

**EMPLOYMENT SECTOR
2002/14**

*Working Paper on
the Informal Economy*

**Informal Finance in the Informal
Economy: Promoting Decent Work
among the Working Poor**

Michael Aliber

International Labour Office Geneva

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First published 2002

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Informal Finance in the informal economy: Promoting decent work among the working poor
Geneva, International Labour Office, 2002

ISBN 92-2-113424-5

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Printed in Switzerland

Foreword

This report throws light on the ambivalent nature of informal finance: it makes economic transactions amongst the working poor possible, it uses different forms of social capital innovatively, but it can also reinforce dependencies and exploitation.

At its 90th session in June 2002, the International Labour Conference held a General Discussion on the informal economy and its decent work deficits. The debate among ILO constituents showed their resolve to come to grips with the constraints that most workers in the informal economy face when seeking the money for small investments or accumulating savings to mitigate and cope with risk. Attention was repeatedly drawn to a sub-optimal functioning of financial markets and the need for policies to enhance competition in the supply of small-scale finance.

The present work makes a significant contribution to activities and knowledge-base of both the InFocus Programme on Boosting Employment through Small Enterprise Development (IFP/SEED) and the Social Finance Programme (SFP). For the ILO, the issue of access to capital for financing business start-ups or expansion is crucial to enhancing the quality and quantity of job creation, from street vendors to small-scale production units in the informal economy. ILO's work on micro- and small enterprise development will be greatly enriched by a deeper understanding of informal financial mechanisms and trends over time. For the ILO, informal finance has long been a subject of research work going back to studies of motorcycle bankers in West African markets carried out in 1991 and 1992. More recently, the ILO launched a scheme in South Asia to introduce micro-savings and micro-loan schemes so as to bring about more competition with moneylenders and reduce debt bondage.

Michael Aliber's report presented here is based on two empirical surveys, one carried out in India and the other in Uganda. The findings suggest the existence of substantial demand-led innovations in credit and savings mechanisms in the informal economy, while cautioning against simplistic views or idealization of informal finance. The report also identifies aspects of service delivery that the banking industry might wish to adapt to better cope with default risk and contain transaction costs. Finally, the pervasive gender dimension of informal finance is identified. The report concludes with several suggested areas for further research and pilot testing of monitored financial innovations.

The funding for this paper came from the Dutch Partnership Programme with the ILO. We would like to thank the Dutch Government for its generous support in helping to further our knowledge on this critical aspect of the informal economy.

Acknowledgment

The author gratefully acknowledges the advice and assistance of Jim Roth, Abdu Muwonge, Alice Nahayo, Sanjiv Phansalkar, and Sachin Mardikar.

The paper reflects solely the views of the author and cannot be attributed to the ILO.

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Acronyms

ASCAs	Accumulating Savings and Credit Associations
HFSC	Himalaya Finance and Savings Company
ILO	International Labour Organisation
MFIs	Micro-finance Institutions
MGAs	Mutual Guarantee Associations
NGOs	Non-Governmental Organisations
ROSCAs	Rotating Savings and Credit Associations
SFP	Social Finance Programme
SME	Small and Medium Enterprises

1. Introduction

Informal finance mechanisms are as diverse as they are ubiquitous, including institutions such as rotating savings and credit associations (ROSCAs), accumulating savings and credit associations (ASCAs), informal moneylending, loan brokers, and burial societies, to name a few. Such mechanisms may or may not be 'traditional', and range from utterly simple to thoroughly complex. They attend to diverse needs such as consumption smoothing, enterprise financing, promoting savings discipline, and intermediation between savers and borrowers. Arguably, the core-identifying characteristic of informal financial institutions is that they emphasize inter-personal relationships, rather than relying on anonymous interaction between a client and a formal institution.

Having access to informal financial services does not eliminate decent work deficits that afflict those who, by choice or out of desperation, pursue their livelihoods in the informal economy as informal operators. Nonetheless, the study examines the hypothesis that informal finance plays a critical role in assisting informal operators take best advantage of opportunities that may exist in the informal economy, and to attenuate whatever deficits are encountered. Accordingly, the main objective of the study is to ascertain the extent to which informal operators look to informal financial institutions in order to finance the start-up of their enterprises, and to understand the reasons for which informal finance may be used rather than formal sector finance.

A second objective of the study is to discern whether and in what way informal financial institutions are changing over time. This is an issue not just of academic interest, but also of practical importance to the welfare of the SME sector. Through the data collected at the study sites, some notion of short-term changes in informal finance can be derived. However, we also take a longer view, and by means of examining the underlying processes according to which informal financial institutions are apt to change, venture forecasts on the shape of informal finance in future decades.

Thereafter, the study addresses two questions of strategy. The first of these concerns the manner in which formal sector financial institutions – meaning mainly micro-finance institutions and banks – can borrow and adapt features of informal financial institutions, so as to improve their ability to service informal operators and low-income households. The second question of strategy is the extent to which similar goals can be achieved by means of “linking”, wherein formal financial institutions seek to link with actual informal sector institutions as a means of reaching the latter's members or clients. The potential of each of these strategies is assessed, first, by making a cursory survey of what has been attempted along these lines and with what effect, and secondly, by examining the logic of these strategies in relation to what has been learned from the study sites.

Woven through the research questions mentioned above is the issue of gender. In the first instance, the study attempts to determine the extent to which women and men have differential access to different types of informal financial services. Additionally, we ask whether the fashion in which informal financial institutions change over time may be to either advantage or disadvantage women. The fact that, in many cultures (including those of the study sites) traditional savings clubs are predominantly comprised of women members, is one indication that gender is tied up in an important way in the underlying logic of informal financial institutions.

The study is based primarily upon fieldwork that was conducted in Kampala, Uganda, and Nagpur, India, from September to November 2001. By examining the similarities and differences in the use of informal finance in settings that have such different histories and cultures, we are better able to understand what is generalisable from the fieldwork, and indeed we have a better chance of grasping what is essential to the logic of informal finance.

The organization of this report is as follows: Section 2 presents a concise overview of informal finance and the current debates around informal finance; Section 3 presents the results of fieldwork which was conducted in Uganda and India. The purpose of the fieldwork was to find out what sources of finance informal operators rely upon to start their enterprises, and what trends are discernible in terms of the use of informal versus formal financial services. In section 4, we attempt to identify the longer-term trends in the nature of informal financial services, in particular in indigenous savings clubs and traditional money-lending. Here we draw on information from the fieldwork, as well as examples from elsewhere in the world as documented in the literature. Section 5 examines two related areas of micro-finance practice, the one having to do with the strategic adaptation by MFIs and banks of features endemic to informal financial institutions, and the other relating to the forging of strategic linkages between informal financial institutions on the one hand, and formal sector financial institutions on the other. Section 6 synthesizes the discussion, and then concludes with inferences about lessons for policy.

2. Definitions, themes, and debates

The purpose of this section is to set out, in a non-technical way, what is meant by informal finance, to identify some of its distinguishing features, and to sketch some of the debates regarding informal finance from the literature.

2.1 What defines informal finance and what are informal financial institutions?

Informal finance is perhaps most intuitively defined relative to what it is not. It is not to do with banks or micro-finance institutions (MFIs), credit unions, cooperatives, insurance companies, etc. Developing a meaningful *positive* definition, however, is more difficult. In the 1960s, when the development profession began to realise that traditional moneylenders were in some instances outperforming heavily subsidised development banks, informal finance was more or less synonymous with “non-institutional” finance (FAO, 1965).¹ The problem with this approach is that it seems to imply that informal finance is unstructured or is only practiced by lone individuals, which, as will be shown below, is not necessarily the case. More importantly, it is often useful to speak of “informal financial institutions”, by which we mean not just particular moneylenders or savings clubs, but more broadly the recognisable conventions or social constructs of which specific real-life moneylenders or savings clubs are examples.

Another approach is to define informal finance as that which is not regulated, and formal sector finance as that which is (Hussain *et al.*, 1998). However, while regulatory regimes may be of great importance in influencing how different types of financial services are structured and offered, as a definition this approach is unhelpful. It is unhelpful firstly

¹ "It appears that ... many farmers prefer applying for non-institutional credit which is provided with a minimum of delay and discomfort and without red tape, awkward questions and supervision of the manner in which it was spent" (FAO, 1965, p.17).

because many types of financial services are regulated more in principle than in reality, and secondly because this means that essentially the same financial service is defined as informal in one country and formal in another, merely by virtue of different legal treatments.

The definitional approach we adopt is a rather colloquial one, whereby “informal” implies that the proper functioning of the institution relies at least as much on the establishment of personal relationships as on formal rules and procedures. While also imperfect (and somewhat idiosyncratic), the virtue of this definition is that it draws attention to the logic of why informal financial institutions work, as well as why sometimes they cease to do so.

One problem that remains with this definition is whether certain informal practices that involve money should indeed be called “informal finance” or “informal financial institutions”. Two examples are of particular importance. The one example is the case of gifts from friends or relatives, in particular those that are used to finance one's business. Analyses of informal finance or of how informal operators finance themselves often omit gifts altogether, which more likely has to do with uncertainty about how to interpret gifts than with their actual absence (e.g. Adams, 1992; Steel *et al.*, 1997). Perhaps one is inclined to suppose that gifts fall outside the ambit of informal finance, because the absence of an obvious mutual transaction makes them seem almost “too informal”.² Also, certainly one would have to exclude gifts of no economic value, but where does one draw the line? As will be shown below, gifts figure prominently as a source of start-up finance in both the Kampala and Nagpur study sites. This is reason enough for including such gifts as a form of informal finance, especially since gifts fulfil the definition of informal finance stated above.

The other example has to do with savings. As will also be shown below, many enterprises are started with one's own savings, and much if not most of these savings are simply kept at the person's home. The importance of these savings is indisputable, but the question again arises whether they should be considered a form of informal finance. A good reason for not counting savings kept at home as a form of informal finance is that, in violation of our definition offered above, no inter-personal relationships are concerned. On the other hand, to omit such savings – which certainly are not forms of formal sector finance – would also be difficult to rationalise. The approach we adopt is that, when tallying the total share of finance that is informal, we report the figures both inclusive and exclusive of home savings.

2.2 Varieties of informal finance, residuality, and the 'riddle of co-existence'

With the ILO's “discovery” of the informal economy in the 1970s, economic research into the informal economy exploded. This ultimately included research into informal finance, touching on the whole “kaleidoscope” of informal financial institutions: moneylenders, indigenous bankers, loan brokers, numerous forms of indigenous savings and credit clubs, pawning, informal credit unions, usufruct loans, savings collectors and money guards, etc. (Adams, 1992, p.8).

A reasonable assumption was that each of these informal institutions had its counterpart in the formal financial sector. A further assumption, albeit usually an unspoken one, was that where it exists, informal finance performs a residual function by virtue of the fact that formal

² In fact, many gifts are not truly free. For example, one fifth of all Kampala respondents who started their enterprises with gifts were obliged to help out with routine tasks or with minor expenses.

sector financial institutions have failed to penetrate as much as they might, i.e.: “...the informal sector exists to fill the gaps left by formal-sector economic activities” (Floro and Yotopoulos, 1991). From an historical perspective, such a claim is dubious, in that informal financial institutions in most cases preceded formal sector ones. However, in a given place and time, it is a serious proposition. It suggests that while informal financial practices may be a great deal better than nothing, they are merely second-rate substitutes for formal sector institutions that one would like to see introduced. Moreover, this accords with the general observation that in contrast to developing countries, informal financial institutions are less prevalent in developed countries, where the development of formal financial institutions has reached its greatest extent.

One shortcoming of this position is that it does not help resolve what we call here the “riddle of co-existence”. For example, why do farmers continue to borrow from moneylenders when subsidised credit has been made available to them (FAO, 1965)? Even more curious, why do women continue to participate in traditional savings clubs many years after they have opened savings accounts in the local bank (Nayar, 1986; Chiteji, 1998)? While sometimes market fragmentation is responsible for the fact that informal and formal financial institutions operate side by side, co-existence of formal and informal institutions, even to the point of sharing the same clientele, is not unusual. An under-appreciated reason for this is that sometimes informal financial institutions, and what appear to be their formal sector counterparts, in fact are providing services that are distinct in the minds of potential clients or participants. In this view, the co-existence of informal and formal financial institutions is no more mysterious than, say, the fact that in some economies, one finds building societies operating adjacent to savings and loans and regular commercial banks. A situation that is sometimes lamented as fragmentation or dualism in financial markets might more properly be recognised as market differentiation.

