put to other
\end{quote}

\begin{thebibliography}{99}
\setlength{\itemsep}{0em}
\bibitem{13} Rozelle S, A Park, J Huang and H Jin 1997 “Liberalization and Rural Market Integration In China” American Journal of Agricultural Economics 79:635-642
\bibitem{14} Yang DT and H Zhou 1999 “Rural-Urban Disparity and Sectoral Labour Allocation in China” The Journal of Development Studies February:105-133
\bibitem{15} Ibid
\bibitem{16} Khan and Riskin, 1998
\bibitem{17} Oi 1999; Schoenhals, M 1999 “Political Movements, Change and Stability: the Chinese Communist Party in Power” September:595-605
\end{thebibliography}
uses. None of the poverty related investment variables were associated with increases in industrial (TVE or SOE) growth, suggesting that investments in these in poor areas may not be the wisest use of funds. The authors’ conclusions highlight the role of creating incentives and instituting safeguards for good governance as part of poverty policy design. Because many poor counties faced a severe shortage of funds under decentralisation, local officials were more concerned with investing in revenue producing activities than in poverty reduction through growth or even used funds to meet payroll obligations. The shift from household to industry and agriculture to enterprises was also prompted by a changing set of incentives in the banking industry, which was increasingly responsible for generating profits so that loan officers wanted bigger, less risky clients. The case of Shaanxi appears to suggest that the allocation of poverty investment funds responds at least as much to the structure of incentives for local economic actors as it does to information about effective poverty reduction. The goal of policy makers should be to have those two match closely.

As a result of the changes that have occurred over the past two decades, the scope and nature of rural poverty have changed. Two hundred million people have been lifted out of absolute poverty but 50 million remain. They are concentrated in north, west and southwest of the PRC, are disproportionately comprised of minority groups and tend to occupy extremely marginal quality land. The eradication of this type of poverty is likely to be a much greater challenge for policy makers since many of the favourable conditions that have led to poverty reduction in the past, such as stocks of human capital, proximity to urban centres and savings that can be mobilised for investment in local industry, are absent.

Infrastructure investment and policies for rural PRC are tied to the more general category of poverty relief. The relationship between poverty areas and the lack of, or poor, infrastructure is striking, making the creation of better networks of infrastructure pressing.

Although PRC has made some remarkable gains in the provision of rural infrastructure throughout the 1980s and 1990s, outside observers agree that neither the stock nor the quality of existing infrastructure is adequate for development needs and indeed is a drag on growth.

Gains Made in Infrastructure

Progress in rural infrastructure has been uneven across sectors throughout the past two decades, in part because different forms of infrastructure play distinct roles in development strategy. The type of strategy chosen will have implications for rural infrastructure creation. For example, in the 1980s, the focus on growth in urban areas meant that the amount of irrigated land in PRC actually fell (from 7.33 million mu to 7.25 million mu) as a result of the expansion of urban and industrial areas. A focus drinking water supply during the 1980s by contrast, saw gains made in providing potable water for rural areas. Some of the trends are summarised in the following table:

<table>
<thead>
<tr>
<th>Year</th>
<th>Gains Made in Infrastructure</th>
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<tbody>
<tr>
<td>1980</td>
<td>Irrigated land fell (from 7.33 million mu to 7.25 million mu)</td>
</tr>
<tr>
<td>1990</td>
<td>Gains made in providing potable water for rural areas</td>
</tr>
</tbody>
</table>

Piazza and Liang, 1998
World Bank, 1994, ibid
Asian Development Bank, 1997, "Report and Recommendation of the President to the Board of Directors on a Proposed Loan and Technical Assistance Grant to the PRC for the Zhejiang-Shanxi Water Supply Project"
67  The financing of rural infrastructure has basically relied on local participation, especially the FFW Programme, begun in 1984, development funds and loans. The FFW Programme was instituted in poor rural areas of PRC with the goals of alleviating poverty and constructing infrastructure, initially focusing on roads and water projects, it was later expanded to other types. Cash is now typically paid to local workers on projects rather than food or other goods. Planning for these projects are the planning and executing units but decisions for funds are taken at the state level and based on poverty estimates overall. Since the mid-1980s approximately 31 billion yuan has been spent on the programme.

68  One of the difficulties in financing rural infrastructure has been the difficulty in using loans. Because the benefits are long term, but also often the investments would not bring enough extra revenue to counties to allow them to repay the loans, and there are relatively few funds available from the state, domestic banks are unwilling to lend much for rural infrastructure projects. This contributes to the lack of sufficient funds to meet infrastructure needs.

69  Compared with trends internationally, rural infrastructure projects in PRC have focused less attention in at least three areas. These are first, less attention to operations and maintenance costs. While O & M has been a chronic problem for infrastructure projects world-wide, which often do not spell out the mechanisms or responsibilities for recurrent costs, the fact that the rural counties in PRC have so few resources yet are responsible for O & M make this a priority. Second, cost recovery is an area where much work needs to be done. Although little data on cost recovery are available, anecdotal evidence suggests that it is fairly low. Management is fairly centralised and not as flexible as much of the international work suggests that such processes need to be. A third area where PRC diverges from international thinking is beneficiary participation or consultation. Participation is generally limited to supplying labour for projects rather than having an impact on the selection, design or implementation of projects.

**Case Study of PRC**

70  As part of the current project, a team of PRC and international researchers visited poverty counties in three southwest provinces: Yunnan, Guangxi and Guizhou to gather preliminary details on infrastructure needs and current projects. The findings based on meetings with local officials, bank officers and utility managers as well as conversations with farmers included the following:

- poorest villages are not targeted for poverty funds/infrastructure projects;
• cost recovery of many projects through user fees is very low;

• little knowledge exists about the impact of past poverty reduction or infrastructure projects;

• infrastructure loans perform significantly worse than other types of loans;

• there is little local support among officials for using market rate loans for infrastructure projects;

• the quality of existing infrastructure (especially rural roads, electricity) needs to be significantly improved;

• little money exists for maintenance of current infrastructure;

• local incentive structures favour building infrastructure, but not necessarily poverty reduction or addressing farmers' needs; and

• there is little, if any, beneficiary consultation during any phase of infrastructure project and few organised groups such as NGO or consumer groups appear to exist that could speak on behalf of beneficiaries.

Future Development

71 The recent experience with poverty reduction in the PRC suggests that no single policy intervention will solve the problem of rural poverty, but rather is likely to be a multi-pronged strategy that involves investments in human capital, small town development, labour mobility, policy reform as well as investments in infrastructure. However, we lay out here suggestions for future policy related to infrastructure development and provision, keeping in mind the policy environment in which such investments are likely to take place.

72 What these findings suggest is that decisions about infrastructure in the poorest areas need to be better co-ordinated with poverty reduction efforts. This means first, a better understanding of what infrastructure investments will have the most significant impact on poverty is needed. Currently available data, such as those from the household sample surveys carried out by the government, might shed some light on this. Some new data collection efforts in the form of pilot projects could also be targeted to this specific question. More information on the effectiveness of different types of small-scale infrastructure in poor counties needs to be analysed in terms of their relationship to growth and poverty alleviation. Data from SSB as well as information gathered under some of the World Bank's poverty projects could be a source of such knowledge but it must be incorporated into the policy making process. Officials making decisions about investments in infrastructure should have better information about what is likely to lead to more growth and be rewarded for making them.

73 However, information alone is insufficient in the absence of incentives to make use of it. If a perverse incentive structure exists such that local officials feel compelled to make investments in forms of infrastructure that have lower poverty reducing potential or to generate revenues rather than promote growth, the optimal
benefits of infrastructure are unlikely to be realised. For this reason, it is essential that poverty reduction be accorded priority in decision-making and in the career rewards of local officials.

74 Investments in hard forms of infrastructure alone are unlikely to produce optimal benefits. Soft infrastructure such as credit and micro-credit, agricultural extension and marketing information are necessary to help farmers and local officials take advantage of new infrastructure to maximise the ability of these areas to generate cash crops and promote other economic activities.

75 Mechanisms of beneficiary involvement need to be developed. This ought to be co-ordinated with credit and micro-credit programmes because of the current difficulties with cost recovery. On one hand, it is important to familiarise farmers with the notion of loan repayment and higher user fees, so that these are not considered grants. On the other hand, the poorest farmers may not be able to afford a wide array of infrastructure services or pay back loans in a short period of time. Consultation would allow officials to target the most needed or wanted services as well as devise innovative repayment schemes. Small flexible organisations also might be created that could manage small loans. Moving away from subsidies to loans should be a priority in those areas where identifiable beneficiaries exist, a clear payoff to users is evident and the infrastructure is excludible (i.e. irrigation tanks for household fields).

76 Infrastructure should play a role as one part of a well co-ordinated poverty alleviation package that also includes micro-finance, agro-industry and voluntary migration. Currently, at the local level, there is little understanding of how these might create anti-poverty synergies. In addition to building local capacity of officials, incentive structures must be developed to encourage them to find innovative ways of promoting growth and reducing poverty.

77 Another area where the effectiveness of small-scale infrastructure could be enhanced involves promoting its better use. Because the lack of human capital in many of the country’s poverty areas is especially great, the need for training is also great. The poor quality of the land suggests that one area where productivity can be increased is through the use of new seed varieties, fertiliser. However, farmers must be trained in their use. Much greater use of agriculture extension services should accompany investments in agricultural infrastructure. This also includes marketing information, which is essential if farmers decide to switch to cash crops.

78 The FFW programme has been an extremely important component of rural infrastructure construction. The focus on agricultural infrastructure that enhances productivity should be maintained in poor areas as a way of reducing poor households’ dependence on paying cash for staples. At the same time, programme officials should maintain its focus on building infrastructure that has a clearly visible payoff in terms of poverty reduction. Since the labour spent working in the programme represents an opportunity cost for farmers, demanding excessive unpaid labour both has a potentially negative effect on poverty reduction as well as represents a potential source of discontentment and instability.

79 For the foreseeable future, out-migration of labour is likely to be an important source of household income in poor areas. Poverty officials should consider how
infrastructure can be used in a strategy that enhances the returns to migration. For example, it may be that better roads cut down on the cost of migrating or allow labourers to spend more time working out of the village. Better telecommunications may help disseminate information about potential jobs.

80 Finally, cost-recovery for infrastructure is an important consideration for its provision. In order to ensure that costs can be recovered as effectively as possible, it is imperative that officials take consumers’ preferences into account when designing programmes. Beneficiaries must be consulted both in terms of what they want and how much they are willing to pay for infrastructure. In addition, creative financing mechanisms should be instituted, such as flexible payment schedules and possibly the use of micro-credit mechanisms for financing the initial costs of services such as connections or equipment.

Annex 1 System Structure of Rural Water Conservancy
(Hydropower)

81 The Bureau of Rural Water Conservancy under the Ministry of Water Conservancy is the supreme administrative department for rural water conservancy. There is a wide range of water conservancy in the countryside, including irrigation of farmland, drinking water for man/livestock and small hydropower works and etc. The county level and higher governments are also equipped with administrative departments for water conservancy. The water conservancy departments at different levels receive administrative leadership from the governments of the same level and operational leadership from the special water conservancy departments of upper levels. Starting from the mid1980s, grass-roots service systems in three different layers including: village water conservancy management stations, special supervising organisations for projects and citizen water management groups were established.

82 Generally there are different kinds of water conservancy units within the administrative water conservancy department all the way from the central government to local levels. These units are responsible for providing assistance to the water conservancy administrative departments in project development, planning, engineering and construction. For the completed projects, water conservancy administrative departments of different levels carry out the operational management and maintenance on behalf of the government. In other words, water conservancy (hydropower) administrative departments at provincial, area and county levels take full responsibility for projects, including irrigation and drainage, small hydropower, drinking water for man/livestock, flood prevention, from working out plans, engineering, construction, management until operation. The water conservancy management stations in the villages take responsibility for the operation and maintenance of each water conservancy works. These stations also provide technical service to farmers. The following sketch illustrates the management structure:
With the reforms and open-door policy and the economic development of the countryside in PRC, there was a rapid increase of demand for electricity. As a result, the electricity grid developed rapidly. Total consumption of electricity in the county level or below reached 440 billion kilowatt hours, representing 40.2% of the total non-industrial consumption, of which the rural areas use 220 billion kilowatt hours or 20.1 percent of the total non-industrial consumption. However, the development of the rural grid is unbalanced, with problems of lagged construction of the electricity grid, outdated equipment, weak cable networks, irrational distribution, management problems, etc. All these have brought risks to usage and high charges in rural areas. Many farmers cannot afford to use electricity, which not only hinders agricultural production and upgrading living standards, but it also jeopardises the market development of electricity in the countryside. The TV-Telephone meeting held on June 19, 1998 on accelerated construction of electrified cable networks, served as the prelude to the construction of cable networks in the countryside. Both this and reducing rural electricity fees is an important for economic development and raising rural living standards. It is also an effective way of increasing household demand and encouraging household development.

On August 10 1998, the State Development and Planning Committee issued the first part of projected plan for the construction of rural power grids, with a total investment of 11.2 billion yuan. Affected areas include 17 provinces, municipalities and regions that consist of Beijing, Tianjin, and 364 county grids. On October 4 1998 the State Council transmitted the request of "two reforms for the price of one", meaning merging urban and rural grid systems with a unified price. In doing this, the State Council has set a clear direction and goal to construct and update the power...
grid network by combining these with management and cost structure reform. This is not formally on the agenda of different parts of the government. Relevant programmes and plans have been made by different levels of governments to carry out “two reforms for the price of one”. In the next three years, a total of 185 billion yuan will be invested for the construction and renovation of electricity grid.
Training Programme

The Training Programme

Training in the Philippines
The Programme
The General Findings
Ideas for Consideration in PRC
Follow-up Activities
Participatory Methods for Poverty Reduction Programmes Training Course
Training in Thailand

Outcome

Annex 1

The Context of the Training Programme
Poverty in PRC
The Technical Assistance

Objective

Components of the Training

The Training Methodology
Participation
Participants
The Dynamics of the Training Programme

Training Needs Analysis
Present Job Functions of Participants
Determination of Needs
Knowledge and Skills of Counterpart Staff and Workshop Participants
The Workshop and Fieldwork Findings
Summary of the Proposed Overseas Training Coverage

Country Selection
<table>
<thead>
<tr>
<th>Training Programme</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Overseas Training Implementation</strong></td>
<td>29</td>
</tr>
<tr>
<td>The Requirements of the Programme</td>
<td>29</td>
</tr>
<tr>
<td>Participant Selection</td>
<td>29</td>
</tr>
<tr>
<td>Timing, Logistics and Financing</td>
<td>30</td>
</tr>
<tr>
<td>Knowledge and Skill Development Expectations</td>
<td>31</td>
</tr>
<tr>
<td>Follow-up Activities</td>
<td>31</td>
</tr>
<tr>
<td>Evaluation</td>
<td>32</td>
</tr>
</tbody>
</table>
The Training Programme

1 Under the TA a training programme was formulated. The overall training objective was that participants were able to understand, describe, promote and apply successful international approaches to poverty reduction, modified where necessary to take account of the PRC context.

2 The training result was to be that in their job functions participants were able to disseminate the knowledge and experience gained and to positively influence the future design and implementation of poverty reduction projects through bringing to bear their knowledge of international best practice and success factors in poverty reductions elsewhere. There were two distinct aspects to this:

- development of selected LGOP staff to enhance their skills and knowledge to enable them to better fulfil their own job responsibilities in the design and management of poverty reduction projects; and

- development of selected LGOP staff to act as trainers and disseminators of information so that the skills and knowledge of others in LGOP and LGOP’s partners in project implementation are also enhanced.

3 After careful consideration, the Philippines and Thailand were selected for training.

Training in the Philippines

The Programme

4 Various organisations were approached and the International Institute for Rural Reconstruction (IIRR) was selected to provide the training that was carried out between 20 February and 12 March 2000. The training programme was attended by eight poverty officials from PRC drawn from LGOP and officials of the Poverty Alleviation Departments of Guangxi, Henan, Guizhou, Shanxi and Ningxia.