2.3 Trust and transaction costs

One of the key explanations for this market differentiation is that informal financial institutions rely on strategies for minimising transaction costs that are generally not available to most formal financial institutions. As an example, moneylenders and commercial banks adopt different strategies for trying to cope with the fundamental challenge of asymmetric information between lenders and would-be borrowers. Banks are apt to cope with asymmetric information by rationing according to objectively observable criteria such as occupation and financial history, which has the effect of reducing the transaction costs they incur at the expense of altogether screening out many lower-income applicants. Meanwhile, the application process imposes high transaction costs on credit applicants, i.e. waiting in bank queues, overcoming language and literacy obstacles, producing legal documents, and enduring lengthy delays while they wait for a verdict on their application. By contrast, the forte of informal money-lending is to exploit personal acquaintance with the applicant, as with loans from shopkeepers or input suppliers with whom the applicant is in frequent contact, or loans from one's landlord or rich neighbour. The observation has thus been made, over and over again, that even where they might succeed in qualifying for a bank loan, many people seeking credit will rather approach a local moneylender, even if this means paying higher interest rates. A similar comparison can be made in respect of savings services. Consider the operator of a market stall who pays for the right to entrust her modest surplus to an itinerant savings collector, without legal assurances of any kind, rather than make frequent

deposits in the bank down the road (Adechoubou M.A. et Tomety, S.N., 1994, and Rutherford, 2001).³

2.4 The moral economy of the moneylender

Arguably the most enduring and heated debate to do with informal finance centres on the moral character of the informal moneylender. Where traditionally economists and social historians tended to assert that moneylenders used their monopoly power to exploit their clients, the modern trend is to doubt both the extent of monopoly power and the exploitative character of such lending. Although there is no dispute that moneylenders charge high interest rates, these are now rationalised as necessary to compensate the moneylender for the seriousness of the risk borne, the screening costs incurred by the money-lender, and the high level of the opportunity cost of the moneylender's capital (e.g. Marshall, 1920, p.588; Adams and Fitchett, 1992, p.3; Aleem, 1990).

The moral rehabilitation of money-lending is emblematic of the broader paradigm shift in development finance, whereby informal arrangements that used to be shunned are now deemed benign and efficient almost by definition. The old set of adjectives – exploitative, backwards, unorganised, stifling, etc. – has now been replaced by a new set: efficient, flexible, innovative, etc.⁴ Although this switch would appear to be exaggerated, the virtue of the new paradigm is that it encourages development professionals to be more open-minded when encountering informal financial institutions. Indeed, one important expression of this new respect for informal financial institutions is the practice of studying such institutions with a view to discovering whether some of the features that account for their efficacy can be adapted for use in formal sector financial institutions (see e.g. section 5 of this study).

3. A comparative study of informal finance in Kampala, Uganda and Nagpur, India

This section reports the results of a comparative study of the role of informal finance among informal operators in Uganda and India. The purpose of the study was to establish to what extent informal operators rely upon informal finance relative to formal finance, and to determine what forms of informal finance predominate.

In each study site, the research involved a survey of informal operators using a standardised questionnaire, plus follow-up interviews with selected respondents, as well as supplementary interviews with MFIs, NGOs, and moneylenders. The study site in Uganda was central Kampala, specifically the area of Nakasero Hill plus the portion of Mengo-Kisenyi that includes Owino Market. After ejecting a small number of unusable questionnaires, the final sample size was 155. In India, the study site was the central area of the city of Nagpur, in eastern Maharashtra State, and the final sample size was 145. The questionnaire comprised five main sections:

³ Even in developed economies, the transaction costs of conducting business are frequently reduced by fostering inter-personal trust. See e.g. Macaulay (1963).

⁴ "Informal financial markets often include a collage of dynamic, innovative, and flexible arrangements that are adapted to the local economic and social environment.... Contrary to popular opinion, there is surprisingly little evidence of exploitation or monopoly profits in recent studies of informal financial markets.... Traditionally, informal finance has been viewed as a plague on poor people. In contrast, [we] argue that large numbers of poor people benefit from their participation in informal financial markets.... Informal finance also enhances the efficiency of resource allocation" (Adams and Fitchett, 1992, pp.3-4).

- i) personal information and work history;
- ii) business and household expenses;
- iii) source and nature of start-up capital for the present enterprise;
- iv) current financial arrangements, including current liabilities, savings habits and methods, risk management mechanisms, and participation in groups; and
- v) use of and satisfaction with formal sector financial institutions.

Notwithstanding the current trend of assuming that the economic enterprise of a person is indivisible from the “household enterprise” of which the person is a member, the survey aimed to focus on financial services and transactions that were explicitly related to the creation and maintenance of the enterprise *per se*.

There are three caveats with this empirical exercise that should be noted from the outset. The surveys did not aim for statistical representativeness, and as such did not employ a representative sampling methodology. With informal (often hidden) workers, enumerating the population (a necessary condition for representative sampling) is almost impossible. Rather, enumerators were directed to focus on well-defined geographical areas, and to ensure a diversity of enterprise types and a measure of gender balance, but otherwise to approach people “at random”. Inferences that are drawn on the basis of the surveys make use of techniques such as triangulation to validate the data. A second difficulty is that the present exercise attempts to explore the question of trends in informal finance over time, and yet the survey information was collected at one point in time. This constraint is partially addressed by taking advantage of the fact that each survey includes SMEs that were started in different years (some going back several decades), and by asking respondents' perceptions as to how the informal financial environment has changed over time. Thirdly, while it would have been ideal to incorporate rural sites, the resources available for the study did not permit both urban and rural. The choice of urban rather than rural sites was informed by the reasonable expectation that urban areas would afford more opportunity to observe how informal and formal sector finance may compete with and/or complement one another.⁵

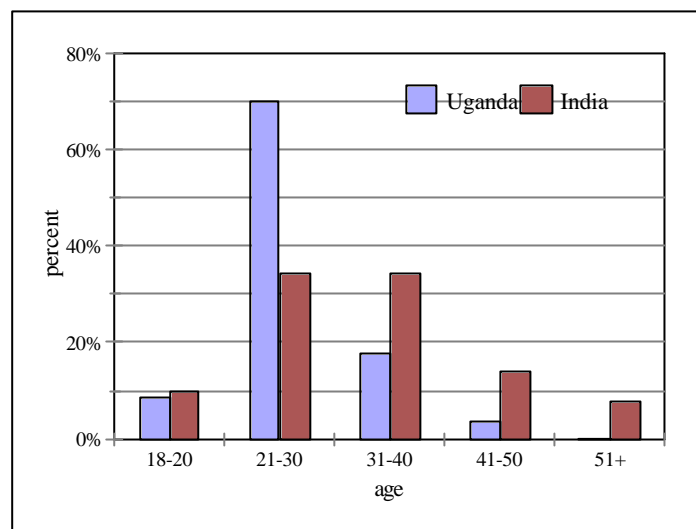
Briefly, the composition of the final samples is as follows. The share of women in the Kampala sample is 43%, while that in the Nagpur sample is 36%.⁶ As a whole, the members of the Kampala sample are younger than those from the Nagpur sample, with an average age of 28.5 years versus 37.2 years. Figure 1 below shows the age-distribution for the two samples, and reveals that for Kampala there is a relative absence of entrepreneurs over the age of 30. This corresponds to the flat age-pyramid that characterises the Ugandan population.⁷

⁵ Uganda was 14% urban in 1999, up from 9% in 1980 (World Bank, 2000). According to the state-run National Environment Monitoring Authority, the urban population is expected to increase by a factor of 9 over the next thirty years. For India, 28% of the population was urban in 1999, versus 20% in 1980 (World Bank, 2000).

⁶ For Kampala, this is somewhat higher than USAID's 1995 estimate that 38% of all SMEs in the Kampala area are owned by women (reported in Dichter and Kamuntu, 1997).

⁷ The percent of the Ugandan population 14 years or younger is 48%, versus 39% for India. Life expectancy at birth for Uganda and India for 1998 was 41 and 63 years, respectively (World Bank, 2000).

Figure 1 – Age-distribution of samples



Whereas in Kampala the average age of men and women in the sample are near identical, in the Nagpur sample women are on average more than ten years older than the male respondents (44 years versus 33 years). Not surprisingly given the demographic contrast, a higher fraction of women respondents in the Nagpur sample are widows relative to the Kampala sample (25% versus 7%), and many of these only started their enterprises since being widowed. By contrast, a relatively tiny fraction of women in the Nagpur survey are single women (4% versus 46% for Kampala). It would appear that in Nagpur, women are expected to marry young, or at any rate are not expected to work outside the home until married. Moreover, of Nagpur women respondents who are married, 38% work either in the home (e.g. doing handicraft work), directly in front of their home (e.g. doing retail), or in a shop that is situated within the home (e.g. “general needs store”).

Tables 1 and 2 below show the composition of the samples in more detail, disaggregating according to marital status and gender. The household dependency ratio is defined as the number of non-earning members of the respondent's immediate household (of whatever age) divided by the number of earning members.

Table 1 – Composition of the Kampala sample

	Women			Men		
	Percent of sub-sample	Average age (years)	Average dependency ratio	Percent of sub-sample	Average age (years)	Average dependency ratio
Single	46.4%	26.5	0.90	61.6%	24.9	0.31
Sep/Div	5.8%	28.7	2.50	4.7%	30.5	1.71
Married	40.6%	31.7	1.54	31.4%	33.2	2.17
Widowed	7.2%	30.0	2.10	2.3%	35.5	3.75

Table 2 – Composition of the Nagpur sample

	Women			Men		
	Percent of sub-sample	Average age (years)	Average dependency ratio	Percent of sub-sample	Average age (years)	Average dependency ratio
Single	3.8%	44.0	1.25	30.1%	22.9	2.03
Married	71.2%	43.0	1.91	69.9%	37.7	2.99
Widowed	25.0%	47.8	1.99	0.0%	na	na

Although age is not a good predictor of one's marital status (i.e. average age does not differ greatly across categories of marital status), the dependency ratio is though in different ways for the two samples. In the Kampala sample, those who are separated, divorced, or widowed experience the highest dependency ratios. However, even single women experience a high dependency ratio relative to single men. In the Nagpur sample, widowed women are likely to experience higher dependency ratios than single or married women.

Most respondents bear or share primary responsibility for the upkeep of their households. About 95% of the Kampala respondents indicated that they make the highest contribution to the upkeep of the household. For Nagpur, the figure was 61% among women respondents, and 72% among male respondents.

The Kampala sample is more ethnically diverse than the Nagpur sample, as evidenced by native language. Although 52% of the Kampala sample were Luganda speakers, the other 48% was comprised of those speaking 14 other languages, including northerners (16%), those from the East (5%), those from the West (12%), and those from the central region (14%). In the Nagpur sample, 61% speak Marathi, the principal language of Maharashtra; 34% speak Hindi, and about 6% speak Urdu, generally indicating that they are Muslim.

3.1 Work patterns

An important aspect of employment in the informal economy is that it frequently consists of self-employment. As will be argued below, this fact has an important bearing on the manner in which decent work deficits associated with working in the informal economy can be attenuated. For the cases at hand, 61% of the Kampala respondents are self-employed and work alone, versus 55% among the Nagpur respondents. In terms of the total numbers of people employed in the enterprises surveyed, the workforce can be disaggregated as follows:

Table 3 – Composition of work force in surveyed enterprises

	Kampala	Nagpur
Proprietors	57%	55%
Family members	12%	25%
Non-family members	31%	20%

In other words, a striking majority of those employed in the informal economy are either self-employed (i.e. proprietors), or working for a family member or family business.

For both country samples, the diversity of enterprises is enormous. Very roughly, for each sample, 13% are involved in some sort of manufacturing or production, 30% in provision of services, and 57% in retail:

manufacturing – furniture making, bead work, making mattresses, fabrication of metal implements, making pots, animal husbandry, etc.

services – flour milling, motor rewinding, food and traditional beer preparation, music playing, photography, hair styling, butchering, tailoring, stove repairing, providing telephone services, welding, clothes washing, charging cell phone batteries, cell phone rental, sex worker, etc.

retail – retail of fruit, vegetables, costume jewellery, posters, plastic items, clothes, flowers, potted plants, scooter seat covers, motor oil, religious items, etc.

Respondents were asked why they had chosen the activity in which they were presently engaged. Among the Kampala respondents, the main reasons given were that they had the necessary experience (18%); that the enterprise appeared to promise reasonable profits (16%); and, from a more negative perspective, that the enterprise was feasible given the limited amount of capital at hand (16%). Among Nagpur respondents, the predominant reason for choosing the present occupation was previous experience in that activity (38%), followed by caste/tradition (20%), and 'interest' (16%). Very likely, some fraction of those who indicated experience as the main reason for choosing that kind of enterprise also had that experience by virtue of their caste or family tradition.

The entrepreneurs surveyed are overwhelmingly involved with their enterprises on a full-time basis. In the Kampala sample, 97% work 6 or 7 days per week, and 86% work 8 hours or more per day. For Nagpur, the figures are 97% and 87%. The respondents in the Kampala sample were more likely (10%) to be engaged in some fashion in a second enterprise, usually through the agency of a household member.

3.2 Evidence of self-employment in the informal economy as a source of decent work

While it is not the objective of this study to analyse why people end up as informal operators, the survey does in fact reveal evidence that is consistent with the theme, that informal economy employment – especially *self*-employment – can serve as a source of decent work. The main line of evidence in this regard stems from the question as to what work people did previously, and why they changed. For both samples, around one third of the respondents previously held wage employment, for the most part in the formal sector. Of these respondents who previously had wage employment, 82% and 94% left voluntarily in favour of their present self-employment activity in the Kampala and Nagpur samples, respectively. The reasons provided for these *voluntary* transitions fell into the following categories:

Table 4 – Reasons given for leaving previous job*

Reasons stated for leaving previous job	Kampala	Nagpur
Wanting to be independent / mistreated / 'fed-up'	54%	50%
Low pay	38%	31%
Too taxing / health problems	11%	6%
Other	11%	13%

* Figures do not sum to 100% because some respondents mentioned more than one reason.

The sentiment of wanting to be self-employed is frequently motivated by a desire to reap the rewards of one's own efforts, as well as have the convenience of being able to determine one's own hours, possibly work from home, etc. In the words of Richard, a 26 year-old man who previously was a "house boy" and who now sells stationery on the pavement,

"...By comparison, this is a very good start for me. I am happily independent, free and realise my own profits. I really put in much effort because it is my personal business and own achievement. Secondly there is no pressure in this work, so I am not tensed up at all, I have a peace of mind and generally like my work. Lastly I have job security compared to my previous job, anytime I could get fired."

Many of those who left wage employment ended up starting businesses closely related to the employment previously held, e.g. a salesman in a bookstore opened his own bookstore, an employee in a hair salon opened up her own hair salon, a man who worked cleaning a church left to become a salesman of religious items, etc. Together with the fact that the previous employment often serves as an opportunity to save up money with which to initiate the new enterprise, it would appear that formal sector employment is often used as a stepping stone towards more desirable self-employment, typically in the informal economy.⁸

Those leaving employment because of mistreatment tended to be domestic workers, mostly women but also some young men. Some of those leaving wage employment in search of better income were civil servants (e.g. teachers and nurses), frustrated with government's tardiness with paying salaries. Other respondents who left wage employment due to discontent with the level of pay included factory workers, hotel staff, and even a bank clerk.

Among the other two thirds of respondents whose previous employment was also self-employment in the informal economy, the overwhelming reason for switching to the present enterprise was to seek better profits, or because the previous enterprise was overly vulnerable to price fluctuations (especially in farming), or because the activity was too "hectic". On numerous occasions, the theft of one's stock or productive assets became an occasion to start over in a different enterprise, especially in the Kampala sample.

Although pursuing a livelihood as an informal operator is rightly associated with hardship and vulnerability to risk, self-employment in the informal economy can nonetheless prove to be a preferable alternative to wage employment in an economy which is ill-equipped to ensure decent working conditions of wage earners.

3.3 How informal operators finance themselves

We turn now to the crux of the comparative study, that is, to identify how informal operators finance the start-up of their enterprises. Respondents were asked in what year they had started their present enterprise, how much money they had invested to start the enterprise, and what the sources of this money were.

Trends over time in Kampala and Nagpur

We start by looking at trends in investment levels, regardless of whether the source of the investment is formal or informal. Using the consumer price index, investment levels that took place in past years were converted to 2001 constant values, allowing an inter-temporal comparison in terms of real values. Figures 2 and 3 below reveal the pattern of investment over time for Kampala and Nagpur, respectively. However, for the case of Kampala, although some respondents had started their businesses as early as 1981, the period of hyperinflation that lasted until the late 1980s makes hazardous any inter-temporal comparisons that include

⁸ This is not to suggest that all Ugandans and Indians prefer to work in the informal sector, but rather to point out that there is a significant number of Ugandans and Indians who do. It may be that this is only true of certain kinds of people, and/or is likely to happen in an environment where the unemployment rate is high and wage employees are vulnerable and poorly remunerated.

this period.⁹ The scatter plots represent the observed average investments for each year. One of the solid lines shows the 5-year moving average so as to make more evident whatever trends there may be¹⁰, while the other solid line shows real per capita GDP for the country as a whole for sake of comparison.¹¹

Figure 2 – Trends in informal finance, Kampala

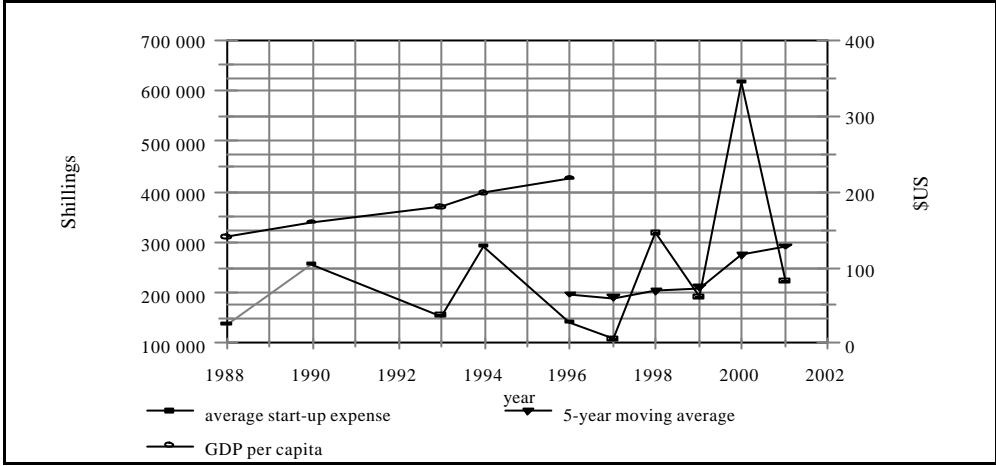
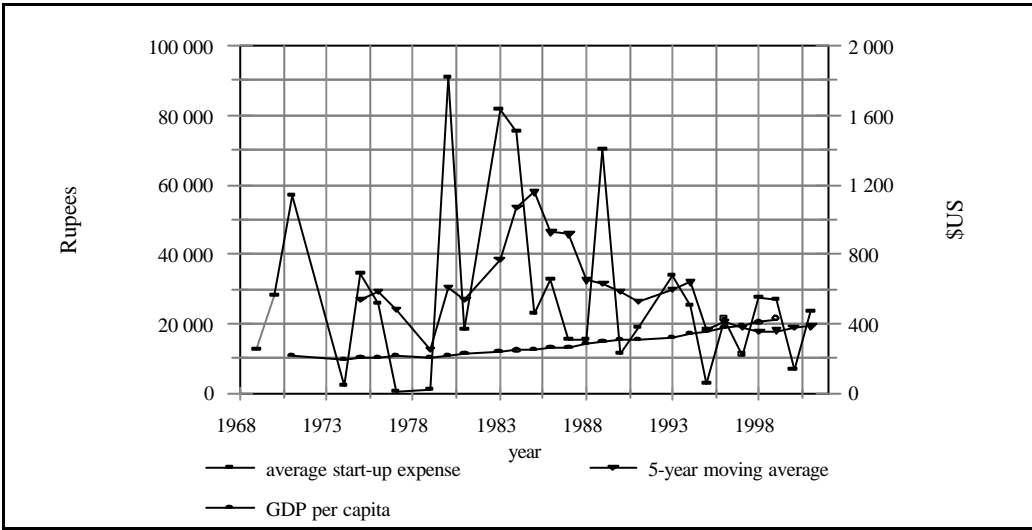


Figure 3 – Trends in informal finance, Nagpur



⁹ Consumer price indices are taken from the *International Financial Statistics* of the International Monetary Fund. For Uganda, the average annual rate of consumer inflation from 1981-1993 was 169%, versus less than 7% from 1993 to 2001. The fact that the Kampala SMEs are confined from 1981 on, whereas in the Nagpur sample they start in the 1960s, probably owes to the relative youth of the Kampala sample, but perhaps also to the stabilising influence in India of inherited or caste-based occupations.

¹⁰ The 'volatility' in the averages over time owes to the fact that for most years, the averages are taken over a very small number of observations, thus taking little advantage of the smoothing effect associated with larger samples.

¹¹ While most money amounts are reported in local currencies, these can be converted to \$US using average 2001 exchange rates of Shs 1750 = Rs. 48 = \$1. Therefore, Shs 200,000 is about \$114, and Rs. 20,000 is about \$417.

It would appear that in Kampala there is a gradual increase in the amount of money spent on launching informal enterprises, probably indicative of the recovery of Uganda's economy over the past 15 years. However, the position of the investment trend relative to the trend in per capita income indicates that, at least for the sample at hand, capital investments in informal enterprises are modest relative to average personal income.¹²

In the Nagpur sample, the pattern is somewhat different. Average investment in informal operations appears to peak in the early 1980s, and since then has sunk to levels observed in the early 1970s. Even so, one observes that investment levels remain high relative to GDP per capita.

Composition of start-up finance in Kampala and Nagpur

Turning now to the composition of the finance respondents used to start their businesses, we focus first on the Kampala sample. Figures 4 and 5 below show where businesses sourced their finance, in terms of the share of the total number, and share of total volume. For example, of those businesses that started between 1988 and 1997, about 52% did so with accumulated savings (Figure 4), yet these savings represented only 37% of the total amount of money invested in that period (Figure 5).¹³ One can conclude from these figures that informal operators rely more on savings than on any other source, but that in terms of volume of financing, loans also play a very large role. Gifts are also very significant, and for the 1998-2001 period (which represents 6 times as many enterprises as for 1988-1997), in fact gifts are as important as loans, whether in terms of number or in terms of volume. Another important revelation from the figures is that financing by means of sale of assets is relatively rare.¹⁴

¹² This comparison should not be taken too literally, e.g. in terms of a given ratio, not least because the GDP per capita applies to the whole country, rather than to the sample area. However, given that Uganda is overwhelmingly rural and that urban incomes are relatively high, the statement that investment levels are low relative to incomes is even more the case.

¹³ This interpretation is not perfectly precise, because almost 10% of respondents relied on more than one source of financing, e.g. a loan as well as savings, or savings as well as a gift, etc.

¹⁴ "Other" in this instance consists of a young man who won Shs 500,000 in a lottery, a woman who received Shs 300,000 when she retired from her job as a midwife, and another women who received Shs 10,000 from an unspecified source other than savings, a loan, or a gift.

Figure 4 – Finance sources, by number of respondents, Kampala

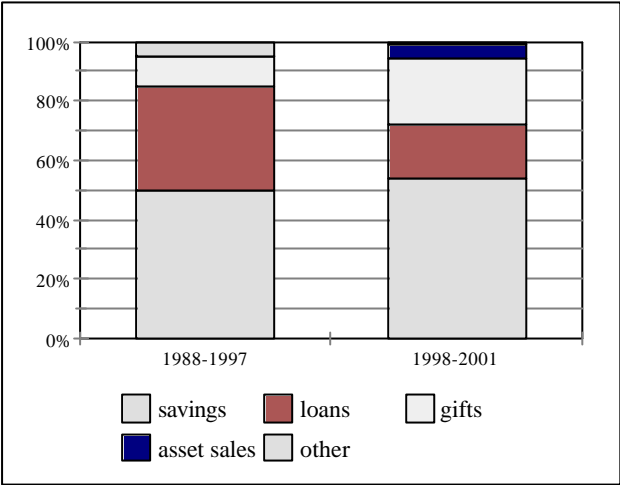
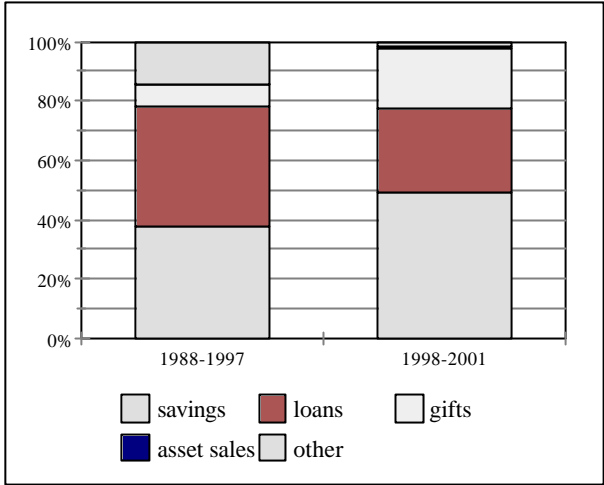


Figure 5 – Finance sources, by volume of finance, Kampala



Turning now to the Nagpur sample, we present similar graphs to those above for Kampala, the only difference being that we start further back in time, and report the composition of finance by 5 year intervals (except for the first interval, which spans 10 years).