5 The programme designed by IIRR focused on:

- the interlocking nature of poverty;
- philosophies and principles of rural reconstruction (in the Philippines);
- people’s participation in integrated rural development;
- co-operative and rural enterprise development;
- Philippine Government poverty reduction policies and approaches;
- local government support for rural enterprise development;
- agroindustries and rural enterprises as a means of poverty reduction;

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1 See annex 1 for the detailed training proposal used in the TA.
• rural infrastructure development as a means of poverty reduction; and
• sustainable natural resource management.

6 The programme design used field experience to deliver messages to participants through a cycle of orientation, field visits and contacts with key informants in Government and beneficiaries, sharing of experiences between participants, and identification of key concepts and approaches that may lead to useful ideas for PRC.

7 The programme schedule is summarised in the table below.

<table>
<thead>
<tr>
<th>Date</th>
<th>Activity</th>
<th>Topic Areas</th>
</tr>
</thead>
<tbody>
<tr>
<td>20 Feb</td>
<td>Arrival in Philippines</td>
<td></td>
</tr>
<tr>
<td>21 Feb</td>
<td>Introduction to the Philippines</td>
<td>Overview of the Philippines administrative and political structure</td>
</tr>
<tr>
<td></td>
<td>Introduction to IIRR</td>
<td>Overview of IIRR history and mandate</td>
</tr>
<tr>
<td></td>
<td>Rural reconstruction philosophies and principles in the Philippines</td>
<td>The Philippine approach</td>
</tr>
<tr>
<td></td>
<td>Participation and integration concepts and dimensions</td>
<td>Understanding the dimensions of poverty and the concepts of popular participation and integration</td>
</tr>
<tr>
<td>22 Feb</td>
<td>Visits to Cavite Farmer’s Feedmilling and Marketing Co-operative and Barangay Scholar Multi-purpose Co-operative</td>
<td>Co-operative development, rural enterprise development (livestock and lowland farms</td>
</tr>
<tr>
<td></td>
<td>Group reflection</td>
<td>Functional participation and integration</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Insights and lessons from the field</td>
</tr>
<tr>
<td>23 Feb</td>
<td>Visit to National Anti Poverty Commission and National Economic Development Authority</td>
<td>Poverty policy</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Government approaches to poverty reduction and rural development</td>
</tr>
<tr>
<td>24 Feb</td>
<td>Visit to Land Bank of the Philippines/People’s Credit and Finance Corporation</td>
<td>Regulation and supervision of microfinance institutions</td>
</tr>
<tr>
<td></td>
<td>Visit to Philippine Business for Social Progress</td>
<td>Use of apex organisations to mobilise and channel funds for the poor</td>
</tr>
<tr>
<td></td>
<td>Group reflection</td>
<td>Agroindustry and rural enterprise technologies and financing</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Insights and lessons from the field</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>Activity</th>
<th>Topic Areas</th>
</tr>
</thead>
<tbody>
<tr>
<td>25 Feb</td>
<td>Visit to Centre for Agriculture and Rural Development</td>
<td>Microfinance development in the Philippines</td>
</tr>
<tr>
<td>26 Feb</td>
<td>Rest Day</td>
<td></td>
</tr>
</tbody>
</table>
8. LGOP has summarised its findings from the training programme which are presented below.

**The General Findings**

<table>
<thead>
<tr>
<th>Date</th>
<th>Activity</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>27 Feb</td>
<td>Travel Day to Bagio</td>
<td></td>
</tr>
<tr>
<td>28 Feb</td>
<td>Visit to Cordillera Highland Agricultural Resources Management Project</td>
<td>Upland development</td>
</tr>
<tr>
<td></td>
<td>Meetings with line agencies supporting the project</td>
<td>Line agency collaboration Agricultural support service delivery</td>
</tr>
<tr>
<td>29 Feb</td>
<td>Meetings with NGOs working with CHARM Project</td>
<td>NGO-Government collaboration Community organising, mobilisation and peoples participation</td>
</tr>
<tr>
<td>1 Mar</td>
<td>Interactions with Department of Agriculture on Integrated pest management.</td>
<td>Sustainable agriculture</td>
</tr>
<tr>
<td></td>
<td>Interaction with CHARM Project</td>
<td></td>
</tr>
<tr>
<td>2 Mar</td>
<td>Visit to the Co-operative Bank of Benguet (CBB)</td>
<td>Microfinance to Self-help groups</td>
</tr>
<tr>
<td></td>
<td>Visit to Kibungan Local Government and self-help client group of CBB</td>
<td>Local government-private sector co-operation</td>
</tr>
<tr>
<td></td>
<td>Group reflection</td>
<td>Local government support to rural enterprise development</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Insights and lessons from the field</td>
</tr>
<tr>
<td>3 Mar</td>
<td>Visit to CLSU</td>
<td>Academic perspectives and initiatives on poverty reduction</td>
</tr>
<tr>
<td>4 Mar</td>
<td>Travel day to Manila</td>
<td></td>
</tr>
<tr>
<td>5 Mar</td>
<td>Travel to Negros</td>
<td>Upland development programme</td>
</tr>
<tr>
<td></td>
<td>Project Briefing on Northern Negros Forest Reserve</td>
<td>Rural infrastructure</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Sustainable natural resource management</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Agroforestry and reforestation</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Project transition to local government management</td>
</tr>
<tr>
<td>6 Mar</td>
<td>Meeting with Governor of Negros</td>
<td>Local government poverty reduction initiatives</td>
</tr>
<tr>
<td></td>
<td>Orientation for Project Dunganon</td>
<td>Microfinance for women’s self help groups</td>
</tr>
<tr>
<td>7 Mar</td>
<td>Discussion with Ilog Municipality officials on collaboration</td>
<td>Government-NGO-private sector-academic collaboration on poverty reduction programme design and implementation</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Social services and food security</td>
</tr>
<tr>
<td>8 Mar</td>
<td>Wrap-up and programme synthesis</td>
<td></td>
</tr>
<tr>
<td>9/10 Mar</td>
<td>ADB Training</td>
<td>ADB Poverty Reduction Strategies</td>
</tr>
<tr>
<td>11 Mar</td>
<td>Rest Day</td>
<td></td>
</tr>
<tr>
<td>12 Mar</td>
<td>Return to PRC</td>
<td></td>
</tr>
</tbody>
</table>
The Philippines is comprised of more than 7,100 islands with an area of 300,000 sq km. The population is estimated at 72 million. In 1997, the poverty rate was 32.1% equating to about 23 million poor people, mostly in rural areas. A feudal system of land ownership has been the most important cause of poverty. Before land reform only about 30% of peasants have their own land. The percentage has increased to 40% through land reform efforts, but most peasants are still landless. The land ownership system has mitigated against investment and improvement of agriculture techniques and out migration from rural areas with growing population had led to extreme urban poverty because jobs have not been available.

In 1997, Philippines Government set the goal for the poverty rate to decrease 7% in the current five year plan (1999-2004). The Government’s anti poverty strategy addresses living needs, security needs and rights needs and has 33 indexes to measure poverty covering, for example: food and nutrition, health, drinking water, hygiene, clothing, housing, peace and public security, income and employment, basic education and culture, mass participation, family and social welfare and others.

In the Philippines, poverty reduction is regarded as the most important task for developing the economy. The Government does not centrally carry out poverty reduction work in the way LGOP manages it in PRC, but implements strategy through policies and funds that support self-help, civil society and NGOs initiatives and contributions to local government budgets sometimes individually and sometimes in combination. Such “partnerships” are a feature of poverty reduction work in Philippines. The National Economic Development Authority (NEDA) Committees is responsible for overall co-ordination.

The Philippines has a market economy, and market principles such as beneficiary payment for services (for example from infrastructure projects), and free interest rates for micro-credit so that there is sustainability are common, empowering the organisations that implement the projects by giving them responsibility for profits and losses.

“Participation”, particularly that of beneficiaries, is another theme in poverty reduction in the Philippines and is common from the outset of projects to help to ensure projects meet real needs, ownership is created from the outset, and the risks of high cost or delay in implementation are minimised. The aim is sustainability. To ensure beneficiary and other views are reflected in planning one quarter of the members in each level of the NEDA committees are drawn from NGOs, civil society, the private sector and beneficiaries. The national Anti Poverty Commission also has representatives from area governments.

Training is central to all Philippines poverty reduction projects. The training is comprehensive and covers productive skills training, organisation ability training and project planning and designing training. Most of these inputs are financed from the government budget and TA grants from donors.

The Philippines Government also attaches importance to documentation and promotion of projects. Most projects have detailed written materials describing their activities and some of also have audio visual materials.
16 Despite the undeniable effectiveness of the Philippine approach at a project level, there are still major constraints in poverty reduction. Specifically, the most important are observed to be: the limited progress with land reform which effectively denies the poor ownership of natural resource assets and impedes investment in physical assets to improve the natural resource base; below the provincial government level, there is not a decided poverty reduction cadre so management can be weak; sustainability in management and funding is not always apparent because resources for implementers are not necessarily guaranteed over the long term; and although the government has established measures of poverty, these are often not used in practice to measure project progress and success.

Idea for Consideration in PRC

17 As hoped, the study tour led to several useful ideas for further consideration by LGOP in future planning of poverty reduction in PRC. Specifically, the study tour participants conclusions were as follows.

- In PRC there has long been an income index to define poverty. This index is suitable for the phase that solves the needs of food and clothing, but the value is limited. PRC could learn the “Basic Needs” strategy from Philippines. It is suggested that PRC should consider establishing broader, more comprehensive and composite poverty reduction targets and relevant indices when working out the 21st Century Poverty Reduction Plan consistent with PRCs own societal goals and compatible with international standards.

- Greater attention could be given to publicization of LGOP activities. Pamphlets, a yearbook and a PRC Poverty Reduction website are ideas to consider. LGOP could issue regular information on poverty status, poverty reduction projects (internationally and domestically sponsored) and could use the information base to help secure new investment in poverty reduction.

- It is suggested that LGOP should orientate the use of poverty reduction funds’ increasingly to market principles. Interest rates should be liberalised and microfinance organisations should be free to lend at higher interest rates than for commercial credit in recognition of the higher costs. For the infrastructure projects where the beneficiaries are clearly identified (for example: in irrigation and electricity projects) recovery mechanisms for principal and interest should be considered.

- LGOP should formulate a general poverty reduction programme in accordance with the State Developing Plan that in turn would be implemented though different project initiatives. In specific projects, developed over time, greater civil society, NGO, private sector and beneficiaries participation in project design, implementation and supervision should be developed.

- The present PRC poverty reduction programme is worked out by county. This often reflects the country cadres’ wishes rather than being based on an analysis of the actual needs of the poor. New working methods should be introduced to consult with beneficiaries and assist them to analyse their status and needs to achieve better results through self-education and capacity building.
Government should ensure the agriculture departments have enough funds and energy to provide proper agricultural extension services including farmer training, on-farm advisory services and continuous capacity building for extension agents.

Urban poverty issues can not be ignored. World Bank, ADB and some international institutes would like to develop the collaboration in urban poverty field, but there is no relevant department in PRC. It suggested that urban poverty reduction is incorporated into State Poverty Reduction Plan, managed by LGOP.

It was observed that ADB was most interested in collaborating with PRC on poverty reduction, particularly at the provincial level. It is necessary to continue to deepen the understanding in LGOP of ADB procedures and policies in order to take advantages of this intention. There are many options for use of OCR funds, particularly in combination with softer resources.

Follow-up Activities

Following the study tour each of the participants prepared a report on their findings and the applicability to poverty reduction in PRC that was submitted to their own provincial authorities. FCPMC received positive feedback from the provincial level poverty offices on these reports and they were consolidated into the findings above. These have been widely circulated, and have also been distributed to poverty officials in some provinces at the prefectural and county levels. Other initial follow up activities have included:

- Two training workshops carried out for poverty offices in Ningxia and Guizhou for about 40 poverty officials to share the experiences and lessons from the study tour;
- Presentation of the findings of the training to 30 poverty officials in Guangxi in July 2000;
- Circulation of the study tour findings to 25 professional staff members of FCPMC in June and July 2000 for their review and comment in relation to FCPMC's future operations and in depth discussions with study tour participants to learn in more depth about their experiences and ideas.

FCPMC will also incorporated the findings of the study tour into its internal training programmes where appropriate. The first example is a course on "Participatory Methods for Poverty Reduction Programmes" which will be given under the auspices of the "Honghe Valley Environmental Improvement and Poverty Reduction Project" which is being funded by the European Union. The course is planned for two weeks and will involve 42 participants including 10 officials from the State Council Leading Group Office and FCPMC and 32 poverty officials from Guangxi, Guizhou, Yunnan, Shaanxi, Sichuan, Ningxia, Gansu, Inner Mongolia, Hubei, Hunan, Chongqing, Jianxi, Anhui, Shanxi, Hebei and Xinjiang. The course outline is illustrated below.
Participatory Methods for Poverty Reduction Programmes Training Course

<table>
<thead>
<tr>
<th>Activity/Topic</th>
<th>Trainer</th>
<th>Duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction to the Honghe Project</td>
<td>Yunnan EU Project Management Office</td>
<td>1 day</td>
</tr>
<tr>
<td>Overview on international Poverty Reduction policy and Practice</td>
<td>Invited outside expert</td>
<td>1 day</td>
</tr>
<tr>
<td>Grameen Bank Microcredit</td>
<td>International Expert/LGOP</td>
<td>0.5 days</td>
</tr>
<tr>
<td>International Mountain Agriculture Development Policy and Practice</td>
<td>FCPMC</td>
<td>0.5 days</td>
</tr>
<tr>
<td>Theory and Practice on Participatory Methods</td>
<td>Centre for Integrated Agricultural Development</td>
<td>2 days</td>
</tr>
<tr>
<td>Participatory methods in the Philippines</td>
<td>Participants in the Philippines Study Tour</td>
<td>1 day</td>
</tr>
<tr>
<td>Field visits to and interviews with project households with focus on beneficiaries participation</td>
<td>Led by Yunnan EU Project Management Office</td>
<td>3 days</td>
</tr>
<tr>
<td>Group discussion</td>
<td>FCPMC facilitator</td>
<td>2 days</td>
</tr>
<tr>
<td>Wrap-up</td>
<td>FCPMC facilitator</td>
<td>1 day</td>
</tr>
</tbody>
</table>

Training in Thailand

At the time of writing the Final Report, the training Thailand had yet to be carried out because of budgetary constraints. Preliminary plans have been made with the Bank for Agriculture and Agricultural Co-operatives (BAAC) in Thailand for the training if adequate resources become available. The planned training schedule is shown in the table below.