Figure 6 – Finance sources, by number of respondents, Nagpur

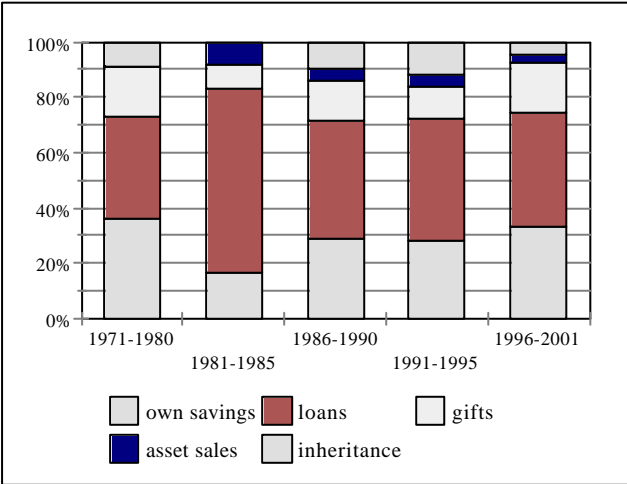
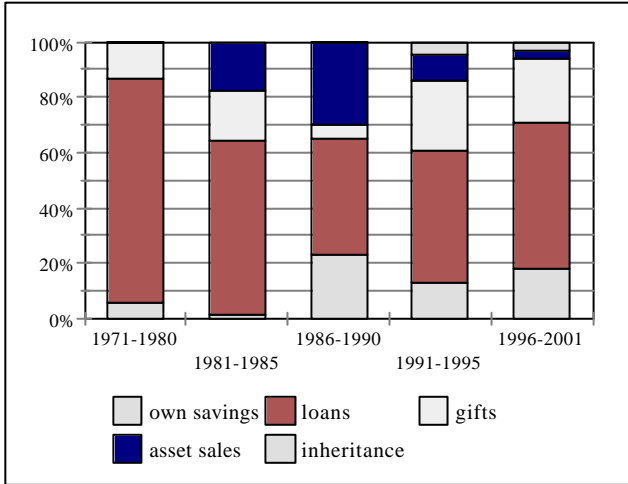


Figure 7 – Finance sources, by volume of finance, Nagpur



Overall, the pattern one observes in Nagpur is not dissimilar to that in Kampala. Savings appear to be somewhat less important than in the Kampala case, especially in terms of volume. One can infer then in the Nagpur case, the average size of loans is relatively large (the volume share is large relative to the number share). Also, as in Kampala, gifts play a significant role. Perhaps the most surprising observation is that there is no discernible trend over time – it is not at all evident that entrepreneurs initiating their businesses in the 1990s, do so in a fashion different to their counterparts in the 1980s or 1970s. If anything, it would appear that loans have become marginally less predominant over time.

Means of finance and gender in Kampala and Nagpur

An important question at this point is whether women and men rely in the same measure on these sources of finance. The first important fact is that, on average, women spend less on starting their businesses than men. For the Kampala sample, the figures are Shs 249,000 for women versus Shs 354,000 for men, whereas for the Nagpur sample, women spend on average Rs. 16,000 versus almost Rs. 29,000 for men. Moreover, this discrepancy holds true for almost all of the finance sources, as shown below for the Kampala and Nagpur samples, in Figures 8 and 9, respectively.

Figure 8 – Average investment levels by gender, 1988-2001, Kampala (in constant 2001 Shillings)

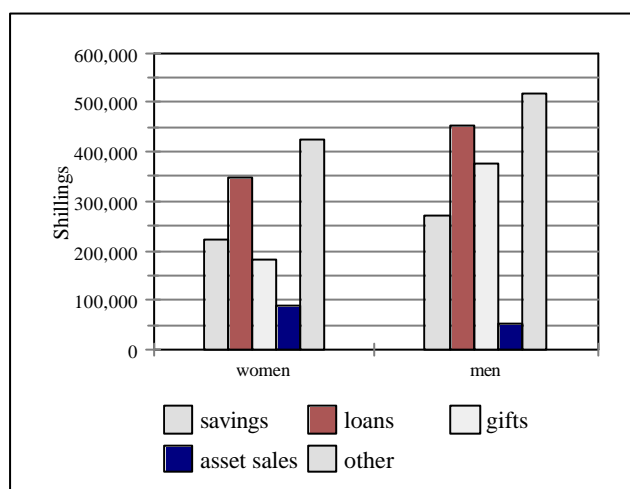
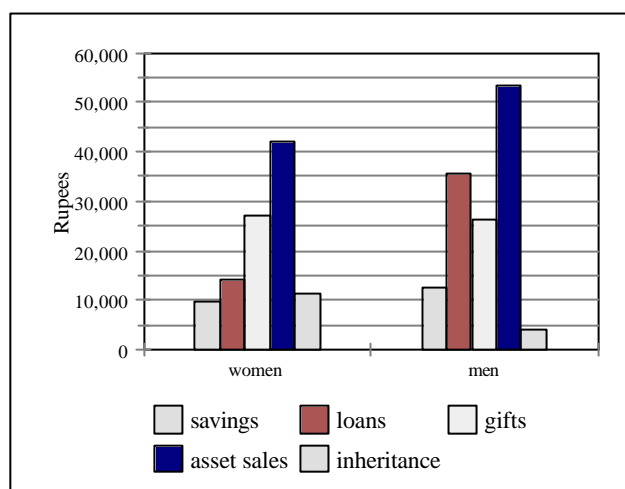


Figure 9 – Average investment levels by gender, 1971-2001, Nagpur (in constant 2001 Rupees)



In the Kampala sample, the discrepancy in the average size of gifts used to start one's business is especially large, while in the Nagpur sample the same is true of loans. The main exceptions to the pattern are, in Kampala, asset sales, and, in Nagpur, inheritance, both of which, as will be shown below, are of little overall importance for both men and women.

To gain a more complete picture, it is useful to look as well at the number of women and men relying on different finance sources. Figure 10 reveals that for the Kampala sample, more women rely on own savings than on any other source, with gifts being the second most common finance source. For men, the reliance on savings is even greater, but reliance on gifts is less by almost the same measure. The category of gifts emerges as somewhat curious, in that women are far more likely than men to have used them in starting their businesses, but on average these gifts are far smaller than those that men receive. Part of the explanation is that about one third of women who relied on gifts, received these gifts from their husbands, which on average are relatively small at Shs 114,000 each. However, gifts received by women are on average smaller whether the giver was a blood relative or a friend.¹⁵

¹⁵ For women, gifts from friends average Shs 86,000, versus Shs 133,000 for men, whereas gifts from blood relatives (parents, aunts and uncles, and siblings), average Shs 229,000 for women versus Shs 425,000 for men.

Figure 10 – Finance sources, by number and gender, 1988-2001, Kampala

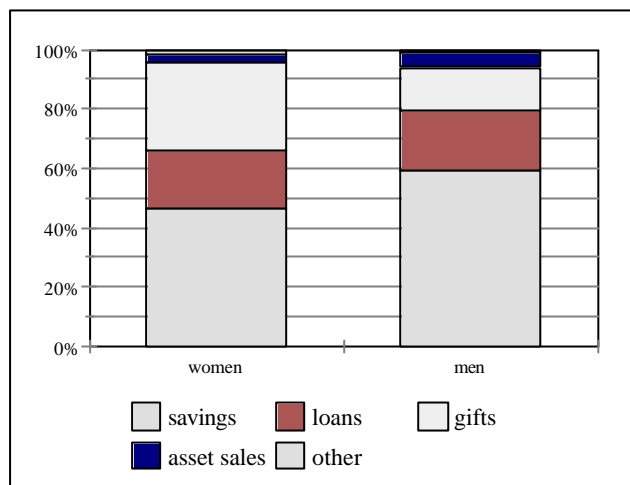
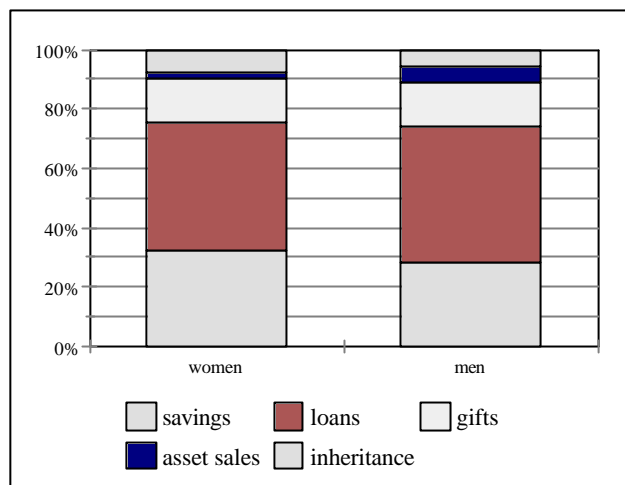


Figure 11 – Finance sources, by number and gender, 1971-2001, Nagpur



Within the Nagpur sample, loans are the single largest source of start-up finance for women and men, particularly the latter, with savings coming in second. Reliance upon gifts is marginally more common among women compared to men.

As of this point no distinction has been made between informal and formal financial sources, though at least one category – gifts – is informal by definition. The question is, to what extent are loans from formal or informal sources, and to what extent are formal sector institutions used in the process of accumulating savings?

Sources of loans in Kampala

First looking at loans (Table 5), the most striking observation is the degree to which loans from friends and relatives predominate.¹⁶ These loans constitute around 70% of all loans used by respondents to start their businesses (restricted to 1988-2001), whether by number or volume. A notable characteristic of this category of loans from friends and family is its enormous variation. These loans vary in size from Shs 11,344 to Shs 3.1 million (about \$6.50 and \$1780, respectively), the latter being some 274 larger than the former. This wide variation is not surprising, given that there are more observations in this category, but more so because people may vary greatly in terms of the means and generosity of their friends and relatives.¹⁷

¹⁶ Observations prior to 1988 are not included here because of the problem of rendering into 2001 Shillings. Three such loans were omitted, namely 1 from a moneylender, one from an MFI, and one from the respondent's friend.

¹⁷ A similar conclusion is reached if one uses a more conventional measure of dispersion, e.g. the standard deviation of loans from friends and relatives is 77% greater than that for the next most dispersed category.

Table 5 – Sources of loans, Kampala 1988-2001 (in constant 2001 Uganda Shillings)

	Number	Total volume	Min	Max	Max ÷ Min	Mean	Median
Friends/ Relatives	21 (68%)	8,683,759 (71%)	11,344	3,110,048	274	434,188	180,000
Money- lenders	2 (6%)	274,031 (2%)	34,031	240,000	7	137,016	137,016
MFIs	6 (19%)	2,511,377 (21%)	113,438	1,036,683	9	418,563	283,595
Banks	2 (6%)	695,164 (6%)	127,974	567,190	4	347,582	347,582

The second largest source of loans is micro-finance institutions (MFIs), which furnished about 20% of the credit by number as well as by volume. This attests no doubt to the successful introduction of MFIs in Uganda, and in Kampala particularly, in the last 15 years or so. These loans are also potentially quite large, though none of those in this particular sample had loans that were near as large as the maximum friend/relative loan. This, and the fact that the smallest MFI loan is large relative to the smallest friend/relative loan, might of course owe to the small number of observations in this category. However, the fact that in the aggregate, loans from friends and relatives largely outstrip those from MFIs (by a ratio of 3.5 to 1) must be considered robust, and would no doubt have contrasted even more starkly if the sample had been drawn outside of Kampala.¹⁸ One reason the use of MFIs is not greater is that MFIs either require – or are believed to require – collateral. Of the 6 respondents who had borrowed from MFIs, 3 had to pledge their land title as collateral.¹⁹

Banks and moneylenders come in last. As for banks this is little surprise, as commercial banks are notoriously ill-suited to serving those who are self-employed in the informal economy, because they tend to lack collateral and are often unable to present a convincing business proposal on a scale that is cost-effective for the bank to consider. The two individuals who did receive bank loans had unique characteristics that might explain their ability to access these loans. One of them, a young university graduate named Kassim, received a gift from his parents towards the start-up of the business that was in fact twice as large as the loan he obtained. In addition, he pledged a piece of land to which he had title in order to secure the loan. At the suggestion of friends, the other bank loan recipient, Matia, sought a loan from the Centenary Rural Development Bank, which in some respects is not dissimilar to an MFI. As with Kassim, Matia also pledged title to his land, as well as numerous other assets at his disposal. It must be stressed that the informal operators interviewed have easy physical access to banks, and indeed a large fraction of informal operators are actually bank clients in terms of having savings deposits (see below). One interesting case is that of David, a 27 year-old fruit seller, who borrowed Shs 170,000 from a family friend who happened to be a bank manager.

Perhaps the biggest surprise is the very limited use of loans from moneylenders. One of those who did obtain a loan from a moneylender was Joseph, a 27 year-old man who in

¹⁸ The numbers of respondents receiving loans from MFIs, banks, and moneylenders are too small to allow us to say much about the nature of these loans (i.e. they may not be 'typical' of loans received by informal sector operators from these sources), except that they are small in number.

¹⁹ For two of the others, the person who introduced the respondent to the MFI (the "supporter") stood as guarantor for the new member's loan.

January 2001 took out a loan to enable him to operate a *boda-boda*, i.e. a motorcycle taxi. The moneylender from whom he borrowed the money is the businessman who sold him the motorcycle, and who frequently gives out loans to enable people to purchase his motorcycles. It may be misleading to call this man a moneylender, in that he does not give loans for anything other than his own motorcycles. Joseph was introduced to the businessman by friends who themselves operate *boda-bodas*, also by means of borrowing from the businessman. Asked if he had considered rather getting a loan elsewhere, Joseph indicated that he had thought of approaching a bank or MFI, but did not because he had no security to offer in order to obtain a loan. Asked if he knew of other moneylenders he could have approached, Joseph indicated that he knew a number, but chose the businessman because he decided he wanted to go into the *boda-boda* business. The other respondent who had borrowed from a moneylender was Ben, a 30 year-old man who in 1997 borrowed money to start a shoe repair business. The moneylender in question was his brother-in-law, whom he found "easy to approach".

Sources of loans in Nagpur

The pattern of loan financing for entrepreneurs in Nagpur (Table 6) is quite different in that, although loans from friends and family are the single most common category, the total amount of finance they represent is exceeded (albeit marginally) by bank credit. Loans from moneylenders are about as common as those from banks, but because they tend to be smaller than bank loans, they represent only 12% of the total amount borrowed.

Table 6 – Sources of loans, Nagpur 1971-2001 (in constant 2001 Rupees)

	Number	Total volume	Min	Max	Max ÷ Min	Mean	Median
Friends/relatives	28 (47%)	539,848 (34%)	186	278,846	1,501	19,280	4,569
Money-lenders	11 (18%)	190,655 (12%)	621	62,861	101	17,332	12,414
Suppliers	6 (10%)	106,924 (7%)	210	55,769	266	17,821	2,442
Benevolent societies	5 (8%)	173,361 (11%)	6,207	99,771	16	34,672	8,347
Banks	10 (17%)	593,035 (37%)	7,250	164,523	23	59,304	39,908

As with the Nagpur sample, a distinguishing feature of the category of loans from friends and relatives is their high variability relative to the loans in other categories. However, relative to the Kampala samples, all of the categories allow a fair degree of variability in loan size.

Given the large number of years over which the figures in the table above are aggregated, one might wonder whether there have been any changes over time in the distribution of loan sources used. Decomposing into two groups, namely pre-1990 and post-1990 loans (inclusive), there are three important trends: first, loans from moneylenders become much more predominant, increasing from 6% to 24% by number, or 6% to 17% by volume, from the first to the second period; second, loans from banks also increase, from 11% to 19% by number, and 25% to 48% by volume; and third, loans from friends and relatives undertake a precipitous decline, from 78% to 33% by number, and 62% to 8% by volume. Interestingly, what one observes is not a trend away from informal finance towards formal

finance, but rather a trend away from one kind of informal finance (loans from friends and families), and towards another type of informal finance (money-lending) as well as formal finance from banks.

An interesting pattern emerges among those borrowing from banks. One individual indicated that in order to get his bank loan, he had to bribe one or more bank officials, maintain a fixed deposit worth 60% of the loan amount, and still endure an excessive amount of paper work. Another bank borrower indicated that "if you know someone it's of great help" and "without contacts it's difficult to get [bank] finance". A third indicated that the terms of the bank loan she obtained were favourable on account of "the old relationship" she had with a bank official. And a fourth also complained of the burden of formalities. In other words, borrowing from a bank is not necessarily the impersonal affair one might suppose, but where it is impersonal, it imposes significant costs.

Gender and borrowing in Kampala and Nagpur

In a previous sub-section, it was established that women entrepreneurs in Kampala and Nagpur are just as likely as their male counterparts to finance the start-up of their enterprises with loans. Here we note that, notwithstanding this similarity, women and men who borrow money for investment purposes do so according to distinct patterns. Figures 12 and 13 reveal the frequency with which women borrow from different sources for the Kampala and Nagpur samples, respectively. (For Nagpur, the results below are restricted to 1990 and later, to take account of the significant change over time in loan types as described above.)

For the Kampala sample, there are two important differences between women and men. First, women rely on only two of the four credit sources that men rely on, namely from friends/relatives and from MFIs. This is not to say that women entrepreneurs in Kampala *never* borrow from moneylenders or banks – presumably a larger sample would have picked up some examples of each – but that doing so is relatively rare. Whether women are not able, or rather do not wish, to access credit from these sources, is difficult to judge, but very likely there is an element of both. One factor inhibiting women from borrowing from commercial banks is that they are less likely to hold land title in their own name that can be pledged as collateral. (It cannot be explained by lower literacy levels or less education among women since they are equally literate and educated as men.)

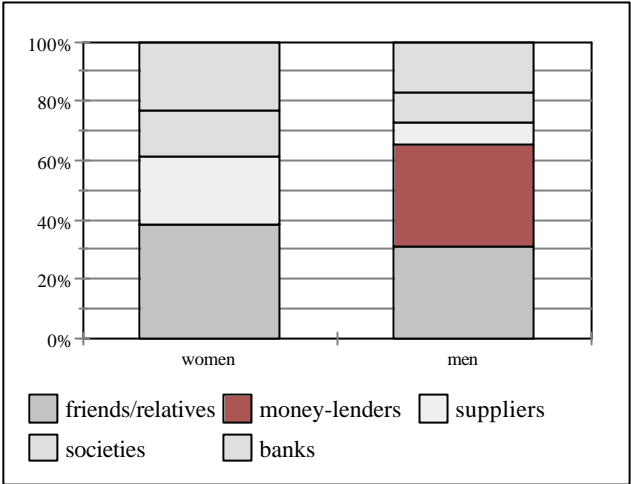
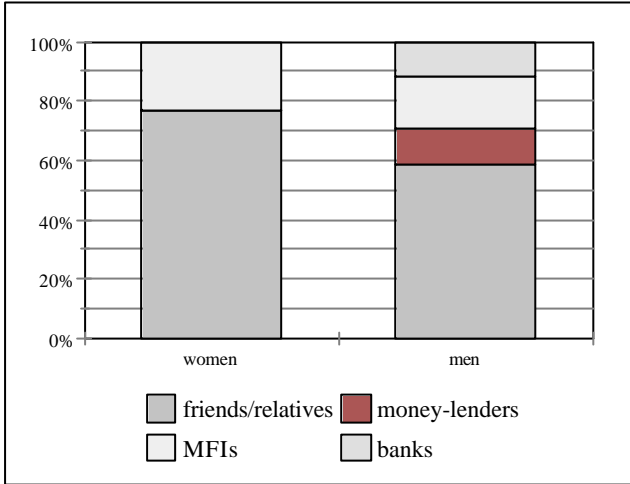
The other main difference in the pattern of borrowing between women and men in Kampala is that, for each of the two loan sources they have in common, the average loans to women are less than those to men. That loans from friends/relatives are on average less for women than for men may seem curious. In fact it parallels the gender asymmetry observed above with respect to gifts. As with gifts, a number of these loans are from husbands, which pull down the average considerably.

The fact that loans from MFIs to men are greater than those to women might also be surprising – and something MFIs themselves might be inclined to contest. The result might be explained by the fact that among Ugandan MFIs, as elsewhere, there are two main lending modalities. On the one hand are group-based loans, which tend to be dominated by women and which typically involve loans of a small size. On the other hand are larger individual loans, which tend to be more equitably allocated between men and women. Having said this, the result that loans from MFIs to women are on average lower than those to men is not, in any event, robust, given the small number of observations in each group.

One other curious observation is that the average size of loans received by women from MFIs is lower than those they receive from friends and family. While the conclusion must again be qualified by the small number of observations of women receiving loans from MFIs, the size of the gap is nonetheless striking, and would tend to emphasize the significance of informal loans from friends and family.

Figure 12 – Loan sources, by number and gender, 1988-2001, Kampala

Figure 13 – Loan sources, by number and gender, 1990-2001, Nagpur



For the Nagpur sample, the salient difference between women's and men's borrowing patterns is that women do not borrow from moneylenders, but rather are particularly reliant on loans from friends and relatives, and from suppliers.

Methods of saving in Kampala

Turning now to savings that were used to start entrepreneurs' businesses, we asked where respondents kept these savings while they were being accumulated. One objective of asking this question was to find out to what extent formal financial institutions were used to assist in the accumulation process, and to what extent informal institutions were. This, in turn, may give us insights as to entrepreneurs' savings behaviour.

As revealed by Table 7, about two thirds of all respondents who used savings to start their businesses kept their savings at home. However, these savings account for only about one quarter of the total amount of money saved by this group, meaning that, per entrepreneur, the average amount of savings kept at home (Shs 112,314, or about \$64) was below average.

Table 7 – Where savings were kept, Kampala 1988-2001 (in constant 2001 Uganda Shillings)

Where savings were kept	Number	Total volume	Average savings at time of start-up	Average months accumulated	Average rate of saving (Shs per month)
At home	54 (67%)	6,064,948 (27%)	112,314	8	41,560
With a friend or relative	8 (10%)	1,447,821 (6%)	180,978	13	28,410
At Post Bank	6 (8%)	877,192 (4%)	146,199	4	69,470
At a bank	12 (15%)	14,209,906 (63%)	1,184,161	28	82,630

Many of those who save at home do so using a 'safe', a wooden box which functions in the same manner as what in the West is commonly known as a "piggy bank". That is, the safe is built with only one small opening, so that to remove one's money the safe must be destroyed. For example, Ruth, a 20 year-old woman who sells consumables, has bought three of these safes in the past 5 years. A safe presently costs about 1500 shillings (less than \$1). Asked why she did not rather keep her money at Post Bank, Ruth declared, "Yes, using these boxes is better than having an account with Post Bank because I don't have to line up to deposit into it and I don't have rules to be followed."²⁰

Saving with a friend or relative has the purpose of assisting the saver with motivation and self-control. The fact that the average savings in this category are 61% greater than those of people saving at home suggests that this strategy is potent. In the words of Eliot, a 27 year-old man who fabricates charcoal stoves, "*The friend with whom I kept my money did not allow me to pick it up until the time was ripe to set up the business*". The fact that the average period of time during which these savings are accumulated is greater than for either those who saved at home or at Post Bank also supports the interpretation that savers can benefit from the moral support of others. However, relatively few people avail themselves of this strategy, implying that most people do not find it attractive, or do not have people whom they would consider suitable to safeguard their savings. It should be pointed out, however, that friends and relatives assist with savings in other ways as well, for example simply by encouragement, as with Robina, who credits her husband with having motivated her to make regular deposits at the bank.

The average amount of savings kept at Post Bank is of the same order of magnitude as that kept at home or with friends or relatives, which is far less than that kept at regular commercial banks. This suggests that the usage of Post Bank and commercial banks is fundamentally different. As in many other countries, the Post Bank is a bank for poor persons, established by government to compensate for lack of *de facto* access of the poor to banks. The fact that so few respondents from our survey do in fact use the Post Bank suggests, however, that it is not to many people's liking. While Post Bank is appreciated for the fact that it is accommodating to low-income people and has a well-distributed network of branches, it is often described as "inefficient" and "slow".

Finally, although only 15% of those who used savings to start their businesses kept these savings in a commercial bank, the average magnitude of these accounts is such that

²⁰ For a description of the use of similar safes on the Gambia, see Shipton (1992).

these savings comprise almost two-thirds of the total volume of savings of this group. That these savings are so much greater is not surprising. It conforms to our precept that those using banks are relatively well off to begin with. What is interesting about the result here, however, is that what also distinguishes those who kept their savings in a bank is that on average they saved towards the establishment of their enterprise for a significantly longer period than those saving by other means. The 'rate of saving' (last column of Table 7) – i.e. the number of Shillings put into savings per month – is higher for those saving in banks, but not hugely higher. This suggests that those saving in banks may not be so much better off than one might have supposed from the investment levels alone.

In an earlier sub-section, it was remarked that the level of investment for starting new enterprises did not appear to be high relative to per capita GDP. In part this can be explained by the fact that for many of those using savings to start their enterprises, the period of accumulation is not very long. Nonetheless, in response to a question about what obstacles were encountered in trying to save, the majority of respondents told of considerable self-sacrifice. Many respondents reported such privations as holding off on having relationships or starting a family, discontinuing use of electricity, reducing support to siblings and parents, and depriving themselves of even basic needs such as clothes and food. One reason the duration of saving may often be quite brief (in comparison to the Nagpur survey, as will be discussed below) is that the process of saving is so exacting. This underscores the importance not only of finding ways of making saving easier and more remunerative, but also of promoting alternative ways of enabling investment, not least loans.

Methods of saving in Nagpur

The overall pattern of saving in Nagpur is not altogether different from that of Kampala, with the majority (58%) of respondents keeping their savings at home, but with the bulk of savings volume being held in banks. In addition to sharing this 'many-small' versus 'few-large' contrast between home savings and bank savings (albeit less dramatically than for the Kampala sample), it is also the case that those saving in banks for purposes of starting an enterprise save over a longer period (on average 4 years) than those saving by other methods (except for the one respondent who collected a provident fund through his former employment), and at a somewhat faster pace. Most likely the relatively strong use of banks relates to the fact that many banks in Nagpur, as elsewhere in India, offer clients a service whereby they can make daily deposits by means of deposit collectors. A client who might otherwise find making deposits too inconvenient is thus enabled to make deposits on a frequent basis, and is welcome to deposit even tiny amounts of money.