<table>
<thead>
<tr>
<th>Day</th>
<th>Activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Day 1</td>
<td>Arrival in Thailand</td>
</tr>
<tr>
<td>Day 2</td>
<td>Introduction to Thailand&lt;br&gt;Introduction to BAAC&lt;br&gt;Meeting with President of BAAC&lt;br&gt;Briefing on rural development policy and poverty reduction in Thailand&lt;br&gt;Overview of BAAC operations and rural and microfinance products and services</td>
</tr>
<tr>
<td>Day 3</td>
<td>Briefing on SME credit&lt;br&gt;Briefing on savings mobilisation and deposit schemes&lt;br&gt;Briefing on farmer’s institutions in Thailand</td>
</tr>
<tr>
<td>Day 4</td>
<td>Briefing on credit unions in Thailand&lt;br&gt;Visit to women’s self-help group</td>
</tr>
<tr>
<td>Day 5</td>
<td>Field visit to Chacherng Sao Province to environment conservation centre and Wangnamyen Agricultural Co-operative</td>
</tr>
<tr>
<td>Day 6</td>
<td>Visit to Sakaew Branch&lt;br&gt;Visit to BAAC farmer clients&lt;br&gt;Visit to dairy co-operative&lt;br&gt;Travel to Chantaburi Province</td>
</tr>
<tr>
<td>Day 7</td>
<td>Visit to Kloong Credit co-operative&lt;br&gt;Visit to BAAC Chantaburi Branch&lt;br&gt;Visit to BAAC clients growing durian and mangosteen&lt;br&gt;Travel to Rayong Province</td>
</tr>
<tr>
<td>Day 8</td>
<td>Visit to rubber plantation&lt;br&gt;Visit to Wangchan Social Investment Fund Project&lt;br&gt;Travel to Cholburi Province</td>
</tr>
<tr>
<td>Day 9</td>
<td>Visit to BAAC Cholburi Branch</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Day</th>
<th>Training Programme</th>
</tr>
</thead>
<tbody>
<tr>
<td>Day 10</td>
<td>Visit to His Majesty the King’s Project, Chitralda Palace</td>
</tr>
<tr>
<td></td>
<td>Visit to the population and community Development Association (PDA) family planning project</td>
</tr>
<tr>
<td>Day 11</td>
<td>Visit to Her Majesty the Queen’s Project Supplementary Occupation Promotion Group</td>
</tr>
<tr>
<td></td>
<td>Visit to orchid plantation group</td>
</tr>
<tr>
<td>Day 12</td>
<td>Rest day</td>
</tr>
<tr>
<td>Day 13</td>
<td>Travel to Saraburi Province</td>
</tr>
<tr>
<td></td>
<td>Visit to Thai market</td>
</tr>
<tr>
<td></td>
<td>Visit to His Majesty the King’s Project for self sufficiency development</td>
</tr>
<tr>
<td></td>
<td>Visit to Mouglek agricultural co-operative</td>
</tr>
<tr>
<td></td>
<td>Travel to Nakorn Ratchasima Province</td>
</tr>
<tr>
<td></td>
<td>Visit to Chakarat community development project</td>
</tr>
<tr>
<td>Day 14</td>
<td>Visit to BAAC Nangron Branch</td>
</tr>
<tr>
<td></td>
<td>Visit to Community based integrated Rural Development Project</td>
</tr>
<tr>
<td></td>
<td>Travel to Bangkok</td>
</tr>
<tr>
<td>Day 15</td>
<td>Travel to Ayuthaya Province</td>
</tr>
<tr>
<td></td>
<td>Visit to Ayuthaya Land Reform Project</td>
</tr>
<tr>
<td></td>
<td>Travel to Nakorn Sawarn province</td>
</tr>
<tr>
<td></td>
<td>Visit to Central Paddy Market</td>
</tr>
<tr>
<td>Day 16</td>
<td>Travel to Pichit Province</td>
</tr>
<tr>
<td></td>
<td>Visit to Social Investment Fund Project</td>
</tr>
<tr>
<td></td>
<td>Visit to Bang Kratoom Hospital Social Investment Fund Project (Herb Planting Group)</td>
</tr>
<tr>
<td></td>
<td>Travel to Pisanulok Province</td>
</tr>
<tr>
<td>Day 17</td>
<td>Travel to Chiang Mai Province</td>
</tr>
<tr>
<td></td>
<td>Visit to BAAC Chiang Mai Branch</td>
</tr>
<tr>
<td></td>
<td>Visit to Rural Community Development Projects</td>
</tr>
<tr>
<td>Day 18</td>
<td>Visit to GTZ Microfinance Project</td>
</tr>
<tr>
<td></td>
<td>Visit to farmer’s Association</td>
</tr>
<tr>
<td></td>
<td>Visit to Sarapee Agricultural Co-operative</td>
</tr>
<tr>
<td>Day 19</td>
<td>Travel to Bangkok</td>
</tr>
<tr>
<td>Day 20</td>
<td>Visit to Nong Po Dairy Project</td>
</tr>
<tr>
<td></td>
<td>Visit to fish farming project</td>
</tr>
<tr>
<td>Day 21</td>
<td>Seminar discussion and wrap up</td>
</tr>
<tr>
<td>Day 22</td>
<td>Depart for PRC</td>
</tr>
</tbody>
</table>

**Outcome**

21 Para 17 above shows that the Philippine Study tour has in fact had a deep impact on the participants, and many new ideas have been brought to the forum for the discussion of future poverty reduction efforts in the Philippines. Resources permitting, it is recommended that the study tour to Thailand goes ahead.
The Context of the Training Programme

Poverty in PRC

22 The 8/7 programme initiated by the PRC Government in 1994 to lift the remaining 80 million poor out of poverty in 7 years draws to close in 2000. With the likely positive achievement of the 8/7 objectives it is an appropriate time to consider the future of poverty reduction programmes in PRC based on the lessons learned domestically and internationally and the emerging challenges.

23 Despite the exemplary success of the poverty reduction efforts in PRC, research into and analysis of the existing programmes (subsidised loans, food for work, and budgetary grants for poor areas) has highlighted opportunities for improvement including reassessment of the poverty line, improvements in targeting of poverty funding, and improvements in sustainability of poverty reduction programmes and governance.

24 The nature of the poverty problem in PRC is also changing. Many of the remaining 42 million “very poor” live in remote mountainous regions where the provision of infrastructure is uneconomic and delivery of social services difficult. There are more than 120 million rural unemployed, and productivity gains in agriculture are increasingly difficult to achieve. Reform of state owned enterprise is swelling the ranks of the unemployed with layoffs expected to reach 25 million by 2000. Urban poverty is rising as a result. Inequality between urban and rural incomes is rising. While in the long run the solution to poverty in remote mountainous regions may be the expansion of the resettlement programmes of the government, there are many other pressing priorities: to ensure that those near the poverty line do not slip back below it and to proactively address the emerging urban poverty problem: “poverty avoidance”. These emerging challenges justify the consideration of new approaches and the application of international learning experiences.

25 PRC is unique in its bureaucratic infrastructure for poverty reduction reaching from national to township level through the State Council Leading Group Office for Poverty Alleviation and Development (LGOP) and Poor Area Development Offices (PADOs). As the problem of the very poor is progressively solved, this infrastructure could be very usefully refocused on consolidating the gains, improving impact by addressing the constraints of existing programmes, and perhaps most importantly bringing to bear the international experience and lessons learned about effective poverty reduction in the design of its own programmes and those of the official development agencies that support it.

The Technical Assistance

26 The training programme is being undertaken as part of an Asian Development Bank (Bank) financed technical assistance (TA) to the Government of
the People’s Republic of China (PRC) and is fully integrated into the TA activities and methodology.

27 The overall goals of the technical assistance are to:

- reduce poverty in PRC by implementing sustainable poverty reduction activities and narrowing regional disparities; and
- disseminate knowledge gained to poverty experts throughout PRC.

28 Consulting services under the TA are to provide a comparison between PRC and international approaches and experience to poverty reduction, make recommendations for poverty policy dialogue and reform on poverty related issues, and identify areas for the use of the Bank’s Ordinary Capital Resources (OCR) loans for poverty reduction activities.

29 In the process the TA is generating outputs in five key areas, specifically:

- proposals for a microfinance system for the rural poor (including women and ethnic minorities); a checklist of key social factors to be addressed if State sponsored voluntary mobility is to be successful; funding guidelines for the use of OCR funds for agroindustries and other enterprise-driven private sector activities; and guidelines for rural infrastructure provision in poor areas to maximise the effectiveness in poverty reduction. These outputs will be used to help guide the design of future poverty reduction projects.

30 The TA is being executed by the Foreign Capital Project Management Centre (FCPMC) of LGOP that provides counterpart resources for the consultants at national, provincial and county level.

Objective

31 The overall training objective is that participants are able to understand, describe, promote and apply the successful international approaches to poverty reduction, modified where necessary to take account of the PRC context.

32 The training result is to be that in their job functions participants are able to disseminate the knowledge and experienced gained and to positively influence the future design and implementation of poverty reduction projects through bringing to bear their knowledge of international best practice and success factors in poverty reduction elsewhere. There are two distinct aspects to this:

- development of selected LGOP staff to enhance their skills and knowledge to enable them to better fulfil their own job responsibilities in the design and management of poverty reduction projects; and
- development of selected LGOP staff to act as trainers and disseminators of information so that the skills and knowledge of others in LGOP and LGOP’s partners in project implementation are also enhanced.
Components of the Training

33 The overall training plan under the TA as articulated in the TA Paper and the consultant’s technical proposals has several components:

- in-service training on a day-to-day basis to transfer knowledge and skills to counterpart staff by the international and domestic consultants during fieldwork, beneficiary consultations, discussion groups and seminars to review the emerging strategy and recommendations;

- in-country workshops on poverty policy, microfinance, rural infrastructure, agroindustry and rural enterprise development and voluntary rural mobility in which international and domestic consultants are involved in presenting aspects of international and PRC experience and working with counterpart staff in LGOP, LGOP Provincial staff, leading Chinese academics, representatives of line Ministries and ADB staff to identify useful lessons for PRC in the formulation of future poverty reduction strategies;

- where required, overseas training for selected LGOP staff to strengthen their capacity with first hand experience of selected poverty reduction initiatives of other governments and development assistance agencies that reflect the findings of the most recent ODA, academic and scholarly research about the design of poverty projects, and the effective use of aid;

- the wider application of the in-country and overseas learning though further LGOP-run internal training and training for implementation partners;

- the medium–term implementation of a pilot rural infrastructure project in PRC that will provide learning experiences about poverty measurement and the impact on poverty of rural infrastructure; and

- a high level seminar to eventually disseminate the findings and recommendations of the TA to senior policy makers and others.

34 The in-country work in PRC provides a perspective to all LGOP staff participating in the TA on different approaches in Asia, Latin America and elsewhere, many of which would be new to PRC if they were adopted; will upgrade the knowledge and skills of counterpart staff; and eventually involves the dissemination of the findings and recommendations at a policy and an operational level.

35 The overseas component is to enable selected LGOP staff to gain first hand insights of aspects of such approaches that it is agreed have potential for applicability in PRC. Overseas training is restricted to a limited number of LGOP staff who will be key in the application of the learning from the TA and the dissemination of the results.
The Training Methodology

Participation

36 The training is participatory with a minimum of lecture style delivery. The approach is based on proven adult education training research that shows that adults learn most by doing and by reference to their own experience and least by listening. The application of this principle is embodied in each of the components of the training programme as far as is possible to create a variety of learning opportunities for selected participants:

• the in-service training is one-on-one training between consultants and counterparts during fieldwork and discussion sessions, strengthened by group review of working papers and discussion and refinement of findings and TA recommendations with counterpart staff participating in the analysis to strengthen the ownership of TA findings;

• in the in-country workshops, initial brief audio-visual presentations of international and PRC experience have been followed by group discussion and group activities to arrive at conclusions about potential lessons for PRC on project design and implementation. The format of the workshops has been participatory, participant numbers have generally been restricted to less than 20, and there have been opportunities for individual participants to make presentations about group work findings as well as to express their views during discussion;

• in the overseas training, exposure to real-life situations that involve the application of poverty reduction approaches not in use in PRC will afford the opportunity for a deep and lasting impact on participants that will go far beyond what can be learned in the lecture theatre and workshop;

• in the internal roll-out, the continued use of participatory methods, the eventual use of real-life case studies in PRC, and the reinforcement of lessons learned through on the job application will progressively strengthen participatory skills;

• in the pilot project, a hands-on opportunity to measure poverty in a guided applied research environment and to carry forward findings about the poverty impact of infrastructure to future project design will be provided; and

• in the high-level workshop, although of necessity a formal affair, there will be opportunities for discussion and questions, with LGOP as hosts leading the presentation.
Participants

37 The different components of the training are targeted at different, but overlapping sets of participants:

- in-service training is targeted at nine counterpart staff from FCPMC who have poverty reduction experience in policy, microfinance, agroindustry and rural enterprise, rural infrastructure and voluntary rural mobility working in five small subteams with the international and domestic consultants;

- in-country workshops have been targeted at the same counterparts; selected provincial staff of LGOP, particularly those who are likely to be involved with the pilot project and with the implementation of future poverty reduction projects in partnership with external agencies such as the Bank; and representatives of line ministries and other Government organs that will need to buy-in to the Bank’s strategy for PRC if the Bank is to participate in poverty reduction;

- the overseas training is targeted at about 10 selected FCPMC and LGOP provincial and county level staff who will best be able to benefit from first hand insights based on balanced of selection criteria and their job functions with emphasis on their ability to lead the roll-out process;

- the internal roll-out training is targeted at provincial, prefecture and county level LGOP staff and will continue over an indefinite period beyond the end of the TA to provide learning opportunities for a wide range of LGOP operational level staff, to be selected on an on-going basis;

- the pilot project is targeted at FCPMC staff and county level LGOP staff who participate in research design, supervision of data collection by the County Household Survey Bureau, analysis of data and its interpretation, and documentation of the findings, supported by international and domestic consultants at key stages in the process;

- the high-level workshop is targeted at those who need to be persuaded about new priorities and approaches for poverty reduction in PRC and the potential for use of the Bank’s OCR funds in support of this, selection of whom will be made after the findings of the TA are complete.

The Dynamics of the Training Programme

38 The training programme is conceived as dynamic, with each step leading to the next in terms of training needs and participant identification with increasing responsibility passing from the consultants to FCPMC. In-service training is the day-to-day responsibility of the consultants in the five subteams. The in-country workshops were organised jointly by the FCPMC and the consultants with the consultants leading the workshop activities. The overseas training is being organised

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2 Staff are to be selected following the workshops and fieldwork based on specific training needs identified during these foregoing activities.

3 The pilot project is the subject of a separate detailed proposal.
by FCPMC with the consultants making recommendations on training needs and the Bank facilitating the process. The rollout training is the responsibility of FCPMC. The pilot project is the responsibility of FCPMC with design inputs from the consultants. The high level workshop is the responsibility of FCPMC with participation by the consultants as deemed necessary by FCPMC and the Bank.

39 These dynamics harness FCPMC’s already strong training and organisational capacity to their progressive ownership of the TA findings and increasing knowledge of participatory training techniques. The latter point is important because in the PRC context training tends to rely on lecture style presentation and round table discussion rather than participatory methods. FCPMC management recognise that there are advantages to the use of participatory methods and intend to strengthen their capability in this through the in-country workshops and the overseas training where participants will be exposed over an extended period to such methods.

40 The initial counterpart selection was made by FCPMC on the basis of the core skills and knowledge of the counterpart staff, with counterpart staff curricula vitae shared with the consultants. The selection of additional LGOP participants for the workshops was made by FCPMC based on job functions and experience of provincial LGOP staff and their ability to contribute to the workshop discussions and group work from their PRC experience with both the PRC government poverty reduction programmes and special projects such as the World Bank’s poverty alleviation projects. The selection of participants for the overseas training will be made by FCPMC based on the core existing knowledge and skills of participants in relation to the subject matter to be covered and other selection criteria that aim to maximise the benefits of the training. The selection of participants for the rollout will be made by FCPMC based on specific future project developments that need personnel able to apply new approaches and will continue into the medium term. The counterpart subteam involved in rural infrastructure together with county level LGOP staff at the chosen site for the pilot project will be the participants in the pilot project training. The participants in the high level workshop will be determined by FCPMC when the findings of the TA are finalised.

41 The overseas training, although relatively expensive in comparison to the other components of the training programme is vital for the training programme's overall success. The training programme is intended to create deep understanding and training capability with a limited number of people who in turn will be able to train others in PRC. The workshops and fieldwork have clearly shown that many aspects of successful international approaches and experience are not present in the PRC government programme or in existing donor assisted poverty reduction initiatives in PRC (including the World Bank’s poverty reduction projects). First hand experience of such approaches is a prerequisite if LGOP staff are to be able to effectively promote the concepts involved and persuade others to adopt them. Without such first hand experience, the training becomes theoretical with the trainers unable to cite examples with conviction from their own experience. Without the overseas component it is unlikely that the rollout will be successful and the TA objective may be jeopardised.
Training Needs Analysis

Present Job Functions of Participants

42 Participants in the training programme currently work in LGOP at national, provincial or county level. The spectrum of participant job functions involves:

- participating in the formulation of national policies for poverty reduction and design of the overall means;
- determination of poverty lines for rural poor and national poor counties;
- definition of the targets for poverty reduction programmes;
- organisation of collaboration with the international community in poverty reduction efforts;
- mobilisation of the resources of civil society for poverty reduction;
- formulation of operational plans for poverty reduction and allocation and distribution of central government funding for poverty relief;
- operational management of poverty reduction projects;
- co-ordination of poverty reduction efforts sponsored by specific government departments and specific poor counties and by coastal provinces in inland provinces; and
- monitoring and evaluation of poverty reduction efforts.

43 Those working at national level have greater involvement with policy, high level planning and target setting, collaboration with the international community, and evaluation. At all levels with regard to the next level there is involvement with fund and resource allocation. Those working at provincial level and below have greater involvement with field implementation and monitoring.

Determination of Needs

44 The training needs for the in-country workshops were determined by the terms of reference in the TA Paper, which in turn were the subject of detailed research and consultation with FCPMC by the Bank.

45 The overseas training needs have been determined from:

- the knowledge and skills displayed by counterpart staff and participants in the in-country workshops as a proxy for the knowledge and skills of LGOP generally; and
- findings of the workshops and the field work observations about the approaches and experience in other countries that have potential applicability in PRC.
Knowledge and Skills of Counterpart Staff and Workshop Participants

46 The consultant’s general assessment of the counterpart staff and workshop participants is that:

- they are qualified at graduate level, articulate and able to critically assess the findings and recommendations of the TA in relation to PRC experience but not in relation to international experience;
- the premise of the TA that greater knowledge of international approaches and experience is needed to provide a frame of reference for improved poverty reduction programme design in PRC is well founded;
- counterpart staff and workshop participants already have a deep knowledge of PRC poverty reduction programmes, but find it difficult to critically assess these because of the above;
- there is strong ownership of the TA in FCPMC evidenced by the high level of co-operation, attention to detail and a desire to be involved in each step of the methodology; and
- there is a lack of familiarity with participatory training processes and the techniques of effective adult education.

47 This translates into general training needs for first hand exposure to international approaches and experience and exposure to participatory training methods as participants, in order to later become advocates of this training approach.

The Workshop and Fieldwork Findings

Poverty Policy

48 The poverty policy workshop, founded on a presentations about the evolution of donor, government, NGO and private sector approaches to poverty reduction internationally and a critical historical analysis of the PRC programmes led to the conclusions that:

- PRC poverty reduction programmes have been successful in attaining a dramatic reduction in poverty in PRC;
- existing PRC approaches have their designs based on thinking that was common between the late 1970s and the early 1990s with a predomination of earlier approaches; and
- present programmes are only sustainable as long as government continues to fund them from the budget and are subject to many targeting difficulties.

49 The fieldwork and review of the thinking that underlies the design of PRC programmes both indicated that there was little evidence that the conclusions of current international academic and scholarly research were not being applied in the design of PRC projects (including some foreign funded projects) and that specific
principles about poverty concepts, design concerns, project operations and learning mechanisms should be seriously considered in future. Specifically, in summary, the principles are that:

- poverty is recognised as complex and associated with natural, physical, financial, human and social capital access and development, is individually variable and is affected by externalities;
- the goals need to address policy, economic growth, income redistribution, gender equality, livelihood quality, facilitating access and the environment;
- donor, government and NGO approaches are all legitimate ingredients provided they are client based; sustainability, capacity building, environment, gender and subsidy reduction are the main design concerns;
- individual projects should build on people’s strengths, and target households, communities, implementing agencies and wider policy;
- a multisectoral approach should be accommodated;
- design should be participatory, iterative and flexible in implementation;
- the long term nature of capacity building and social capital development should be recognised in design;
- project interventions should be made at the local level and may be small or involve many small components;
- local and national governance issues should be addressed;
- partnerships of all types should be encouraged (particularly between the public and private sector and with NGOs where appropriate);
- project management should be within the implementing organisations and not discrete; and
- monitoring and evaluation should be linked to learning now, not later.

It was concluded that a combination of detailed research for information about specific projects with these characteristics and direct exposure of FCPMC and LGOP staff to such projects would be valuable and necessary.

**Microfinance**

51 The microfinance workshop provided contrasting presentations of international and PRC experience and approaches to rural finance and microfinance followed by discussion on the principles of successful microfinance and the impediments to microfinance development in PRC.

52 With regard to PRC, where the microfinance initiatives of donors and NGOs are currently regarded as "reasonable but illegal", the main conclusions about the present situation, supported by the fieldwork and case studies, were as follows.
• There is an urgent need to put in place a regulatory and supervisory framework for microfinance institutions in order to ensure that the development of microfinance in PRC can be taken forward on a legal basis. Such regulation needs to cover organisations other than the Agricultural Bank of China (ABC) and the Rural Credit Co-operatives (RCCs) so that alternative means of financing and achieving outreach to the poor can be explored;

• While the concept of self-sustainability for microfinance providers was generally accepted in academic circles, government officials particularly at a provincial level had difficulty accepting the concept of the poor paying the full cost of financial services because they do not have experience of alternative systems.

• There was general understanding of microfinance methodologies including small loan sizes, short loan periods, frequent repayments, close supervision and the use of group guarantees, but significantly less understanding of cost structures, the need for self-sustainability and the consequent need for interest rate liberalisation and the micro and macro economic implications of the continuation of the government's continuation of the subsidised loan programme.

• The exception to the above was found to be with the institutions currently handling poverty reduction lending in PRC (ABC and RCCs) where larger loans for fixed terms payable in lump sums on maturity are preferred.

• Some participants felt that in PRC the linking of microfinance and extension services was essential and that present extension services were of poor quality in remote rural areas. However, the suggestion that microfinance providers should also provide subsidised extension services was generally rejected, but the possibility of linking microfinance with agroindustry and rural enterprise (perhaps through “dragonheads”) was worthy of exploration.

53 With regard to international experience it was agreed that the examples and analysis provided bore out the TA research findings which show that characteristics of successful microfinance involve:

• Design factors including: passing the full cost of credit on to the borrower, minimising the total transaction cost to the borrower, catering to the needs and preferences of the borrower; providing incentives for repayment; reducing the unit cost of lending to a minimum; making savings an integral part of services.

• Strict control of the eligibility of operators covering conditionality for participation including excellent financial performance; good client outreach; and good governance and sustainability.

• A good legal and regulatory framework including registration of operators, minimum capital, proper juridical constitution, capital adequacy, reserve requirements, limits on allowable depositors, loan classification and loss provisioning, exposures, balance sheet structure, reporting and auditing, and regular financial ratio calculation.
• Integration with second tier institutions or networks to provide financial and institutional support to the microfinance operators and assist with their capacity building and make most efficient use of resources.

• The need for certain socio-economic conditions for effectiveness including viable enterprise opportunity, borrower skill development, the potential for borrower graduation, and implementable loan recovery collateral arrangements (including joint liability mechanisms).

• Focus on the bankable and productive poor, including urban poor, and not on the absolute poor.

54 These findings pointed to a need to first hand experience for LGOP staff of sustainable microfinance programmes to deepen their understanding of how in practice such programmes can operate in a regulated environment with liberalised interest rates and how they can be linked to formal financial institutions and private sector agroindustry.

**Rural Infrastructure**

55 The workshop commenced with presentations on rural infrastructure development in PRC and internationally and the impact of rural infrastructure on poverty. Subsequently, participants worked in small groups to discuss the benefits and priorities from infrastructure investment; the implications for financing of those benefits; what actions need to be taken in terms of institutions or management to realise benefits; and what participation mechanisms are needed. The findings were as follows.

• There was general agreement on what infrastructure can achieve such as human development or quality of life goals, increasing productivity, raising incomes, dynamising backward areas, and improving the environment. There was disagreement on whether the economic benefits should be given the highest priority or whether assuring subsistence was most important.

• Participants had limited knowledge, especially at the county level, of how to identify the benefits of anti-poverty spending and the development of better poverty monitoring and evaluation was identified as a priority so that applied domestic research can be fed back into the policy making process at a national level.

• The international trend of increasing use of private sector participation either for financing or for service provision or for both was not yet reflected in PRC and there was limited understanding about how the private sector can participate in small scale rural infrastructure development.

• Government interventions that can improve the impact of infrastructure projects to ensure transparent bidding processes, tariff increases that reflect the costs of services, lifeline services for the absolute poor, privatised project management, dialogue with stakeholders and ensuring good information flows were not yet developed effectively in PRC.
Training Programme

- Participants had limited knowledge of participatory processes and international best practice, and found it difficult to understand and describe these processes both with regard to the involvement of communities in infrastructure development and maintenance, and with regard to their use in other aspects of poverty project design and implementation such as microfinance.

56 The conclusions from the fieldwork and the in-country workshops were that improved knowledge of the measurement of poverty impact was highly desirable (and could in part be addressed through the pilot project though much wider coverage is eventually necessary), and that providing first hand experience of participatory planning and implementation and private sector participation techniques is a priority, particularly in the context of PRC’s transition from a centrally planned economy.

**Agroindustry and Rural Enterprise**

57 The agroindustry and rural enterprise workshop presented a detailed case study from the fieldwork to demonstrate the success of the “dragonhead” concept in PRC. A subsequent presentation compared the characteristics of international agribusiness and links with poor farmers with practice in PRC citing two additional case studies of successful “dragonheads” in a poverty and a non-poverty county. Subsequent discussion and working groups considered the characteristics of enterprises that could successfully link with poor farmers, how to safeguard the benefits for poor farmers, and how to channel funds from international sources to selected enterprises. From the discussion groups and presentations the following findings emerged.

- From review of international and PRC experience there was general consensus and good all round understanding about the characteristics of enterprises that could successfully link with poor farmers, specifically that they were market oriented, need comparative advantages, used modern technology, have qualified and experienced management, have local government support, have adequate access to infrastructure and have adequate financial backing to withstand start-up costs and market fluctuations.

- The experience with the development of small and medium scale enterprises in PRC pointed to systemic problems, and although many of them had been successful, there were also many failures. It was concluded that ways to ensure that SMEs were able to have the above characteristics through capacity building support should be sought since these were generally absent in PRC. Possible examples of support suggested included training, technology innovation services, market information services, and demonstration enterprises.

- From the PRC case studies and international experience it was concluded that to secure the benefits for poor farmers the linkages needed to be contractual to assure their rights, provision of technical support, price guarantees, minimum purchases, and assurance of the supply of quality inputs were key factors for success, and that credit supply or facilitation for
inputs not provided in kind was necessary including microcredit where appropriate.

- There was limited familiarity with the existing Bank (two) and World Bank (six) agribusiness credit lines through the ABC and the criteria that had been developed on some credit lines to try to ensure poverty indirect poverty reduction.

- There was general agreement that funding should be through the banking system. There was debate about the use of international funds for these purposes as they would be funding private sector goods. However, it was agreed that there were barriers to market entry for “dragonhead” enterprises in PRC including high entry costs and an absence of long-term capital and that such funding was justified under these circumstances.

58 These findings indicated a good understanding of many market principles, but a need for further exposure of participants to the ways in which support services to micro and SME development can be provided, the use of agribusiness and SME credit lines and their indirect targeting at the poor, and the potential for linking microfinance for producers and microprocessors to agroindustry and rural enterprise.

**Voluntary Rural Mobility**

59 The voluntary rural mobility workshop commenced with presentations about international and PRC experiences and approaches to voluntary rural mobility. Based on the comparative analysis, discussion groups arrived at the following conclusions about the PRC programme:

- Since the 1970s, PRC has implemented many large-scale government-supported voluntary resettlement projects for poverty alleviation in remote, resource-poor villages. Most projects are judged successful by the Government, in terms of the economic and social gains that these projects have brought to the settlers.

- There remain many barriers to market transactions in land and labour in PRC so spontaneous resettlement is difficult. However, there also remain 20 million absolute poor living remote, resources poor, and environmentally degraded areas. Resettlement, although a last resort, is the most effective way to reduce poverty in these areas, but government involvement is necessary while there are barriers to spontaneous resettlement.

- In the PRC programme the voluntary nature of mobility is exemplified by settlers being allowed to keep their land in the originating villages for a number of years until they are satisfied with the situations in the resettlement area. If they are not satisfied with resettlement, they are allowed to return to their original villages.

- The PRC programme is designed to give each settler sufficient land to have substantial improvements in living standards simply through agricultural production, but settlers also have better opportunities for non-farm
employment and greater access to markets for the disposal of any agricultural surplus in the settlement areas.

- Settlers generally come from the same villages so there is good opportunity to maintain cultural, social and community life in the new settlement areas.

60 It was also concluded that the international experiences offered useful lessons for PRC in its future resettlement projects. Specifically:

- There are limited international cases of government-supported voluntary rural resettlement, most of that are not successful, and as a consequence the international community is wary of resettlement programmes in any country.

- Adequate funding for all phases of a resettlement project needs to be committed at the outset, and good management, monitoring and evaluation systems are needed to feedback into on-going design.

- Private participation through market competition in the implementation of some activities in the resettlement project can reduce the costs of the project.

- Spontaneous resettlement is the least-cost way of poverty reduction and spontaneous settlers should be encouraged. To make it possible for spontaneous settlement, it is necessary to reform the existing land tenure system and household registration system in PRC.

- Host populations should be adequately compensated for giving up their land to resettlement projects and the benefits of infrastructure and social improvements in a settlement area should also be extended to host populations.

- A wide range of economic and social investments (irrigation, roads, water supply, electricity, and social services) are required in resettlement areas. Where government’s fiscal resources are limited or government wishes to accelerate the process, external funding can be applied, particularly where full cost recovery with interest is possible.

- External funding can also be used to support the settlers’ income-generating activities and other private-good investments (including private infrastructure).

61 It was concluded that the land tenure issues, cost recovery and international best practice were the main areas in which further dialogue and study was necessary.

Summary of the Proposed Overseas Training Coverage

62 Based on the above analysis, the overseas training will centre around poverty interventions in microfinance, agroindustry and rural enterprise, rural infrastructure and voluntary rural mobility, with poverty policy knowledge enhancement featuring in each component. Components that also enhance knowledge about the Bank, its comparative advantages and its policies and procedures are also important, because
those involved in poverty reduction in PRC have little knowledge of the Bank, compared to the World Bank for example.

The priorities for overseas training coverage to provide the required exposure to international experience, examples of OCR funding and useful lessons on poverty reduction approaches are:

1. **on poverty policy:**
   - the partnerships between government, civil society, assistance agencies and the private sector in defining development needs and implementing programmes (both sectoral and multisectoral);
   - consultation processes between these partners;
   - the treatment of structural and social concerns at the same time as macroeconomic and financial concerns; and
   - targeting and sustainability issues in poverty reduction programmes.

2. **on microfinance:**
   - the regulation and supervision of microfinance institutions;
   - the use of apex microfinance organisations as a means of mobilising and channelling resources;
   - the application of microfinance best practice in rural and urban environments in schemes that use commercially priced funds and are fully self-sustaining; and
   - the subsectoral use of microfinance for farmers, settlers and community infrastructure.

3. **on agroindustry and rural enterprise development:**
   - agribusiness and SME credit lines and their impact on poverty;
   - development of SME support services and the relevant roles of government and the private sector; and
   - the subsectoral use of microfinance for SMEs (including urban SMEs).

4. **on rural infrastructure:**
   - how to maximise the impact on poverty of workfare programmes;
   - community and private sector participation in rural infrastructure development, operation and maintenance; and
   - measurement of the poverty impact of rural infrastructure.
• on voluntary rural mobility:
  • land titling and transferability policies of other governments;
  • cost recovery mechanisms; and
  • best practice guidelines.