Table 8 – Where savings were kept, Nagpur 1971-2001 (in constant 2001 Rupees)

Where savings were kept	Number	Total volume	Average savings at time of start-up	Average months accumulated	Average rate of saving (Rs. per month)
At home	22 (58%)	177,758 (38%)	8,080	26	446
Through a savings club	2 (5%)	8,707 (1%)	4,354	13	320
At a bank	13 (34%)	257,371 (55%)	19,798	48	662
Other	1 (3%)	24,829 (6%)	24,829	48	517

One general contrast with the Kampala case is that for each corresponding category of saving, those in the India sample save on average for a significantly longer period of time, which may partially account for the fact that the level of investment in the Nagpur sample is generally high relative to per capita GDP. The contrast is most likely due to a broader age-distribution of respondents, and perhaps more robust family support systems. Respondents did not report having to make sacrifices in order to save, though two women encountered difficulty with relatives who frequently seized their money. As in the Kampala case, a number of those who save at home keep their money in a 'safe', though in this case the safe consists of a specially made ceramic pot (widely available from street vendors) rather than a wooden box.

Interestingly, no respondents reported keeping savings with a friend or relative, although some indicated that they benefited from the moral support of friends or relatives. The lack of reliance on friends most likely relates to a spirit of independence that prevails in the Nagpur sample in general. As two examples, when asked what they would do or to whom they would turn in a business crisis, most respondents said that they would deal with the problem themselves; when asked if they had ever provided financial assistance to someone else to start an enterprise, only 12% said yes, versus twice as many for the Kampala sample.

Of the two respondents who saved by means of savings clubs, one was a member of a "chit fund" and the other a member of a *bishi*. Reasons why so few people finance the creation of their businesses by means of saving through such clubs will be ventured in a later section.

Summary of survey findings in respect of start-up financing

The findings from this sub-section are summarised in Table 9:

Table 9 – Summary of findings with respect to start-up financing

	Kampala	Nagpur
Financing methods	<ul style="list-style-type: none"> • Own savings are most important single source of start-up financing, followed by loans and gifts • Magnitude of loans is relatively large 	<ul style="list-style-type: none"> • Loans are most important single source of start-up financing, followed by savings and gifts • Use of loans becoming marginally less predominant over time? • Magnitude of loans is relatively large
Overall share of informal finance	<ul style="list-style-type: none"> • Taking together all forms of informal finance (gifts, loans from friends, etc.), informal finance was used by 85% of respondents, and accounted for 57% of the start-up financing • Excluding 'saving at home', the figures are 46% and 44%, respectively 	<ul style="list-style-type: none"> • Taking together all forms of informal finance (gifts, loans from friends, etc.), informal finance was used by 74% of respondents, and accounted for 57% of the start-up financing • Excluding 'saving at home', the figures are 54% and 51%, respectively.
Main loan sources	<ul style="list-style-type: none"> • Loans from friends/relatives most important by number and volume • Loans from friends/relatives have greatest variance • Second most important loan source is MFIs 	<ul style="list-style-type: none"> • Loans from friends/relatives account for almost half by number, but only third by volume • Loans from friends/relatives have greatest variance • Loans from banks account for 37% by volume, but only 17% by number

Moneylenders	<ul style="list-style-type: none"> • Minor use of moneylenders, despite apparent rise in number of moneylenders and ease of access • Apparent ambiguity between loans from friends/relatives and those from moneylenders 	<ul style="list-style-type: none"> • Trend over time away from loans from friends/relatives in favour of loans from moneylenders and banks
Bank loans	<ul style="list-style-type: none"> • Bank loans rare; appear to depend on exceptional circumstances, e.g. borrower characteristics 	<ul style="list-style-type: none"> • Bank loans highly contingent upon exploiting personal connections
Savings methods	<ul style="list-style-type: none"> • Most savers (67%) saved at home, but most savings (63%) kept in bank • Saving usually for less than one year, except those saving in banks • Saving with friends/relatives uncommon but efficacious • Saving characterised by self-sacrifice 	<ul style="list-style-type: none"> • Most savers (58%) saved at home, but most savings (55%) kept in bank • Most savings for two years or more • No savings with friends/relatives • Frequent use of daily savings collectors
Gender differences	<ul style="list-style-type: none"> • Average magnitude of women's start-up financing is generally less than men's for each corresponding source, even gifts • Women more likely than men to rely on gifts • Women borrowers overwhelmingly likely to borrow from friends/relatives, unlikely to borrow from moneylenders or banks 	<ul style="list-style-type: none"> • Average magnitude of women's start-up financing is generally less than men's for each corresponding source, especially loans • Women borrowers more likely than men to borrow from friends/relatives and suppliers, less likely to borrow from moneylenders • Women borrowers nearly as likely to borrow from banks

3.4 Experiences with formal and informal financial services

About 40% of the Kampala respondents have savings accounts in a commercial bank, and 54% maintain some sort of savings account either with a bank, Post Bank, or an MFI. Most people with savings accounts make deposits on an irregular basis depending on how well their business is going, but many also maintain a regular regiment of weekly or bi-weekly deposits. The general sentiment of savers with respect to the service provided by banks is that they are satisfied or very satisfied. Respondents' specific remarks reflect a diversity of concerns. The most common comment of approval is that bank accounts can be established with a very low initial balance, e.g. Shs 10,000 (about \$6). Requiring a low starting balance used to be what distinguished the Post Bank from the commercial banks, but in recent years, commercial banks have been competing for this clientele by reducing their initial deposit requirements. Some respondents describe these as "affordable banks". Another comment sometimes made is that bank services are convenient, especially since a number of banks have opened automatic teller machines in various parts of Kampala. The significant fact about the teller machines is that they enable one to perform transactions at all hours of the day, instead of being limited to conventional bank hours. Finally, a handful of respondents made reference to the helpfulness and respectfulness of the bank employees. One respondent applauded the interest rates earned on her deposit, and one complained that bank fees were too high.

The situation with Post Bank is somewhat different. Those that approved of Post Bank were pleased that the starting balance was low and that branches were widely available. However, as many respondents complained about long queues and unhelpful staff. Almost four fifths of respondents with Post Bank accounts also have bank accounts. Although this was not verified, this probably indicates that people who initially opened accounts with Post

Bank subsequently decided to shift their business to commercial banks, as these became more accessible.

Among the Nagpur respondents, 46% have savings accounts in a bank, and altogether 56% have some sort of savings account either with a bank, Post Bank, or a cooperative society. Not quite half of those with bank accounts make daily deposits by means of a deposit collector. Those that have these accounts are generally satisfied with the service they receive, especially those with bank-based savings accounts. One theme rings out from the respondents' remarks, namely that, quite apart from an acceptable level of efficiency, clients feel they are well-treated by bank staff and/or deposit collectors: "behaviour is good", "they are helpful", "they do respect", "they help with forms", and one enthusiastic client averred "the treatment is like a family". What this reveals on the one hand is that, in terms of bank service, clients prioritise being treated personably and with respect, and on the other hand that a significant number of banks in Nagpur are succeeding in doing just this.

The situation with borrowing is quite different. Those borrowing from banks, whether from the Kampala or Nagpur samples, assert that obtaining bank credit is an exacting process, except to the extent it might be mitigated by the intervention of a bank official whom one knows personally.

By contrast, acquiring credit from a friend or moneylender tends to be simple and easy. However, the overall borrowing experience is not necessarily so pleasant. More than half of those who borrowed from friends and relatives, or from moneylenders, stated that they found it difficult to repay the loan because of poor business. This is equally true of the 7% of Ugandan respondents, or 25% of Nagpur respondents, who were busy repaying a new loan at the time of the interview. Borrowers from the Uganda sample were more likely to describe the advantages of such loans to their businesses ("*it boosts development of the business*"), and some even indicate that they appreciate the discipline forced upon them by having to repay ("*it boosts the morale for working*"; "*it is tough and hence has taught me how to save for the future*").

Despite the evident difficulty in honouring repayment obligations, only a small handful of borrowers, whether those borrowing from moneylenders or from friends/relatives, managed to reschedule repayments. One borrower from the India sample indicated that he was being harassed by the moneylender. Some of those borrowing from friends/relatives indicated that borrowing from someone who is close to can have its own perils, e.g. a man who borrowed from a friend indicated "*it is risky, that is, enmity could arise*", while a man who borrowed from his wife said "*it is not advisable to borrow money from an intimate person*".

4. Changing informal finance in a changing environment

The discussion above about sources of start-up finance in Kampala and Nagpur elicited glimpses of how informal and formal finance may be changing over time, for example indications in both countries of an increasing number and/or use of moneylenders; increasing use of banks; and a decline (in Nagpur) in acceptance of loans from friends and family members. Are these various changes mere random occurrences that are likely to be reversed in the next few years, or are they indicative of longer-term trends? If the latter, do these different shifts operate according to a common logic or influence? What, if anything, can be inferred about likely future changes?

On the face of it, any number of social and economic processes could be influencing changes in the use and nature of informal financial institutions. For instance, as Geertz's work on ROSCAs would have it, societies are apt to experience social change over time whereby rational economic behaviour is increasingly segregated from 'traditionalistic' behaviour. A case has also been made that, with urbanisation and modernisation, relationships based on trust are increasingly difficult to establish or maintain. Another change, complementary to the previous one, may be the increasing immersion over time in the cash economy. A third obvious factor is the growing presence of MFIs, as well as initiatives of commercial banking institutions aimed at SMEs and low-income households. Which of these factors, if any, play a role in influencing the manner in which informal finance is changing? While definitive answers to these questions may not be forthcoming, some clues may be gleaned by taking a closer look at two important and intriguing informal financial institutions, namely savings clubs and money-lending.

4.1 Savings clubs in a changing environment

Based on his study of savings clubs in Indonesia, Geertz (1962) asserted that over time a society's ROSCAs will tend to disappear. He attributed this to the fact that once people have become acculturated to the modern economy and the formal institutional structures that correspond to it, these clubs will have completed their 'purpose'. Indeed, there are numerous examples of societies in which once thriving savings clubs declined over time and then disappeared,²¹ although some observers emphatically disagree that ROSCAs will "necessarily fade away" (Ardener, 1995). Seibel (2000) proposes an altogether different scenario as to how savings clubs in a given context change over time. According to Seibel's scheme, rotating labour parties in West Africa evolved into ROSCAs, which in turn evolved into ASCAs (accumulating savings and credit associations), and thereafter into any number of *permanent* financial institutions. The two theories are not entirely mutually exclusive in that the emergence of permanent spin-offs of indigenous savings clubs may indeed entail the disappearance of the indigenous clubs in their original form.

Even so, in order to see if either of these perspectives sheds light on the patterns of change in the informal finance landscape of Kampala and Nagpur, it is useful first to clarify the structure and function of these clubs, and secondly to understand what is the relationship between club membership and use of alternative financial institutions such as banks.

None of the respondents from the Kampala sample indicated that they depended on a savings club to assist with saving in order to start their present enterprise, and from the Nagpur sample, only two respondents declared having done so. However, current participation in savings clubs is somewhat higher than this. Overall, 7 (4.5%) of the Kampala respondents and 16 (11.0%) of the Nagpur respondents indicated that they presently participate in a savings club. Because members of savings clubs are predominantly women, it transpires that 8.7% of the women respondents in Kampala, and 19.2% of those in Nagpur, are active savings club members. Savings clubs are an important feature of economic life among women, but much less so among men.

²¹ Sterling (1995) records the disappearance of ROSCAs among second and third generation descendants of Jamaican emigrés in Great Britain. Similarly, ROSCAs were formerly practiced among ethnic Indians in South Africa, but no longer (Aliber, 2000).

All of the savings clubs represented in the Kampala sample are rotating, i.e. ROSCAs, and most involve weekly contributions, whereas in the Nagpur sample, about half are non-rotating, and mostly involve monthly contributions. The Kampala savings clubs tend to have around 4 members, usually the respondent together with her employees, family members, or those operating adjacent market stalls. Determination of the order of receiving the 'pot' is by mutual agreement, and does not vary from cycle to cycle. Four of the 7 respondents belonging to clubs indicated that it is possible to borrow from the club, and in fact had done so at least once, sometimes for business reasons and other times to meet domestic needs. By contrast, the Nagpur savings clubs average 30 members (the smallest has 10 members), and among the rotating clubs, determination of sequence is almost always by lottery. About half of the savings clubs to which Nagpur respondents belong allow borrowing, but only one respondent had actually availed herself of this opportunity. As a gross generalisation, the small size and higher contribution frequency of the Kampala savings clubs means that the savings are used for routine needs (stock for enterprise, food, etc.), whereas the Nagpur savings clubs are more geared to enable the member to purchase durables or larger assets.

When asked how compliance is maintained in the savings clubs, there were generally three answers: first, some respondents indicated that the club's treasurer maintains order; a second response was that there are rules which have to be followed; and a third answer was that compliance is ensured because the club is based on trust. Arguably, inter-personal trust forms the basis of the other two explanations as well, in the sense that in the absence of trust, neither the treasurer's guidance nor the group's rules would be efficacious in maintaining order and cohesion.

One of the perplexing aspects of savings clubs is that it is not altogether clear what economic function they serve. It is patently obvious that they are involved with savings, but does this imply that people join them because they are not able to open a savings account in a bank, or do not like formal financial institutions? While this may be true for some members²², overall it is contradicted by the facts: 71% of savings club members from the Kampala sample have a savings account in a bank, Post Bank, or an MFI, versus 49% in the sample at large. For the Nagpur sample, 80% of savings club members maintain a savings account, versus 56% of the sample at large. In other words, membership in a savings club is associated with a *higher probability* of having a savings account in a formal sector institution. The implication is either that savings clubs and savings accounts are complementary (i.e. savings clubs help motivate people to save, and banks provide a safe place to put one's savings); or that savings clubs tend to attract the same sort of person as is apt to open a savings account.