64 Within the countries visited, where there are opportunities to review global trends and strategies in poverty reduction and the policies and experiences in other countries and of international donors as a result of domestic research, these will taken. Specific aspects of poverty reduction project design and implementation including participatory approaches, social dimensions and analysis, environmental considerations, sustainable natural resource development, and project monitoring and evaluation and poverty measurement will also be explicitly addressed.
Country Selection

65 The coverage of the overseas training programme is demanding within the resources of US$ 50,000 available. Based on the international research findings four countries within the region have been considered. The table below summarises some specifically identified possibilities within these countries, though training providers will be required in their proposals to expand on opportunities to provide full coverage.

66 Recognising that the budget is limited, FCPMC have expressed a wish to confine the training to two countries: the Philippines and Thailand. Although good coverage of the topics can be gained in both India and Indonesia, the Philippines presents the opportunity to have first hand contact with Bank staff members involved in poverty reduction and for the Bank to demonstrate its comparative advantages; and Thailand offers the opportunity to see cutting-edge poverty reduction activities in an environment where reducing regional economic disparities has been a major government priority for two decades.
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Overseas Training Implementation

The Requirements of the Programme

The expectation is that training organisers as appropriate will devise the training programme to include:

- consultation with senior poverty reduction policy makers in the country visited;
- consultation with leading academics and scholars in the field of poverty reduction in the country visited;
- attendance at relevant sessions of any concurrent national or international conference or workshop on aspects of poverty reduction;
- visits at national level to government poverty reduction agencies, appropriate line ministries (for example agriculture and social services) and government finance institutions (for example BAAC in Thailand and Land Bank in the Philippines);
- visits to NGOs, private sector and other civil society organisations participating in poverty reduction activities;
- visits to international organisations based in the countries (specifically Asian Development Bank in the Philippines and ESCAP in Thailand);
- a programme of field visits to poverty areas to gain first hand knowledge of project design and implementation mechanisms including:
  - initial review of case study and project documents for project sites to be visited;
  - visits to existing ADB, government and other donor projects with poverty reduction and social development objectives with emphasis on projects that have sectoral components in agroprocessing, rural mobility, microfinance and rural infrastructure and that use participatory approaches, have social dimensions and effective monitoring and evaluation systems; and
  - extensive and in depth interaction with poor households benefiting from the projects visited; and
- a closing one or two-day workshop to review participant’s experiences and the lessons learned.

Participant Selection

For each country there will be 4 to 6 participants drawn from the State Council Leading Group Office for Poverty Alleviation and Development (LGOP); the Foreign Capital Project Management Centre (FCPMC) of LGOP; the Ministry of Agriculture; and the Provincial and County level LGOP.
Participants will be selected by reference to the following criteria:

- **required characteristics:**
  - less than 50 years old with a college degree, and at least five years experience in poverty reduction and development activities;
  - good verbal and written communications skills;
  - understanding of the background and objectives of the TA; and
  - limited exposure to international approaches and experience.

- **preferred characteristics:**
  - English language skills;
  - further relevant postgraduate education or training;
  - experience as field workers in poverty reduction;
  - experience of the design, appraisal, implementation, management, monitoring and evaluation of rural development programmes;
  - experience in one or more of the following sectors: agroindustry and rural enterprise, rural infrastructure development, rural resettlement and labour mobility, and rural finance and microfinance schemes;
  - experience of formulating and presenting policy recommendations to decision makers; and
  - experience of foreign funded poverty reduction programmes in PRC.

Timing, Logistics and Financing

It is planned that the training will take place during January 2000 for a duration of about 20 days in each country visited. Training organisations may suggest alternative timing if it is appropriate for attendance at particular events.

FCPMC will be directly responsible for the selection of participants, the procurement of visas, and the costs and logistics of travel to and from the Philippines and Thailand.

FCPMC will contract with the training organisers for the conduct of the training on a lumpsum basis. FCPMC will negotiate an all inclusive fee with the training organisation for all other costs including translation and local transportation based on a detailed budgetary submission of such costs including a reasonable fee for the training organisation’s time and effort in organising and delivering the training programme.
Knowledge and Skill Development Expectations

73 The training is expected to develop participants’ knowledge and skills. Knowledge based gains need to include all aspects of the coverage of the curriculum set out above. Skill based gains need to include greater ability to:

- identify the factors that contribute to the success of poverty reduction initiatives through the structured review of underlying concepts, design factors and available feedback;
- relate these success factors to the PRC context and to identify where in that context the success factors could be applied to improve PRC poverty reduction activities;
- articulate this analysis to others and present persuasive arguments at all levels for the introduction of change;
- distinguish the opportunities for use of OCR funding and to present the case for OCR funding to policy makers with emphasis not only on repayment and returns, but on the wider quality of life effects, management structures, good governance, and the acceleration of poverty reduction through complementary funding;
- participate in the design of the high-level workshop and the training rollout.

Follow-up Activities

74 Follow-up activities required of participants in the overseas training programme will be:

- written summarisation and presentation of the learning experience and findings to FCPMC;
- reviewing and providing comments on TA reports;
- applying knowledge in practical work, including the operational skills needed for the ongoing rural infrastructure pilot project in participatory methods and monitoring and evaluation;
- conducting training sessions on poverty reduction at provincial, prefecture and county levels for LGOP staff;
- disseminating the findings to line departments including poverty offices, budget bureaux, planning commissions, agriculture and forestry bureaux, technical services centres and others;
- mobilising and influencing local NGOs and community organisations to redirect their development approaches; and
- design of the high-level workshop.
Evaluation

75 An immediate evaluation of the knowledge-based gains will be made on the return of participants to PRC through the presentations of learning experience.

76 Periodic evaluations of the skill based gains will be made through review of participant’s personal performance in the skill based activities and through the longer term assessment of the impact of the TA and the overall training programme as indicated by the adoption of new approaches and the use of OCR funds for poverty reduction.
## Pilot Infrastructure Project

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Statement of the Problem

1 The presence of infrastructure in a society is closely linked to economic development. While not a sufficient condition for development, it is a necessary one. Many studies in developed countries show a strong link between public infrastructure and growth, although the exact magnitude of the effect is still under debate by economists. For developing countries, little attempt has been made to estimate the role of infrastructure on growth due to absence of data but nonetheless, micro-level studies indicate an important potential role for infrastructure.

2 For example, there are direct economic effects. Poverty reduction is an especially important aspect of rural infrastructure. At the macro level, the stock of infrastructure is linked to a country’s competitive position and thus to jobs, investment and export earnings. Labour intensive construction of infrastructure projects may also have a poverty reducing impact, provided the poor are paid for their labour. Rural roads allow farmers better access to agricultural inputs like fertiliser and allow them to better market their surpluses. Irrigation can permit farmers to cultivate their land more intensively and sometimes increase the number of annual cropping cycles, which may allow them to move out of subsistence production and into cash production.

3 In addition, infrastructure such as roads may offer indirect benefits on rural quality of life by allowing people greater access to social services such as health clinics or schools. Health benefits in terms of reducing mortality and morbidity are outcomes associated with the provision of safe drinking water and sanitation. This is an example of a social multiplier, because better health is not simply a good in and of itself, but is also linked to higher incomes as many authors have shown because healthier individuals have higher productivity and are more likely to be in the labour force. Similarly, if infrastructure investments allow children better access to schooling, improve their attendance or allow them to study more, this may lead to indirect, long run benefits in terms of higher productivity or income.

4 The gendered nature of the impact of infrastructure is another area that is receiving increasing attention. Women (and also children) often spend a great deal of time in activities related to basic subsistence such as getting water or fuel. Thus the introduction of wells or electricity for household use may have significant labour savings which can then be put to productive uses (or in the case of children, may allow families to send them to school or may decrease school absenteeism).

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4 World Bank, 1994, ibid
Research Justification

5 At the same time, numerous example around the globe show that the expected positive outcomes of infrastructure have often failed to materialise. The lessons learned from projects that have not lived up to expectations include the following:

- the poor often lack access to infrastructure, lessening the poverty reduction potential;
- project design is not in keeping with local conditions;
- outcomes are often positively linked to beneficiary and stakeholder participation in design and implementation but such participation is not always common; and
- many infrastructure projects fail in the maintenance phase, especially those where benefits are diffuse and direct responsibility hard to assign, and where voluntary labour used for upkeep.

6 In addition, some authors have suggested that the practice of bundling infrastructure may lead to better outcomes in rural areas in terms of increased incomes and poverty reduction than single forms. This is because of the synergies that may be derived from multiple forms of infrastructure that are linked to the rural economy, i.e. irrigation is needed to produce a surplus, roads to transport the produce and reduce input costs, electricity to process output (as well as move into industry). The argument is that the interaction of different forms of infrastructure with each other produce far greater benefits when implemented together than when individual types of infrastructure are introduced alone. Evidence from Southern Africa, for example, suggests that overall development is unlikely to occur if only one form of infrastructure is addressed.6

7 Unlike the discredited models of integrated rural development from the 1970s that were unsustainable, inefficient and bureaucratic, infrastructure bundling in the context of contemporary strategies for rural development focuses on the way that rural livelihoods can be strengthened to meet basic human needs. While integrated rural development projects did often provide a “bundle” of infrastructure it was in the context of packaged solutions assumed to apply to model households or farms, rather than in the context of the recognition of the individual dimensions of poverty and the provision of choices.

8 Understanding whether bundling is an appropriate strategy is especially important for policy makers, although even if supported by evidence, there are policy considerations that would precede the adoption of such a recommendation. Most importantly, it suggests that where all areas could not be provided with multiple forms of infrastructure, some communities would have to wait before any infrastructure could be installed, which could prove politically unacceptable.

6 Wanmali S and Y Islam, 1997, ibid
Another area where additional research is needed is the feasibility of cost recovery for rural infrastructure projects. Because many small-scale infrastructure projects such as irrigation for household plots, electricity or drinking water are services that are provided to private households, it is much easier to collect fees that reflect the cost of providing the services. Since the long-term financial viability of small-scale infrastructure may be a determinant of whether governments are willing to borrow funds or invest resources for its development, better specific information about whether projects can sustain themselves through user fees must be gathered.

Better micro-level studies are needed to understand the impact of infrastructure on poverty reduction and improved quality of life. Additionally, whether infrastructure is economically sustainable in poor communities is an essential question to investigate because it provides important information for policy makers about how to invest in development activities. The research proposed here is a micro-level study of the role infrastructure may have on poverty in Southwest PRC and therefore its role in the borrowing strategy of the PRC for poverty reduction for similar areas, notably remote, mountainous regions. The project will examine both the impact of infrastructure provision and the extent to which it can be sustained by the beneficiaries themselves.

Research Questions

The research will be undertaken through a pilot project that is designed to measure the efficiency and effectiveness of infrastructure provision on poverty reduction in remote, economically backward areas of Guizhou province in the Southwest region. This area is particularly appropriate to study because over the past decade, the PRC has made great strides towards eliminating rural poverty. However, those areas of poverty that remain, concentrated in western areas of the PRC, such as Guizhou, will need a different strategy of poverty reduction than areas that have done well up until now. The geographical remoteness, the poor quality of land and the lack of human capital suggest far more intractable problems than the PRC has been able to resolve.

The primary research questions this project attempts to answer are:

- does the provision of infrastructure lead to poverty reduction?
- if so, then by what mechanism(s)?
- is ‘bundling’ infrastructure advantageous for poverty reduction?
- to what extent is infrastructure economically sustainable?

The literature on infrastructure offers numerous mechanisms through which different types may bring about poverty reduction. The study design will allow the effects of these to be assessed in the villages. The benefits include the following.

Roads can:
dramatically reduce transport time of crops, allowing farmers time for other activities;

allow farmers to market crops at more distant markets where prices are likely to be higher;

cut down input costs such as fertiliser since prices may be better farther away;

improve communications about when to bring goods to market;

improve access to credit by cutting down on information costs;

depending on road quality, may allow the transport of more perishable/higher margin goods.

Irrigation and drinking water can:

allow marginal lands to be brought under cultivation;

allow more intensive cultivation such as through double-cropping;

allow a greater variety of crop mix;

allow aquaculture such as the cultivation of fish and eels;

free time spent by women, children and elderly collecting water for more productive remunerative activity;

free time spent in agriculture by young/middle-aged men to allow them to migrate or migrate further in search of work, increasing household income through remittances;

lead to less lost productivity due to illness.
Electricity can:

- allows creation of micro-industry both in agricultural and non-agricultural uses;
- cut energy costs if it is cheaper than kerosene or diesel used previously;
- free time spent by women, children and elderly collecting fuel for more productive remunerative activity;
- and is generally thought to have fewer direct economic benefits to poor communities than other forms of infrastructure but strong positive quality of life gains for example, allows access to mass communication, and may be linked to better health outcomes if it allows the substitution of electric energy sources for biogas forms that create indoor pollution and health hazards.

13 The secondary questions the research will also try to answer about the impact of infrastructure are:

- does the provision of infrastructure enhance quality of life (QOL)?
- if so, what aspects of QOL are most affected?
- do specific groups have better outcomes than others, either in terms of poverty reduction or improved QOL? The focus here is especially on whether the effects are different for better-off families compared with poorer ones, for women compared with men, and for Han Chinese compared with ethnic minorities.

Indirect and Quality of Life Effects of Infrastructure

14 While the quality of life effects of infrastructure that are often noted in the literature do not necessarily have a direct influence on poverty alleviation, the pilot project includes measures of them for several reasons. First, much of the focus in development now centres on quality of life concerns rather than issues related to purely income. Second, to the extent that quality of life is enhanced by infrastructure, people may be more willing to pay for it, thus increasing possibilities for cost recovery. Third, the factors influencing quality of life are linked to economic factors in most theoretical models such as Amartya Sen's. For example, enhanced education promotes both a higher quality of life and earnings. Thus, this project will examine outcomes such as the effects of infrastructure on school attendance and absenteeism, or on the ability of children to study, because while in the short run these might be seen as quality of life gains, in the long run, they are also likely to promote higher earnings.

Gender Impact

15 In keeping with the ADB's goal of monitoring the gender implications of its projects, the research questions will also include a focus on the differential impacts of infrastructure for men and women. The literature suggests that women and men
have different priorities with respect to infrastructure (something preliminary research showed in Qianqiu, see next section) related to their different positions within the division of labour. For example, women frequently give high priority to drinking water or clean sources of fuel since they may spend large amounts of time fetching water or preparing meals. In addition, the introduction of infrastructure may change the division of labour within the household. If women's time is freed to engage in more productive activity and they are perceived as contributing more to household income, their relative power within the household may increase. In addition, research has shown that when women whose husbands migrate to find work become de facto heads of households as a result of long periods of absence of their husbands, the household dynamic of decision making changes, with implications for spending and savings patterns. Though not a major focus of the research to be undertaken here, such questions will be investigated through an attitudinal survey and qualitative follow up.

**Data and Methods**

16 To answer the research questions, the pilot will use both quantitative and qualitative methods. The research will be carried out in Kunzhai township in Nayong County in Guizhou province. The area is in a poverty county and per capita household income in the township is also well below the poverty line. The project takes advantage of the extension of the electricity network to some villages in Kunzhai Township to create an experiment. By providing certain other forms of infrastructure in a village, it will be able to measure the effects of a bundle of infrastructure, and compare this to providing electricity alone and to the situation where infrastructure is not provided.

17 There are twenty-two administrative villages in Kunzhai with varying degrees of infrastructure development. Eight villages are scheduled to receive electricity by the end of 1999, which will leave five villages without access. The project will use ADB funds to provide resources to the pilot village (Qianqiu) to build a small irrigation and drinking water scheme, a small connector road that will link the natural villages sites in this village to each other and to the road to the township in addition to the electricity supply. The pilot design will attempt to test the effects of this ‘bundle’ of electricity, irrigation/drinking water and road transport on poverty reduction. Conceptually, bundling infrastructure components is thought to lead to a more positive outcome than simply the sum of components individually. The synergies between different forms of infrastructure create an 'interaction effect' which is presumed to have a higher correlation with income growth than the correlation between individual forms of infrastructure and growth.

18 Two other villages in the township will be examined to contrast the effects of introducing infrastructure. The first is the control village: Zhulwohe has no road, electricity or drinking water and no plans to institute these. The second, Xinmin, currently has no road or electricity but is one of the eight villages that will get electricity under the township plan. In this way, the effects of infrastructure in the pilot village will be measured against a similar village that receives none of the services and one that only receives electricity. The latter is especially important because it will allow us to test the effects of electricity only.
The international literature suggests that while rural electrification may allow for productivity gains, it generally does not play a major role in poverty reduction if it is not linked to other development initiatives such as linking farmers to markets. For example, Barnes’ thorough review of the impact of electricity in developing countries shows that while electricity can have important effects, the presence of access to markets (especially due to roads) and credit are important determinants of whether electricity delivers the expected benefits. Other analyses suggest that only after rural areas have reached a certain level of development does it make sense to think about electrification and even then, the costs are likely to be extremely high making true sustainability questionable. Given that this is somewhat at odds with the thinking both of provincial leaders and many of the beneficiaries in the pilot village who see electricity as the most pressing infrastructure need to be resolved, the data generated in the context of the PRC is likely to be especially useful for future policy making. The following chart shows the characteristics of the three villages participating in the study.

<table>
<thead>
<tr>
<th>Village (infrastructure provided)</th>
<th>1998 per capita income (yuan)</th>
<th>per capita grain production</th>
<th>Number of households</th>
<th>Percentage of ethnic population</th>
<th>Per capita dry land (mu)</th>
<th>per capita irrigated land</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qianqiu (all)</td>
<td>760</td>
<td>301</td>
<td>183</td>
<td>48.1</td>
<td>0.40</td>
<td>0.26</td>
</tr>
<tr>
<td>Xinmin (electricity)</td>
<td>900</td>
<td>315</td>
<td>118</td>
<td>54.5</td>
<td>0.30</td>
<td>0.27</td>
</tr>
<tr>
<td>Zhulwohe (none)</td>
<td>780</td>
<td>258</td>
<td>304</td>
<td>36.3</td>
<td>0.32</td>
<td>0.03</td>
</tr>
<tr>
<td>Average Kunzhai township</td>
<td>755</td>
<td>276</td>
<td>196</td>
<td>57.2</td>
<td>0.66</td>
<td>0.07</td>
</tr>
</tbody>
</table>

Qianqiu and Zhulwohe are very close to the township average in terms of income and grain production while Xinmin is somewhat above, especially in income. All three villages are below the township average in per capita holdings of non-irrigated land, while inhabitants of Qianqiu and Xinmin have relatively more irrigated land than average. Nevertheless, all are significantly below the average per capita annual income of the designated poor counties of 1,300 yuan.

**Household Survey**

The pilot will use a household survey, carried out with the help of the Rural Socio-Economic Survey team of the county office of the State Statistics Bureau. Fifty families from each of the three villages will be chosen in a stratified random sample that takes into account amount of land owned by households and ethnic origin.

The household survey will collect detailed information on household expenses, consumption, assets, income flows, credit and loans. The household

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survey will be adapted from the ones currently in use by the national rural household questionnaire and by the World Bank’s Poverty Reduction Project. In addition to issues related to those mentioned, the survey will include a module on estimates of time usage by all members of the household. This will allow researchers to see how infrastructure influences the time spent in productive and non-productive activities over time and how household labour is allocated. In addition, it will give insight into the gendered nature of the impact of infrastructure since changes in the division of labour between men and women are to be expected based on experiences elsewhere. Finally, the survey will include attitudinal and behavioural questions. Attitudes related to expectations about infrastructure, to current quality of life (such as illnesses or schooling for children) and expectations about future QOL will be measured. Because social capital (such as trust in institutions, or connections to local elites) has been shown in the PRC and elsewhere to be related to being able to take advantage successfully of economic opportunities, this will also be measured.

23 An initial survey will be conducted at the outset of the project. This will form a baseline against which future developments will be measured in the three villages. Over the course of the first year, participating households will complete income and expenditure diaries in order to measure the seasonal changes in income and consumption patterns. Local assistants will be recruited and trained to help the households fill out such information and check the diaries for accuracy. At the end of approximately one year, a follow-up survey will be carried out and statistical analysis conducted to disentangle the effects of the different forms of infrastructure. It should be noted however, that ideally the follow-up should be continued over several years since many of the expected benefits will not become apparent within the first year. This is especially true for benefits related to a shift towards cash crops that may need several seasons before becoming productive. In addition, to the extent that the kinds of changes in decision making and division of labour that infrastructure may induce take time, these are unlikely to be fully visible in the first year.

Qualitative Data

24 In addition to the household survey, a series of focus groups and community meetings will be carried out over the course of the first year that will provide additional information about satisfaction, use of infrastructure and the process of implementation such as problems that arise or innovations. In addition, observation data about these same issues will be collected. Currently, discussions are underway with the United Nations Development Programme to place a UN Volunteer in the area during the first year to collect these data.

Community Based Information

25 Because a goal of this research is to measure the quality of life impacts of infrastructure, community level data related to quality of life will be collected. Health and education data are particularly important since over time, infrastructure should influence these. In particular, where clean water is supplied, water borne illnesses should decline. Where a road is put in, people should have more access to health care. In terms of education, school absenteeism should decline both with better roads and fewer health problems and in the long run, fewer children should drop out of school if incomes rise (this latter effect is unlikely to be seen in the first year of the
pilot, however.) In order to collect health and education data at the community level, teachers and health care workers will keep records of school attendance and patient visits over the course of the year.

26 Other community-based information related to local development as a result of infrastructure will also be monitored and collected. For example, do new forms of industry or service spring up, such as transport. Although the project does not provide any telecommunications, the introduction of some telephone services in the villages may enhance the effectiveness of the infrastructure that does exist and many of the villagers in Qianqiu expressed a desire for access to telephones. Monitoring the communities and their overall economic development will complement the data gathered from the individual household surveys.

Sustainability and Cost Recovery

27 Usage of and payment for infrastructure (ie: monthly electric usage, water consumption, etc.) will also be measured. Focus groups conducted recently in Qianqiu (see below for more detailed description) suggested a high willingness to pay for infrastructure services, even the most costly, electricity. Indeed, the suggestion that electricity be deferred until after irrigation which might produce more immediate returns was roundly rejected. One area where participants noted potential difficulty was the initial connection fee for electricity, however, some also suggested that the introduction of infrastructure for a variety of reasons might allow migrant worker to spend more time outside the village, increasing remittances, that could be used for such fees.

28 It is suggested that in Qianqiu (the village that will receive the bundle of infrastructure), households be paid for part of their labour for building the roads and water supply in vouchers redeemable for the cost of the electric connection. A great deal of support for such an idea was voiced during the focus groups. Not only does this avoid the problem that sometimes workers fail to receive the funds due them under collective projects but it also makes bundling a more viable strategy. If the initial costs of electricity can be funded through work on another form of infrastructure, not only do more households potentially use the services (important since the poorest households may decline to get service, thus forgoing any poverty alleviation effects) but it is more attractive to utility suppliers who are better off if a higher proportion of households receive and use services. It is important that the utilities suppliers calculate the real costs of providing services so that the project is able to assess the costs being paid by households as a proportion of the true cost. In addition, the costs of the various forms of infrastructure will be monitored closely by the project in order to assess the benefits of increased income relative to the initial and ongoing costs of the infrastructure.

29 In terms of cost-recovery for infrastructure, focus group participants did not anticipate problems in paying for the monthly fees associated with electricity. This is probably correct, although the cost of electricity will depend on household usage. In similarly poor villages visited as part of the initial field work for this project (albeit in another Southwest province), in villages with electricity, monthly household charges ranged from roughly five to forty yuan depending on whether usage was simply for a few hours of light per day or associated with using machines. In those villages,
inhabitants did not report problems with payments. The local electric utility responsible for Kunzhai township reports an extremely low non-payment rate in the other villages it supplies.

30 With some of the other infrastructure components, the issues of cost-recovery and maintenance are more problematic. The drinking water component, there are two issues related to cost recovery. First, it is more difficult to measure household consumption of water than electricity because supply is to be to the village rather than individual household taps. Second, setting fees low enough so that people use the water (important for health reasons) but high enough that water is not overused and that the costs of the project, including the anticipated future costs of repair and maintenance, can be recouped within a reasonable amount of time. Here, a set fee per household (depending on the number of members in the household) combined with some system of monitoring household water use needs to be implemented. FCPMC needs to work with the project engineers to calculate future maintenance costs in order to allow fees to reflect those costs. One suggestion is to institute a community water board, which would be responsible for the management of the water system as well as influence pricing policy. Community based organisations have been used in some countries to allow inhabitants to determine prices within appropriate guidelines with good results.9 Not only has experience with such bodies in other countries shown that there are fewer problems with long-term maintenance and fewer disputes over usage, but such a strategy is in keeping with the goal of promoting stakeholder participation the ADB envisions for this project.

Monitoring and Expected Outcomes

31 Part of the ADB’s goal for this project is to enhance the ability of both the leading group and local decision-makers to interpret and use information and data for better decisions related to poverty reduction. FCPMC will work with county and provincial poverty reduction offices as well as officials to develop information feedback mechanisms that will incorporate results of the pilot. Initially, this entails carrying out a workshop that will explain the details of the pilot project, what information is expected and what it will mean if it is found.

32 On-going monitoring is also possible with the qualitative information that is collected. Because beneficiary consultation and participation is both assumed to be linked to more positive outcomes as well as being a goal of ADB projects, part of the monitoring will include input from beneficiaries and the creation of dialogue mechanisms with officials. A key role for the UN volunteer is to promote beneficiary participation in the project, both in terms of obtaining their feedback but also working with them to develop suggestions and projects that can take advantage of the infrastructure. In this way, decisions may take into account the experiences and suggestions of the beneficiaries themselves. Part of the intention of holding community discussions during the course of the first year is to obtain feedback that can be used by local officials and poverty teams. The UN volunteer will assist FCPMC with developing county or provincial level workshops that present ongoing information from beneficiaries to officials.

Prior Beneficiary Consultation

33 As part of the preparation for the pilot, four focus groups were conducted with villagers in Qianqiu in September 1999 to understand their expectations about the different forms of infrastructure that will be implemented, their priorities and how they expected to use and pay for services. Groups were divided by age and gender so that there were group discussions with young/middle-aged men; young/middle aged women, older men and older women. While there was some suspicion on the part of researchers that participants had been 'primed' by local officials to elect electricity as their top priority, there are nevertheless important results that related to what the project should include and how it should be managed. First, many villagers made an implicit argument in favour of 'bundling', noting that without irrigation, they do not have enough produce to market; without roads, getting it to market or good prices is difficult; electricity was mentioned as useful for processing grain.

34 Second, there were clear indications both that beneficiaries have huge expectations for the ability of the infrastructure to raise living standards. Many spoke about buying grain-processing machinery both for their own use and as a micro-business locally in conjunction with electricity. Another common expectation was to use water to irrigate marginal land for viable cash crop production such as apples, pears and chestnuts. At the same time, they recognised that they had little technical skill or marketing knowledge to take advantage of many of potential benefits of the infrastructure.

35 Such information has been used in preparing the current pilot both in terms of designing the questionnaire and suggesting the financing mechanism for initial electric connections. Currently, the lessons from the focus groups are being prepared as policy briefs by HIID and the FCPMC. These will be presented to officials and poverty experts in Guizhou.

36 The project also contemplates conducting similar groups, with the help of the UN volunteer, during the course of the project. Doing so would give more in-depth information about the changes households undergo in terms of their strategies for using infrastructure. Understanding those changes will give further insight into how infrastructure might be made more sustainable.

Wider Impact

37 The goal of the pilot project is to provide evidence about the efficacy and impact of infrastructure projects in poor, resource-poor rural areas in Southwest China. For The PRC, the results will be useful in terms of thinking about the best way to cope with some of the remaining pockets of rural poverty after the end of the 8/7 plan. In particular, the information should help answer the question about the feasibility of using OCR funding for infrastructure-based poverty reduction efforts in these areas. By showing the effects of infrastructure not simply on income but on quality of life issues, a greater range of appropriate information will be available to policy makers on which to base their decisions. At the same time, it must be recognised that the results of the pilot project will not give policy makers a ‘blue-print’ design for future infrastructure projects but rather information that will need to be evaluated in light of specific local conditions.
Evaluation of the Progress of the Infrastructure Pilot Project in Early April 2000

38 To the end of March 2000, the construction and installation of the physical infrastructure associated with the pilot project was slower than originally planned. The electricity component was farthest along and was expected that by the end of April, 2000, both Qianqiu and Xinmin would be connected to the power grid and service provision begun. Some households already had connections (which were not yet functioning) and the materials for the rest of the connections have been delivered to the villages. The road that will connect Qianqiu and its natural villages to the township road was under construction but little progress had been made: approximately one eighth of the total length had been finished. Local officials estimate that the road will be completed by the end of July, 2000. The site visit during the week of 3 April, 2000 showed some progress on the water project in Qianqiu, with pipes laid out, but was still at a very preliminary stage of construction. Local estimates put completion of the drinking water project in June, 2000. FCPMC will need to maintain communication with the county to impress upon them the need to complete the projects in a timely fashion.

39 The initial household survey interviews should be completed by the end of April, 2000. During the site visit, FCPMC and HIID representatives met with the county-level State Bureau of Statistics, who will carry out the interviews. Modifications were made to the questionnaire to facilitate participant comprehension and ease of data collection. Because it is crucial that data collection occurs before the full implementation of the infrastructure projects, FCPMC must be in communication with the SBS and urge them to begin and complete their work as soon as possible. One unanticipated discovery was that the county SBS is unable to process the data. There are two possible options for dealing with this problem: 1) contract the SBS in Beijing to process the data as they are already familiar with a similar household survey; 2) have the HIID representative prepare the database in SPSS and ask the UNV to enter the data. The advantage to the second option is that the project will have more control over the coding, can more easily check for problems and will not have to translate the dataset into English; the disadvantage is that it may take longer to get a working database.

40 After the baseline questionnaire is completed, participating households will keep diary books for the following year. Local assistants will work with the UNV to help farmers fill out these books.

41 During the April site visit, the UNV began her year-long stay in the village. She will be living in Qianqiu and make periodic visits to the other sites. In addition to assisting with the SBS’s data collection efforts and the participants’ record keeping, she will report on the introduction and use of infrastructure, as well as help create participation mechanisms through which villagers and leaders can develop projects that allow them to best take advantage of the infrastructure. Because the presence of the UNV is such a good opportunity to learn about what infrastructure means for development, beyond simply the data gathered from the household survey, it is essential that she have support for the ethnographic portion of the work. HIID will provide this.
In discussions with the ADB team, there was a support for the idea of a site visit to the villages by the representatives from HIID and FCPMC later in 2000. In particular, this will allow an assessment of the work of the UNV, collect a great deal of information from the villagers and act quickly to resolve any problems with the project that may have arisen. Such a visit would entail spending approximately 10 days in the villages. This type of visit is particularly important because it would allow the work to be carried out uninterrupted by having to return to the township or county or by the entourages that accompany day visits. Depending on the level of funding, one or two additional visits to the village over the course of the year are advisable, particularly at the end of the year to assess whether and how the monitoring should be continued.
Annex 1 Questionnaires

Baseline Poverty Survey

Assets
- Housing (Number rooms, m², yuan value of home, construction material)
- Livestock count
- Durable goods (radio, TV, VCR, tape player, sewing machine, bicycle, iron)
- Productive machinery (3 wheel vehicle, tractor, mobile, pick-up, threshing machines, water pump, hand cart, water pumps, hand carts, other machinery)

Living facilities
- Latrine
- Electricity
- Water storage tank (if yes, m³ and construction cost)
- Sink
- Drinking water source
- Distance from drinking water source
- Fuel for cooking/heating

Land and application of techniques
- Area of cultivated land (mu); irrigated (mu), terraced (mu)
- Forest land (mu); how much used for cash crops?
- Area of fields for mulberry, tea or orchard (mu)
- Area of cultivated grassland (mu)
- Area of sown land for food crops (mu)
  - Wheat (mu)

*This follows the guideline of the Poverty Survey Questionnaire for Households used by General Organisation of Rural Social-Economic Survey of State Statistical Bureau within the LGOP’s projects. Additions are noted in the text or by an asterisk.*
• Corn (mu)
• Rice (mu)
• Potato (mu)
• Other food crops (indicate what) (mu)

• On how many mu do you use plastic film?