Asked what would happen to the respondent's savings behaviour in the absence of the membership to the club, a typical response was that if not for the club they would interfere with their business profits and would struggle to accumulate. This supports the interpretation that the primary function of savings clubs is to bolster the savings discipline among their members (Mutesasria, 2001; Aliber 2001; Gugerty, 2000). This logic is not dissimilar to the reason for which people use wooden or ceramic 'safes' in their homes, or keep their money with friends, or even maintain their savings in an illiquid form. In terms of these kindred strategies, it is noteworthy that about 4% of Kampala entrepreneurs continue to keep their savings with friends or relatives, and about 5% acquire land, livestock or durables as

²² Solomon, from the Kampala sample, stated, "Money circles are becoming very popular since it's a cheap way of saving money given that banks have tough rules to follow".

conscious savings strategies. In the India sample, 6% place at least some of their savings in fixed deposits, which carry penalties for early withdrawal.

If participation in savings clubs were an antiquated holdover from an earlier era, then it would be reasonable to suppose that members of savings clubs would be older and less educated than non-members. In fact we find just the opposite. As Tables 10 and 11 reveal, people participating in savings clubs tend to be younger and more educated than the sample averages (by gender). Savings club members are even younger than those having savings accounts with a formal sector institution (mostly commercial banks, but also Post Bank, MFIs, or societies), and among women members are more educated as well than those with accounts.²³ Whatever may have been the institutional evolution of savings clubs in West Africa, in Nagpur and Kampala, choice of savings instruments is governed by what is efficacious at the moment.

Table 10 – Comparison of ages according to use of savings vehicles, Kampala

	Women			Men		
	Avg. age (years)	Avg. yrs. school	% of sub-sample	Avg. age (years)	Avg. yrs. school	% of sub-sample
All	29.1	8.2	100.0%	28.0	8.4	100.0%
Those w/ savings account	31.6	12.1	47.2%	29.6	11.2	59.5%
Those w/out savings account	28.4	5.4	52.8%	26.4	4.8	40.5%
Members of savings clubs	25.8	13.0	8.7%	23.0	7.0	1.2%

Table 11 – Comparison of ages according to use of savings vehicles, Nagpur

	Women			Men		
	Avg. age (years)	Avg. yrs. school	% of sub-sample	Avg. age (years)	Avg. yrs. school	% of sub-sample
All	44.3	7.7	100.0%	33.2	8.7	100.0%
Those w/ savings account	43.1	9.0	71.2%	31.5	9.1	47.3%
Those w/out savings account	47.1	4.7	28.8%	34.7	8.3	52.7%
Members of savings clubs	39.9	10.6	19.2%	29.0	7.0	6.5%

Three other observations on savings clubs from the surveys merit mentioning in the present discussion. First, among respondents from the Kampala sample who belong to a savings club, most indicated that the type of person most likely to become a member was one with a stable job or at least stable income, the reason being that this facilitates making the regular contributions. This might explain why the number of respondents belonging to savings clubs is not higher; possibly those with regular wage employment are more apt to join a club. Second, among Kampala respondents who belong to a savings club, there is agreement that, while not new, savings clubs are becoming more numerous and popular in Uganda. One person with a dissenting opinion, Betty, said that, "*Money circles are becoming less popular*

²³ Another interesting feature of these tables is the relationship between the average amount of education and average age of those having a savings account versus those not having one. In both samples, those with accounts are more educated than those without, but in the Kampala sample, having an account is associated with greater age whereas in the Nagpur sample the reverse is the case. The reason is that in the Nagpur sample, greater age (in particular above 40) is associated with less education, whereas in the Kampala sample, older respondents tend to be somewhat more educated.

over time since people are not trustworthy any more compared to the olden times."²⁴ And third, of those in the Nagpur sample not belonging to savings clubs, a number indicated that savings clubs are "a waste of time", in the words of Shakila. Some women are disdainful of savings clubs.

One of the indigenous types of savings clubs in India is the "chit fund", which is a form of ROSCA typically involving lottery, and sometimes bidding, as a means of determining who collects the pot on a particular turn. Roughly half of the Nagpur respondents belonging a savings club are members of traditional chit funds. In addition to the traditional chit fund, however, there has emerged in India multitudes of larger entrepreneur-managed "chit fund companies". Ten thousand of these formalised chit funds are registered in terms of the Chit Fund Act of 1982, but many more (semi-formalised) chit funds presumably remain unregistered. Commercialised chit funds operate in the same manner as their informal counterparts, except almost always involve bidding as a means of pot allocation.²⁵ Also, subscribers to a chit fund run by a chit fund company, typically sign a legal contract, arrange for payments in the beginning by means of post-dated checks, may well never meet other members of the same group, and certainly will not personally know most of the other subscribers beforehand. Bids can be made in person at pre-announced times and venues, but can also be disclosed beforehand in writing. Chit fund companies tend to offer a number of different schemes from which to choose, for example, offering different subscription amounts, frequency of meetings, maximum of discounts, etc. One of India's largest and oldest chit fund companies is Delhi-based Chandra Lakshmi Chit Funds Ltd., established in 1976. Presently, Chandra Lakshmi offers 13 different schemes, has an annual turnover of over Rs. 50 million (about \$5 million), and is presently proposing to launch a scheme specifically catering to the corporate sector.

This process of commercialisation and formalisation of traditional savings clubs has echoes elsewhere in the world, and appears everywhere to follow a similar logic. As savings clubs become more popular, entrepreneurs attempt to capitalise on that popularity by devising semi-formal or formal institutions that are based on some of the same design principles, but which of course afford a profit to the entrepreneur. Instances of formalisation of indigenous savings clubs and burial societies have been observed in West Africa (Gabianu, 1990), Central Africa (Haggblade, 1978), and South Africa (Thomson and Posel, 2001), to name a few.

An interesting example is that of the *dhikuti*, a traditional ROSCA in Nepal, which in recent decades has attracted a fair number of 'professional' organisers (Seibel and Schrader, 1999). The most successful of these entrepreneurs was a civil servant named H. B.

²⁴ In a study in South Africa, respondents were asked to convey what traits distinguish them from others in the community who do not belong to savings clubs. The four traits that most distinguish members and non-members, in the eyes of members, are trustworthiness, honesty, sociability, and sense of community. Notwithstanding the need to be cautious about respondents contrasting themselves with others in such a flattering way, the reasons non-members give for not belonging show that, above all, they themselves do not have much trust in *other* people (Aliber, 2000).

²⁵ In a bidding ROSCA, on any given turn the pot is won by the member who agrees to the largest discount on that pot. If for example 10 members each make a regular contribution of Rs. 500, the available pot each period is Rs. 5000. If a bidder wins by offering a discount of 20%, he receives only Rs. 4000, and the other Rs. 1000 is distributed evenly among the other 9 members as "dividends". If two or more discount bids are the same, then the winner is selected by means of drawing lots. Each member can receive the pot only once in a given cycle. In the case of a registered chit fund company, the promoter ("foreman") earns a commission of 5% of the total collection. The company usually sets a maximum discount that can be bid between 20% and 40%.

Pradhananga, who in 1989 modified the usual practice by deploying deposit collectors to collect members' contributions on a daily basis. After increasing the number of groups over a few years, Pradhananga next dispensed with the group element, and eventually changed the status of collectors from salaried employees to commission earners. By 1998, the Himalaya Finance and Savings Company (HFSC) thus formed by Pradhananga counted 52,000 savers with interest-bearing accounts, and having access to other financial services such as credit and insurance.

Similarly, there is evidence from West Africa that indigenous ROSCAs, known variously as *susu* or *esusu*, inspired the emergence of *susu* collectors, who for a commission would collect and store savings of clients (Gabianu, 1990; Steel and Aryeetey, 1994). Since 1985, *susu* collectors, in turn, have given rise to *susu* companies, particularly in Ghana and Nigeria (Gentil, D., 1994, Aryeetey, 1995).

Finally, a more dated example of the commercialisation *cum* formalisation process is that of the building societies that emerged in the 18th century in England. The early building societies were spontaneous grassroots developments that operated more or less on the principle of ROSCAs. Each member family of a society was in turn assisted by all the other members to build a house, until all member families were thus assisted and the society could disband (Price, 1958). Before the end of the 18th century, however, these informal arrangements were almost entirely supplanted by permanent formal building societies that functioned as neighbourhood savings & loans aimed at providing mortgage financing to lower-income households.

These formalised adaptations of traditional savings clubs enrich the menu of financial services available to low-income households and/or their enterprises, but it can also be argued that, when traditional savings clubs are formalised, some of the valuable features of indigenous forms tend to be sacrificed, most notably the close bonds of mutual assistance and the culture of reciprocity. Moreover, there appears to be a pattern whereby savings clubs or burial societies in which all of the participants and officers were women give rise to and are then supplanted by entrepreneurial ventures (e.g. *susu* collectors, commercial burial societies, etc.) that are run by men (see e.g. Ardener, 1995, and Thomson and Posel, 2001). In India, commercial chit funds are not only organised by men, but draw the bulk of their subscribers from men as well (Sethi, 1995). The formalisation and commercialisation frequently carry a marked gender dimension.

Another interesting aspect of the commercialisation process – and something that seldom gets due attention in the academic literature – is that commercialisation brings with it the possibility of opportunism and fraud. India's commercial chit funds are a case in point:

“All states [with one exception] have banned or heavily regulated the working of chit funds due to the high rate of failure among chit fund companies. Many such companies are floated primarily to swindle the gullible public of their small savings. The failure rate of chit funds is higher than any other business of a comparable type and risk. On the other hand such para-banking institutions are the need of the day to meet the growing credit needs....” (The Tribune, 6 August 1998).

The Chit Fund Department of the Government of Delhi lists 36 chit fund companies that have been debarred from doing chit fund business, plus another 12 companies that have been

found to be doing chit business without being properly registered. Chit fund companies impinge on the public consciousness through endless high-profile scandals involving judges, cricket players, and under-world characters.

In Uganda, similar processes are evident, though on a smaller scale. For example, it has been observed that numbers of entrepreneurs have jumped onto the bandwagon of what appears to be an indigenous form of burial club that operates on the principle of an ASCA. Unfortunately, some of these entrepreneurs have proven to be morally flawed, with the effect that traditional burial societies are also held to be suspect by growing numbers of Ugandans (Rutherford, 1999).²⁶ An almost identical phenomenon is evident in South Africa, where reports abound of unscrupulous burial society managers seeking to cheat pensioners (SA Department of Social Development, 2001).

In 1999, the Bank of Ghana issued a notice to the general public warning of "the emergence of forms of unauthorised *susu* schemes and other illegal financial institutions", with names such as "*mega susu*" and "*modem susu*" (Bank of Ghana, 1999). The implication of the notice was that, notwithstanding their names, these were disguised pyramid schemes or were otherwise set up to defraud their investors.²⁷

The majority of registered commercial chit funds are no doubt scrupulously run, and most entrepreneur-run burial societies in Uganda almost certainly provide a genuinely valuable service. The point is rather that there are compelling reasons why the wide-scale entrepreneurial adaptation of traditional savings clubs is likely to be tarnished by some amount of abuse and exploitation. For one, as mentioned above, formalised versions of informal savings clubs tend to drop one of the key features of these clubs, namely deliberate attention to fostering mutual trust and responsibility. This seems to occur because, in order for a club to become an economically attractive proposition to an entrepreneur, it must have more members than would typically come together to form a self-sustaining traditional club, and the organiser's relationship to the subscribers becomes far more important than their relationship to one another. Transparency, peer monitoring, and reciprocity are no longer essential features of these adapted institutions, and perhaps they are not even desirable from the perspective of the entrepreneur. A second reason clubs are apt to be abused when formalised is that, being so numerous, proper enforcement of regulations is very difficult, especially where the state has limited resources to devote to it.

The traditional and the formalised incarnations of institutions such as chit funds appear to be able to co-exist in the same *milieux*. Whether they can do so forever is another question, and one which, notwithstanding the disappearance of traditional savings clubs in some countries, cannot as yet be answered. In some cases, it may be that the formalised versions meet clients' needs so effectively that the attractiveness of the traditional forms may altogether wither. For example, savings collectors may effectively displace savings clubs, as savers have less time to devote to the regular meetings the clubs require.

²⁶ "Since demand was high and [they] were not forming new groups quickly, shrewd and opportunistic people quickly seized the opportunity and formed additional groups. The new groups had their own variation each promising a heavenly return for a small investment.... 'It is these variants that resulted in massive losses and gave Burial such a bad reputation', said one informant. 'One could not tell the real thing from the fake'" (Rutherford, 1999, p.29).

²⁷ In response to this notice, a company called Brotherly Link Limited announced its intention to sue the Bank of Ghana for libel and defamation.