Do you use any of the following new techniques? (improved crop strain, techniques for improved animal breeding, greenhouse production of crops)

• Raise fish, eels or frogs?

Income

• Total gross household income
• Income from industry
• Income from household business
• Income from farming (get quantity of crops produced, quantity sold and cash value)
• Income from livestock (quantity sold and cash value)
• Income from forestry, fishery, handicrafts, hunting/gathering, industry, construction, transportation, services and other)
• Transfer income (remittances, gifts, food for work, subsidies for education)
• Property income

Expenses

• Total yearly expenses _____ (yuan)
• Household business expenses _____ (yuan)
• Farm expenses _____ (yuan)
• Fertiliser (kg bought, cost in yuan)
• Pesticide (kg bought, cost in yuan)
• Plastic cover (kg bought, cost in yuan)
• Seeds (kg bought, cost in yuan)
• Self-planted seeds (kg bought, cost in yuan)
• Animal raising costs _____ (yuan)
• Grain _____ (yuan)
• Grass _____ (yuan)
• Other _____ (yuan)
• Forestry expenses _____ (yuan)
• Fishery costs _____ (yuan)
• Cost of fixed assets for production _____ (yuan)
• Tax _____ (yuan)
• Agriculture tax _____ (yuan)
• Education tax _____ (yuan)
• Payment to village for duties and obligations _____ (yuan)
• Other fees to village _____ (yuan)
• Living expenses ____ (yuan)
• Food
• Clothing
• Housing & fuel
• *Water (sinks, taps plus cost of water)
• *Electricity (Number lamps, Number bulbs plus monthly cost)
• Household items, good and services
• Medical care and medicine
• Transportation and communication
• Education & recreation
• Other expenses
• Transfer payments and gifts
• Depreciation of fixed assets
• Net income for year

Food consumption
• Grains (get details of kg for each type)
• Beans
• Vegetables
• Oil/fat
• Meat
• Poultry
• Eggs
• Fish and seafood
• Dairy
• Sugar
• Cake
• Candy
• Alcohol
• Tea
• Fruit
• Cigarettes

Credit and Debts
• Amount borrowed or loans taken in year
• Form and amounts
• Source and amounts
• Number of time borrowed
• Source of largest loan
• Condition of repayment (rate, duration, cash or in kind)
• Usage of loan
• Preferred source for borrowing
• Priority of payment
• Would you be willing to borrow money for any of the following (check all that apply) in the next two years?
  • New seed varieties or plant seedlings
  • Purchase new animals
  • Farm equipment (specify)
  • Supplies for aquaculture
  • Transportation (motorcycle, pick-up, etc)
  • Sewing machine
  • TV, VCR, radio

Savings and Deposits
• Cash savings
• Cash in hand
• Deposits and interest rates
• Main aim of saving
• Grain saving
• Grain saved (indicate kg of each type of grain)
• Use of saved grain
• Have you lent anyone money this year?
  • Yes
  • No
• To whom have you lent money?
  • Children
  • Other relative
  • Friend
• How much have you lent to each person who borrowed money? ____ (yuan)
• Monthly rate _____ Percent
• How much money does each person still owe you? ____ (yuan)

Training
• Days of training received by family members ____ (days)
• Number of training programs
• Indicate agencies giving training
• Expenditure on training ____ (yuan)
• If respondent has received training ask (or if other family member has received training ask that person):
  • How would you rate the quality of the training you got?
  • Very poor
  • Poor
  • Average
  • Good
  • Excellent
  • How useful would you say the training was for you?
  • Very useful
  • Somewhat useful
  • Not very useful

*What training would you like to receive? (indicate 2)

(1) Farming
(3) Gardening
(5) Aquaculture
(7) Handicrafts

(2) Agriculture machinery use of repair
(4) Animal husbandry
(6) Product marketing
(8) Other (specify)

Preference of agency to work with
Social Security

(for households without labour)

- Subsidies from relief funds?
- Value of relief
- Main problem
- Can you afford medical care/medicine
- Is household 5 Guarantee household?
- Income mainly from?
- Who takes care of family?

COLLECT THE SAME INFORMATION USED IN POVERTY SURVEY QUESTIONNAIRES BY STATE STATISTICAL BUREAU, AND FOREIGN CAPITAL PROJECT CENTER OF STATE COUNCIL, AND LGOP ON

A. BASIC INFORMATION
B. INFORMATION OF LABOUR STATUS
C. GENERAL EDUCATION INFORMATION
D. INFORMATION OF NON-STUDENTS
E. SCHOOLING
F. CHILDREN’S HEALTH
G. INFORMATION ON WOMEN
H. LABOUR MOBILITY
I. INCOME AND LIVING EXPENDITURES OF MIGRANT LABOUR

HOWEVER, ADD THE FOLLOWING TO INDICATED SECTION:

C. How is the child’s performance in school? (answer for each child in school)
   (1) Excellent
   (2) Above average
   (3) Average
   (4) Below average
(5) Very poor

How would you rate the quality of the education children receive in the local school?

(1) Excellent
(2) Above average
(3) Average
(4) Below average
(5) Very poor

How often do you speak with the teacher about your child’s performance in school? (Ask parents of child only, not other adults in household)

(1) At least once per week
(2) At least once per month
(3) At least once per school year
(4) Hardly ever or never

ADD A SECTION ON HEALTH BETWEEN F AND G

<table>
<thead>
<tr>
<th>CODE IN FAMILY</th>
<th>In last 30 days, indicate if any family members have gotten sick or had accident 0=No (SKIP TO H10) 1= Sick 2= Accident</th>
</tr>
</thead>
<tbody>
<tr>
<td>H1</td>
<td>If sick, indicate with what: 1=cold, flu 2=respiratory 3=intestinal or stomach problems caused by water 4= other (specify)</td>
</tr>
<tr>
<td>H2</td>
<td>If accident, indicate type and cause</td>
</tr>
<tr>
<td>H3</td>
<td>If sick or accident, indicate what action taken: 0=nothing 1=self-medicate 2= traditional medicine 3= midwife 4= clinic in town 5= hospital 6= other (specify)</td>
</tr>
<tr>
<td>H4</td>
<td>If sick or accident and medicine taken, indicate the cost of medicine (including traditional medicines) in yuan</td>
</tr>
<tr>
<td>H5</td>
<td>If sick or accident and M did not visit clinic or hospital, why not? 1= not serious 2= too far 3= too expensive 4= clinic/hospital does not offer good service 5= other (specify)</td>
</tr>
<tr>
<td>H6</td>
<td>If yes, how many days missed?</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>CODE IN FAMILY</th>
<th>If visited midwife, clinic or hospital, indicate costs of transporta- tion</th>
</tr>
</thead>
<tbody>
<tr>
<td>H7</td>
<td>If visited midwife, clinic or hospital, indicate costs of consultatio- n</td>
</tr>
<tr>
<td>H8</td>
<td>If visited clinic or hospital, indicate costs of tests or lab work</td>
</tr>
<tr>
<td>H9</td>
<td>If no illness or accident in last 30 days, indicate date of last illness or accident in</td>
</tr>
<tr>
<td>H10</td>
<td>Indicate cause of sickness at that time: 1=cold, flu 2=respiratory 3= intestinal</td>
</tr>
<tr>
<td>H11</td>
<td>Action taken at that time: 0=nothing 1=self-medicate 2= traditional medicine</td>
</tr>
<tr>
<td>H12</td>
<td>Indicate total costs related to that illness or accident</td>
</tr>
</tbody>
</table>
ADD THE FOLLOWING QUESTIONS TO H. (LABOUR MOBILITY) SECTION

AFTER C56 (HOW DID R. FIND JOB OUTSIDE TOWNSHIP)

Could you please tell me specifically how you found your job? Did you know about the job before you left the village? Did someone contact you or did you contact him? Etc

______________________________________________________________

______________________________________________________________

______________________________________________________________

______________________________________________________________

AFTER C58 (IF RESPONDENT’S JOB IS IN COUNTY)

Main reasons for not seeking job outside county (mark all that apply)

1. Does not have information about jobs farther away
2. Cost of transportation is too high
3. Cost of living is too high
4. Does not have good enough skills
5. Outside of county is too far away from family
6. Too dangerous
7. Other, specify

If R. gives more than one answer, ask:

And which one of those reasons would you say is the most important one?

1. Does not have information about jobs farther away
(2) Cost of transportation is too high
(3) Cost of living is too high
(4) Does not have good enough skills
(5) Outside of county is too far away from family
(6) Too dangerous
(7) Other, specify
Time use and attitudinal survey

(Ask all adult members of household)

During the non-harvest and non-planting season, how much time per day do you personally spend doing the following? (Ask all adult (15+) members of household, ask mother or primary caretaker for each child under 15; if head of household is out of village, ask wife or other adult)

- Gathering fuel ____ hours/day OR ____ hours/week
- Bringing water ____ hours/day OR ____ hours/week
- Cooking and preparing meals ____ hours/day OR ____ hours/week
- Caring for children ____ hours/day OR ____ hours/week
- Caring for elderly family members ____ hours/day OR ____ hours/week
- Tending to livestock ____ hours/day OR ____ hours/week
- Cleaning/sewing/other household chores ____ hours/day OR ____ hours/week
- Building or repairing household ____ hours/day OR ____ hours/week
- Repairing or caring for machinery ____ hours/day OR ____ hours/week
- Taking produce or livestock to ____ hours/day OR ____ hours/week
- Shopping for food or other goods ____ hours/day OR ____ hours/week
- Farming chores (weeding, fertilising, ____ hours/day OR ____ hours/week
- Other remunerated activity (such as Processing grain, handicrafts, gathering, job in village, etc.) ____ hours/day OR ____ hours/week
- Studying (ask about each child in ____ hours/day OR ____ hours/week
- During the harvest periods, how
much of the harvesting are you personally responsible for? ___Percent

• During the planting periods, how much of the planting are you personally responsible for? ___Percent

When there is a major decision to be made in the household about financial matters, can you explain to me how it is made? Who makes the decision? (PROBE: Does decision-maker consult with other family members?)

__________________________________________________________
__________________________________________________________
__________________________________________________________

When there is a major decision to be made in the household about family matters, for example regarding the children, can you explain to me how it is made? Who makes the decision? (PROBE: Does decision-maker consult with other family members?)

__________________________________________________________
__________________________________________________________
__________________________________________________________

Now we would like to know your opinions about a number of issues. There are no correct or incorrect answers; we just would like to know what you think.

Generally speaking, would you say that you can usually trust most people or that one can not be too careful when dealing with others?

(1) Can trust most people
(2) You can not be too careful

Would you generally say that here in the village people can count on their neighbours to help when they need it or do most people look out for themselves and their own families?

(1) People count on neighbours
(2) People look out for themselves

For each of the following statements, please tell me whether you strongly agree, agree, disagree or strongly disagree.

Generally, I would feel comfortable lending my neighbours my tools or other farm equipment.
If offered the chance for me and my family to move far away to live in a village similar to this one but where I would have access to higher quality farmland, I would want to take that opportunity.

I believe my children will have a prosperous future if they stay here in this village.

Generally, I would feel comfortable lending my neighbours money.

It is more important for parents to make sure their sons go to school than their daughters.

Women are less capable of making good decisions about important matters than men.

Men care more about issues of local development and the economy than women do.

Women care more about family issues than men do.

It is better for families if the male head of household makes most of the decisions in the family.

Parents today can not count on as much support from their children as parents could in the past.

It is better to earn a living doing something secure even though it means very little money than to take a risk on earning more money at a job that is very insecure.

It is more important to encourage the development of new technologies than traditions.
(1) strongly agree (2) agree (3) disagree (4) strongly disagree

I believe that in matters related to the well-being of the village, my neighbours listen to my ideas and opinions and respect them.

(1) strongly agree (2) agree (3) disagree (4) strongly disagree

I believe that the village is doing all it can to ensure its future prosperity.

(1) strongly agree (2) agree (3) disagree (4) strongly disagree

Hard work usually leads to a better, more comfortable life.

(1) strongly agree (2) agree (3) disagree (4) strongly disagree

Borrowing money to try out new agricultural techniques or new crops is too risky for farmers like me.

(1) strongly agree (2) agree (3) disagree (4) strongly disagree

(For the following 4 questions, the responses should either be on a 1-10 scale or a 5 point Likert type scale, depending on what is more easily comprehensible to respondents)

Using a scale from 1 to 10, where 1 is completely unsatisfied and 10 is completely satisfied, how satisfied are you with the economic situation of your household?

<table>
<thead>
<tr>
<th>(01)</th>
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<th>(04)</th>
<th>(05)</th>
<th>(06)</th>
<th>(07)</th>
<th>(08)</th>
<th>(09)</th>
<th>(10)</th>
<th>(99)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unsatisfied</td>
<td>Satisfied</td>
<td>Don’t know</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</table>

**Alternative question wording:** Thinking about the economic situation of your household, how satisfied would you say you are with the way things are:

(1) Very satisfied
(2) Somewhat satisfied
(3) Neither satisfied nor unsatisfied
(4) Somewhat dissatisfied
(5) Very dissatisfied

All things considered, how satisfied with your life are you these days?

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<td></td>
</tr>
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</table>
**Alternative question wording:** All things considered, how satisfied with your life are you these days?

1. Very satisfied
2. Somewhat satisfied
3. Neither satisfied nor unsatisfied
4. Somewhat dissatisfied
5. Very dissatisfied

Some people feel that they have complete freedom of choice and control over their own lives while others feel that what they do does not have very much effect on what happens to them. Please use a scale from 1 to 10 where 1 means no control and 10 means a great deal of control; how much control do you feel you have over what happens in your life?

<table>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

**Alternate question wording:** Some people feel that they have complete freedom of choice and control over their own lives while others feel that what they do does not have very much effect on what happens to them. How much control do you feel you have over what happens in your life? Would you say:

1. A great deal
2. A fair amount
3. Not very much
4. None at all

Think for a moment about the kinds of decisions that influence community life and economic well-being here in the village. Please use a scale from 1 to 10 where 1 means no influence and 10 means a great deal of influence; how much influence do you feel you have over the decisions about what happens in the village?

<table>
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**Alternate question wording:** Think for a moment about the kinds of decisions that influence community life and economic well-being here in the village. How much influence do you feel you have over the decisions about what happens in the village?
Would you say:

(1) A great deal
(2) A fair amount
(3) Not very much
(4) None at all

Can you tell me about any associations, organisations or organised activities that exist here in the village, such as sports groups, Women’s Federation, farmer’s groups, credit groups?

__________________________________________________________________

__________________________________________________________________

(If respondent indicates that any groups exist) Are you a member of any of these?

___ (1) Yes    ___(2) No

Which ones? _________________

How well would you say the group functions?

(1) Very poorly
(2) Poorly
(3) Average
(4) Good
(5) Very well

Could you please rank in order of priority the four most important needs of the village?

___ ___ ___ ___

(1) School    (2) Clinic    (3) Road
(4) Drinking water    (5) Irrigation water    (6) Get jobs outside of county/province
(7) Technical training    (8) Production loans    (9) educational subsidy for children
(10) Electricity
When you get together with other members of the village, how often do you discuss ways in which the situation of the village could be improved?

(1) Frequently
(2) Occasionally
(3) Never

Have people in the village offered ideas or suggestions to the village leader about actions that could be taken to improve the situation of the village?

(1) Yes
(2) No

<table>
<thead>
<tr>
<th>Could you please tell me how important each of the following elements is in your life: Would you say...</th>
<th>Very important</th>
<th>Somewhat important</th>
<th>Not very important</th>
<th>Not important</th>
<th>[Don’t know]</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Family</td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>[(9)]</td>
</tr>
<tr>
<td>2. Friends</td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>[(9)]</td>
</tr>
<tr>
<td>3. Free time</td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>[(9)]</td>
</tr>
<tr>
<td>4. Work</td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>[(9)]</td>
</tr>
</tbody>
</table>
Would you please tell me how much trust or confidence you have in the following people or institutions. Would you say…

<table>
<thead>
<tr>
<th>A great deal</th>
<th>Some</th>
<th>Not very much</th>
<th>None at all</th>
<th>[Don’t know]</th>
</tr>
</thead>
</table>

1. Family

2. Neighbours

3. Local school

4. Agriculture extension

5. Health clinic

Thinking about the economic situation in the village 10 years ago, how would you say the local economy was doing at that time compared to today?

1. Very poorly
2. Poorly
3. Average
4. Good
5. Excellent

Thinking about the economic situation in the village today, how would you say the local economy is doing now?

1. Very poorly
2. Poorly
3. Average
4. Good
5. Excellent

And 10 years from now, what do you think the economic situation in the village is likely to be?

1. Very poor
2. Poor
(3) Average

(4) Good

(5) Excellent

(ASK IN PILOT VILLAGES) As you know, there are investments being made in here in infrastructure. Can you tell me what you think the benefits of the infrastructure to the village will be?

___________________________________________________________________

___________________________________________________________________

___________________________________________________________________

___________________________________________________________________

___________________________________________________________________

And what do you think the most important benefits will be to you personally?

___________________________________________________________________

___________________________________________________________________

___________________________________________________________________

___________________________________________________________________

___________________________________________________________________

Thank you for your participation.
Annex 2 Training Plan

1. There are three different areas of training that the pilot project conceives of undertaking. These involve training first, local residents; second, the staff of the Rural Household Survey; and third, provincial and country level officials and LGOP staff.

2. It is standard practice in the rural household surveys collected by the State Statistical Bureau to engage qualified local residents to assist with ensuring the quality of the data collected. Typically, people like school teachers or midwives are contracted to assist families with the task of filling out the income and consumption diaries that are used in the project and to check on the accuracy of what respondents enter. In the pilot project, members of the Household Survey team will train the selected local residents how to do this.

3. In addition, the pilot project asks the local health personnel and teachers to keep track of information related to incidence of illness and school attendance in order to measure quality of life changes. By keeping track of the number of illnesses that are treated and their causes over the course of the project, we will be able to measure the impact of infrastructure, in particular, safe drinking water on the health of the local population. School attendance figures are also necessary because the hypothesised relationship between infrastructure and education is that it directly improves attendance through, in the case of roads, allowing easier access and indirectly, through drinking water both by decreasing illness-related absences and by freeing children’s time needed for fetching water at home. In the long-run, the income improvements that infrastructure may mean also is thought to induce parents to invest more in their children’s schooling; however, such effects are unlikely to be seen in the current pilot project, given its time-frame. The LGOP will work with local health personnel and teachers to show them how to record the necessary information.

4. The second area of training to be undertaken is with the interviewer staff of the Rural Household Survey. Because their work has typically not involved the collection of attitudinal data, there are a number of techniques they need to become familiar with related to getting non-interviewer-biased data. Since they are already professional interviewers, this is relatively straightforward and can be carried out by the LGOP in consultation with the consultants.

5. The third area of training will be directed toward the provincial and country level LGOP staff on the interpretation of qualitative data from beneficiaries for monitoring and evaluation purposes. A two day workshop designed by the consultants representative and delivered by consultants and the Beijing-based LGOP counterpart for infrastructure is envisioned to both give technical training to the provincial and country level staff and also strengthen their capacity to develop linkages with beneficiaries. Such a workshop would focus on the following:
• training on focus group and group interview techniques;
• interpreting the results of focus groups and interviews;
• presenting the results to local officials;
• using the results as feedback for beneficiaries.

6 By using the results of the qualitative data that have already been collected as the resource material for the workshop, provincial and country level LGOP staff will also gain a better understanding of the information the pilot project is gathering and why. By getting an improved sense of exactly what data the pilot project is collecting and the rationale for that, they will be in a position later in the project to analyse, interpret and use the results. Because the project also has the possibility of a United Nations Volunteer (UNV), whose primary task will be spend a year in the project villages to collect information on the process by which the infrastructure is used and implemented, as well as work with the LGOP to promote beneficiary participation, the workshop also will provide an excellent opportunity for the UNV and LGOP staff to work together.

7 This workshop should ideally take place in February 2000, which is after the construction on the infrastructure will have begun but before any of the expected benefits will be apparent. By this point also, the UNV should be in residence in the township and his or her presence at the workshop is a priority.
Annex 3 Terms of Reference for United Nations Volunteer

1 As part of the pilot project on the impact of rural infrastructure on poverty reduction, a United Nations Volunteer is sought to assist efforts in the villages in the study. Specifically, the areas where the UNV will work with the project are: helping to monitor the process of quantitative data gathering, collecting qualitative data, and developing beneficiary participation and planning mechanisms.

Monitoring Data Collection

2 The project will collect a baseline survey that includes information about household income and expenditure, production, and time use. During the course of the pilot, villagers will record their income and expenses in diaries designed for this purpose. While some villagers will be trained and compensated to help farmers with this task, the UNV will also work with the trainers and act as a resource person for the trained villagers and monitor the process to ensure that the quality of the quantitative data is high.

Qualitative Data Collection

3 Qualitative data will also be gathered by the UNV. The purpose of collecting qualitative data on infrastructure use in the pilot project is twofold. First, qualitative data are an essential complement to the information gathered in the quantitative survey on the impact of infrastructure on poverty reduction and, secondarily, enhanced quality of life. Second, the qualitative information collection is an essential part of a strategy for ensuring beneficiary participation in the project.

4 In order to understand the impact of providing infrastructure to poor rural villages on quality of life and on poverty reduction, qualitative data are essential. In particular, infrastructure is thought to impact behaviour. With the arrival of infrastructure, the conduct and decision-making of households may shift. How households make decisions about changing the amount of labour they allocate to different tasks and who does what, for example, is the type of information that will allow us to see the mediating effects that household level characteristics may have on the poverty reduction effects of infrastructure.

5 In addition, qualitative data are often useful for explaining or interpreting quantitative findings. For example, the experiences of some countries with certain types of infrastructure (such as roads) suggest that better-off households receive greater than average benefits from infrastructure while elsewhere, the poorest groups receive proportionately higher returns. By using qualitative techniques in conjunction with quantitative ones, the mechanisms by which certain groups benefit are more easily ascertained. Qualitative information will also be helpful to the pilot project by allowing us to see the usage patterns of infrastructure and the reasoning behind usage. In part, such information is related to cost issues; one of the reasons that infrastructure is often more costly to provide in rural areas is that lower usage by consumers raises unit costs.
Qualitative information will also add to our knowledge of changes that occur at the village level as a result of the introduction of certain types of infrastructure. The project is interested not just in household changes that occur but also in overall village development that comes about due to infrastructure. For example, putting in a road may mean that a competitive market for transportation develops or that there are more frequent visits from health professionals. Similarly, the provision of infrastructure may induce other policy decisions at the local level such as choosing to invest in or seek out other complementary activities such as extension services or micro-credit.

A secondary concern of the project has to do with the quality of life gains that infrastructure can bring. Experience elsewhere shows that there are benefits to infrastructure that are not immediately economic in nature. For example, replacing kerosene lamps with electric light is a cleaner form of illumination that consumers often appreciate and it may make the chores done by light more pleasant. A road may mean that it is easier for children to get to school and therefore lower absenteeism rates or villagers may be more likely to seek medical care if the trip to the clinic is not so onerous. Quality of life gains may differ according to gender. Although the primary purpose of the project is to measure income gains, we also look at quality of life improvements because in the long run, many are associated directly with economic benefits. In addition, because beneficiaries are often willing to pay for services that improve the quality of their lives, such infrastructure may be sustainable and thus we examine it here.

Beneficiary Participation and Planning

The second major reason the pilot project will collect qualitative data is to assist in developing participatory mechanisms through which the beneficiaries of the project can make their needs and opinions known to local officials, the FCPMC and the ADB. The information gathered from the inhabitants of the villages will be used both to give comments to local and poverty officials, and to help develop other anti-poverty interventions. In this sense, the qualitative data collection will provide ongoing feedback to officials throughout the life of the project, allowing interventions to improve performance when deemed necessary.

Effective participation by beneficiaries in the infrastructure project involves more than simply giving their opinions about how satisfactory it is or what problems they encounter. It also entails being able to adapt their household practise in line with their expectations and ideas. There is some evidence that villagers lack the skills to translate their expectations into effective action. One of the tasks of the UNV will be to work with households to help them plan their economic activity to take advantage of the new infrastructure. Such a planning process will also help keep expectations realistic about potential benefits from the infrastructure.

Tasks and Counterparts of the UNV

It is important for the successful completion of the UNV’s work that she or he be able to count on support and guidance from the project. In particular, because the work will be carried out in the villages, local officials must understand and be willing to collaborate with the UNV’s efforts; the FCPMC (Foreign Capital
Management Centre of the State Council Leading Group Office for Poverty Alleviation and Development) will work with county and local poverty and governmental officials to ensure that a mutually co-operative relationship develops. The FCPMC will indicate an appropriate counterpart in the township or county government who can act as a support person for the UNV in terms of answering question and facilitating work in the villages. In addition, both the FCPMC and HIID will assist with developing instruments for the qualitative data collection and give feedback on the reports submitted by the UNV. The FCPMC will also work with the UNV to design participatory mechanisms and workshops for beneficiaries and officials. It is expected that UNV frequently communicates and consults with FCPMC counterpart staff with regard to the progress of the project and any problems occurred in the course of implementation. While the project hopes for participation from beneficiaries throughout, some of the prior design work (such as site selection, infrastructure planning, etc.) has occurred before the selection of the UNV. In no way is the UNV responsible for the results of decisions made prior to his or her selection, although they may impact the nature of beneficiary participation during the residency of the UNV. The following is expected from the UNV:

- Work with the Nayong County Rural Household Survey Team of the State Statistics Bureau in training local village assistants to monitor and help with entering information in the household diaries from those households that are part of the survey.

- Work continuously with local village assistants and survey households to ensure high quality of information entered.

- Conduct regular focus group discussions with villagers to assess issues such as the following: 1) villagers’ expectations about infrastructure and technical training; 2) attitudes towards the process of implementing infrastructure (such as where it is located, amount and kind of their contribution, etc.); 3) satisfaction with quality of infrastructure; 4) attitudes toward pricing of infrastructure and how that affects usage; 5) what changes are occurring in household as a result of the infrastructure.

- Collect data based on observation and informal discussion about the impact of infrastructure at both the household and village level.

- Prepare and submit monthly report summarising activities, and presenting and analysing the results of the data collection. At the end of the third month, this report should include an evaluation of the UNV activities as well as the status of the implementation of infrastructure. At that time, the UNDP, the UNV and the FCPMC will discuss whether any modifications to the TOR are necessary. At the end of the year, the UNV will submit an end-of-assignment report.

- Assist households with (1) planning for infrastructure use; (2) planning for household economic development activities; (3) family financial management and planning, such as loan borrowing and repayment.
• Work to create participatory and consultation mechanisms for beneficiaries and officials, using the results of the qualitative data collection as part of the input for designing those.
## Annex 4 Budget and Disbursement Schedule

### Cost Estimates for Pilot Project

<table>
<thead>
<tr>
<th>Infrastructure Construction Costs</th>
<th>Village</th>
<th>Type of Infrastructure</th>
<th>Unit</th>
<th>Quantity</th>
<th>Rate</th>
<th>Cost</th>
<th>ADB Funds</th>
<th>Local Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Qianqiu</td>
<td>Electricity</td>
<td>Household</td>
<td>183</td>
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<td>Person</td>
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<td>113,390</td>
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<td></td>
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<td>Road</td>
<td>Kilometre</td>
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<td>93646.7</td>
<td>421,410</td>
<td>147,601</td>
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<td><strong>Subtotal</strong></td>
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<td>373,500</td>
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<td><strong>Subtotal</strong></td>
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### Other villages

<table>
<thead>
<tr>
<th>Other villages</th>
<th>Type of Infrastructure</th>
<th>Unit</th>
<th>Quantity</th>
<th>Rate</th>
<th>Cost</th>
<th>ADB Funds</th>
<th>Local Funds</th>
</tr>
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<tbody>
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<td>Electricity</td>
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<td>Zhongji</td>
<td>Electricity</td>
<td>Household</td>
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<td>Guojiachong</td>
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<td>Household</td>
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<td>Aozhuhe</td>
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<td>Household</td>
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<td>Household</td>
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<td>Guanmenshan</td>
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<td><strong>Subtotal</strong></td>
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<td><strong>463,760</strong></td>
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<tr>
<td><strong>Sub-total for Infrastructure</strong></td>
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<td><strong>373,500</strong></td>
<td><strong>1,075,778</strong></td>
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</table>
## Costs of Monitoring and Survey

<table>
<thead>
<tr>
<th>Activity or Expense Category</th>
<th>Unit</th>
<th>Quantity</th>
<th>Rate</th>
<th>Amount</th>
<th>ADB Funds</th>
<th>Local Funds</th>
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</thead>
<tbody>
<tr>
<td>Provincial Supervision Persons/Quarter</td>
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<td>3</td>
<td>147.25</td>
<td>5,300</td>
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<tr>
<td>Subsidies to participating households Household/ year</td>
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<td>150</td>
<td>24</td>
<td>3,600</td>
<td>3,600</td>
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<tr>
<td>Subsidies to support people in villages Person/year</td>
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<td>15</td>
<td>500</td>
<td>7,500</td>
<td>7,500</td>
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<tr>
<td>County household survey team, monthly data monitoring visits Person/month</td>
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<td>72</td>
<td>70</td>
<td>5,040</td>
<td>5,040</td>
<td>0</td>
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<tr>
<td>Interviewers for baseline and follow-up surveys Person/trip travel</td>
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<td>30</td>
<td>1,950</td>
<td>1,950</td>
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<tr>
<td></td>
<td>Person/trip</td>
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<td>50</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Person/trip</td>
<td>15</td>
<td>50</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Training for support people in village by county team Person/trip /day</td>
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<td>15</td>
<td>150</td>
<td>4,500</td>
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<tr>
<td>Training for County team Person/trip</td>
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<td>100</td>
<td>1,500</td>
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<td>Printing Costs for Expenditure Diaries Item</td>
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<td>Contingency</td>
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<td><strong>Sub-Total for Monitoring and Survey</strong></td>
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<tr>
<td><strong>Total Costs of Pilot Project</strong></td>
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<td></td>
<td></td>
<td>1,490,778</td>
<td>415,000</td>
<td>1,075,778</td>
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</table>
Disbursement Schedule

The amount available for the pilot project from the Bank is US $50,000. Disbursement will be made in two instalments to the FCPMC, who will be responsible for channelling the money to the project site. The first instalment to the FCMPC will occur at the beginning of the project in the amount of 45% the total. After satisfactory progress has been made on installing the initial round of infrastructure and the baseline survey conducted, the remainder of the funds will be disbursed (after approximately six months). The FCPMC will make three payments to those in charge of the project locally, corresponding to the disbursements by the Bank but will hold $5000 in reserve, in part to pay the costs of the final survey and in part as an incentive for the timely completion of the infrastructure construction.