Or, as in the Indian and Ugandan examples above, it may be that the occasional abuse of the entrepreneur-run scheme has the effect of corrupting the popular perception of the whole genre, as reflected in the attitudes expressed above by Betty and Shakila, who either distrust or disdain informal clubs. Ironically, because the traditional clubs depend to a much greater degree on the principles of group cohesion and inter-personal trust, they are more vulnerable to this growing sense of wariness. Ultimately, this could also contribute to the disappearance of traditional savings clubs – i.e. a sort of Gresham's law of institutions. We might furthermore hypothesise that the incidence of distrust is likely to increase where urbanisation and social change diminish some of the social capital that is necessary for informal clubs to maintain cohesion.²⁸ Ruthven (2001), for example, in her study of financial strategies of low-income households in a West Delhi squatter settlement, notes the *'limited role of neighbourhoods in the overall networks of residents'*. In other words, over time there is a loss of critical mass of people who are interested in participating in such clubs, who can make time to participate in them, and who can find one another.

If it is true that indigenous savings clubs are apt to eventually become an endangered species, the issue for policy is what modern financial products can most closely substitute for what is being lost. The probable answer in the case of savings clubs is daily deposit collectors, whether these be informal services, as in West Africa, or are rather a service offered by commercial banks, as in India.

4.2 Moneylenders in a changing environment

Professional money-lending in Uganda is not widely practiced. Recent research on the East African region suggests that neither money-lending nor pawn-broking are common in East Africa, though in Uganda there are *'reports of a few market-based moneylenders who lent very short-term at high prices to wealthier business people'* (Rutherford, 1999, p.30). Similarly, the media report the recent emergence of 'briefcase bankers', who make the circuit of office buildings and government ministries offering short-term loans at "exorbitant" interest rates (Juuko, 2001). Perhaps the fact that money-lending has emerged so recently in Uganda owes to the fact that Ugandan society's immersion into the money economy is relatively recent.

That money-lending is limited in Uganda is also consistent with the findings from the Uganda sample, wherein only 2 out of 33 start-up enterprise loans were from moneylenders. However, there is reason to suspect that the story is not so straightforward as a simple absence of moneylenders. Curious as to why money-lending was so rare, follow-up interviews were undertaken with a number of respondents, in part to find out why they did or did not approach a moneylender. Among those who borrowed from other sources, there is consensus that it is not for lack of being able to find moneylenders. All of those interviewed indicated that they knew one or more moneylenders, or knew where to find one. There was also agreement that moneylenders are becoming increasingly common in Uganda. Nankya, a 25 year-old hair salon operator, explains that: *"Moneylenders are more common than before since Uganda as a whole is growing economically and money-lending is a profitable business in itself."* Resty, a 25 year-old food seller, said that: *"Moneylenders are more common than they used to be,*

²⁸ An interesting case in point is the decline of the *informal* building societies mentioned above. This decline corresponds to the more general decline of the myriad of self-help structures that had flourished in the early phases of Britain's industrial revolution (Hopkins, 1995).

because many people prefer personal business and several are willing to borrow as long as they can afford the requirements."

The apparent ease with which moneylenders in Kampala can be found dispels the notion that they have monopoly power. Moreover, among respondents surveyed, the sentiment that moneylenders are exploitative is largely absent. Rather, moneylenders are considered to be people who are trying to improve their own situation, as expressed by Richard, the stationery vendor introduced above: *"Moneylenders are very common because that is also another way of saving their finances other than taking it to the bank"*. Moreover, moneylenders provide a valuable service to the under-privileged, as explained, interestingly, by Matia, despite the fact that he himself had borrowed from a bank:

"...moneylenders are very common because they realise it's good to lend money to uplift people below the poverty line. [Also] moneylenders are very common because they encourage people to borrow from them other than heading to the bank with very hard conditions one cannot meet. More so moneylenders are very common because there is a chance of negotiating other than going to the bank. Lastly moneylenders are common because they simplify things for us the illiterates."

The puzzle is this. If moneylenders are so common, and so benign as well, why are so few entrepreneurs in the sample borrowing from them? The answer is not clear-cut. One reason certainly is that for many people it is simply not necessary. Their needs are adequately met by friends or relatives who are able to lend them money on easy terms or who, even better, give them money as a gift.

However, a second reason appears to be that often times the lines are somewhat blurred between the category of "friend" and that of "moneylenders". In a handful of instances, respondents initially indicated that they borrowed from a moneylender, only later to reveal that this person was a friend or even a close friend. For the purposes of Table 5 above, these were categorised as loans from "friends/relatives". However, the ambiguity may imply that many of those who declared that they borrowed money from friends might just as well have said that they had borrowed from a moneylender, in the sense of someone who occasionally lends money as a means of boosting his income. A particular instance of this ambiguity is the case of Sam, a 24 year-old bricklayer who initially said that he had borrowed from a moneylender, only then to retract it:

"He is not a moneylender but he is a friend. The fact that I knew him, I took up the initiative to ask for a loan from him and start up a business and sustain myself... I would have found another moneylender but I specifically stuck on to this friend of mine who I trusted and knew personally. Moneylenders are very common especially when one knows them personally. In this society, moneylenders are very common in that they also gain a lot from the borrowers."

That there might be such an ambiguity is further supported by the fact that the terms imposed by some lenders on their friends or relatives do not always suggest the casual, interest-free arrangements commonly supposed (Ghate, 1992, p.25). Over two thirds of loans from friends and family entail a prescribed repayment schedule, which with rare exception requires full repayment within six months. In addition, almost one third of loans from friends and family entail interest, ranging from a minimum of 10% up to 120% (annualised). It is

difficult to discern a pattern as to what determines whether a friend or relative will charge interest, though there is tenuous evidence to suggest that more recent loans from friends and family are more likely to include interest.²⁹

To conclude, respondents from the Kampala survey tend to interpret "moneylender" to mean a professional moneylender. While such moneylenders exist and are easily accessible, when it comes to borrowing money to start an enterprise, respondents prefer to borrow from friends and family even if the terms of such loans are not so very different from those on offer from the professionals. Moreover, there is a hint of a trend whereby loans from friends and family are becoming more commercially-oriented over time. Among Kampala respondents who had borrowed from friends or family, more than half indicated that it is more difficult to obtain such loans nowadays, e.g. because "*at present it is more difficult because of poverty, less trust and absence of security*", and "*it has become more difficult since the creditworthiness of people has deteriorated*".

On the face of it, the situation in India is very different, not least because money-lending there has a long – and controversial – history. Since pre-colonial times, money-lending has been associated with specific castes, such as the Chettiars from Tamil Nadu, Mahars from Maharashtra, Marwaris from Eastern India, Rastogis from Uttar Pradesh, etc. (Timberg and Aiyar, 1984). Early money-lending was typically associated with providing capital for long distance trade and for inputs for artisans.

Mukerjee (1916, cited in Ludden, 1999) argued that the process of land alienation at the hands of moneylenders became endemic in the mid-19th century, when the punitive taxes imposed by the British colonial administration compelled peasants to borrow money from moneylenders, who themselves were typically large landowners. The result was that many erstwhile peasant landowners became tenants of their own land, enlarging the land ownership of the lenders. Various protests against moneylenders/landlords ensued, e.g. the Deccan riots of 1875 in Maharashtra; the Punjab Agrarian Riots of 1907, etc. In 1896, food riots were staged in Nagpur, the chief target of the mob's wrath being a prominent local political leader who was also a landlord and a moneylender.³⁰

Money-lending in India has retained much of its negative image up to recent times, especially in rural areas. Accusations are still rife that rural money-lending is applied perniciously to dispossess people of their land, especially *Dalits* (so-called 'untouchables') and members of the scheduled tribes (Human Rights Watch, 2001; Kumar, 2000). A vivid manifestation of this pressure are the intermittent spates of suicides committed by farmers in

²⁹ Of the 11 loans from friends or family in 1999 or earlier, and for which loan conditions were disclosed, 27% charged interest, versus 43% of the 7 loans from 2000 and 2001. It must be stressed however that given the small number of observations, this is far from a statistically robust result. It is also interesting to note that, contrary to what one might expect, the likelihood of being charged interest is no greater if the loan is from a friend than if it is from a parent or spouse.

³⁰ Myrdal's extensive work on Asia (1968) presents an unsettling account of how moneylenders have changed the whole complexion of peasant societies there. Interestingly, what made moneylenders particularly disruptive was the conjunction between their ruthlessness and the erosion of traditional land tenure systems with the introduction of Western tenure systems and institutions based on alienable private property: "By charging exorbitant interest rates, or by inducing the peasant to accept larger credits than he can manage, the moneylender can hasten the process by which the peasant is dispossessed" (p.1042). Thus, for example, over the course of a century from the beginning of British colonial rule, between one third and one half of the acreage of the highly egalitarian peasant societies of Burma had passed into the hands of non-agriculturists, i.e. moneylenders.

the rural areas around Nagpur who are indebted to moneylenders and who cannot repay their loans when the harvest fails (*Indian Express*, February 13 1999). Partly because of this history of money-lending in rural areas (where the accusation that moneylenders earn monopoly profits is most likely justified, if anywhere), many MFIs in India have particularly focused on establishing operations in rural areas.

In Nagpur as in many other towns and cities, during much of the 20th century professional moneylenders have tended historically to be ethnic Pathans (i.e. Pashtuns from either Afghanistan or northwest Pakistan) or other foreign ethnics. Whether accurate or not, the popular image of such moneylenders is that they relied upon harassment or threat of physical force to ensure repayment of unsecured loans. Despite legislation such as the Bombay Moneylenders Act of 1946 (extended to the whole of modern Maharashtra state by 1960), which requires moneylenders to sign up with the Registrar of Moneylenders and also imposes interest rate ceilings, many moneylenders – especially those catering to low-income clients – operate outside of these regulations.

According to key informants, there are two main types of people identified with the epithet "moneylender" in present-day Nagpur. The one category of moneylenders are those who, like the Pathan moneylenders mentioned above, cater to relatively low-income households, for both short-term consumption loans and enterprise loans, often on an unsecured basis, i.e. the proverbial 'loan shark'. Secondly are moneylenders who are themselves well-established businessmen and who lend to other entrepreneurs that they either know personally, or who are recommended by a broker who can personally vouch for them. For this latter type of moneylender, the money-lending is a secondary activity, and business is often conducted in off-hours or weekends. The probability of default on these loans is relatively low because they are meant for business expansion rather than the financing of an altogether new business or for consumption smoothing. However, the loans are relatively large. As security, a post-dated check is required, and a contract is drawn up and registered with the assistance of a lawyer. The other important insurance against default is that the borrower and lender are members of the same business community and have many acquaintances in common. Maintenance of one's good reputation as a reliable businessperson is a strong motivation to honour a loan agreement.

Judging by the nature of the loans taken out from moneylenders by respondents of the Nagpur sample, it would seem that most of the moneylenders in question are not from either of these two types of moneylenders. On the one hand, respondents reported that they chose these particular moneylenders because they know and trust them, and in some instances the moneylender is described as a friend or relative. In a city the size of Nagpur, whose population exceeds 2 million people, it is unlikely that these respondents would happen to be personal acquaintances with a small group of professional Pathan moneylenders. On the other hand, the fact that two thirds of these loans were unsecured, and that on average they were relatively small, makes it unlikely they were from the second category of moneylenders, who in any event would rarely give loans to finance start-up enterprises.

In other words, it would appear that most of the moneylenders from whom the Nagpur respondents borrowed belong to neither category of conventional moneylender, but rather from a relatively new type of moneylender, i.e. "...*part-time lenders who supplement their income through money-lending, such as local farmers, salaried employees, shopkeepers and businessmen*" (Ghate, 1992, p.26). As mentioned in a previous section, a notable aspect of loans from moneylenders in the Nagpur sample is that their sudden increase in importance

since 1990 mirrors the decline in importance of loans from friends and family. Given that the average loan size of loans from friends and relatives and of moneylender loans are roughly the same, we might hypothesise that this apparently new form of money-lending emerging in Nagpur consists of a sort of formalisation of lending from friends and family. This type of money-lending is still largely informal in the sense of not depending on formal sector institutions, but it assumes a degree of formality relative to loans from relatives and friends, even when the moneylender in question *is* a relative or friend. What this also means is that loans from friends and relatives which are not treated as moneylender loans are becoming more difficult to obtain. A number of Nagpur respondents who had started their businesses with loans from friends or relatives, indicated that such loans were either becoming more difficult to come by (one respondent had been turned down by three friends before finding one willing to lend to him), or were coming with higher interest rates, or were more dependent than before on the prospective borrower's ability to offer security. This recalls the discussion above about money-lending in Kampala, where it was observed that there is a degree of ambiguity between money-lending and lending to friends and family.

The fundamental question is: what is the underlying reason for this gradual formalisation of lending from friends and family into lending from moneylenders who happen to be friends and family? There appears to be something about loans from friends and family that is no longer suited to the social environment.

4.3 The formalisation of the informal

Economists are correct to point out that informal finance continues to play a very large part in the overall provision of financial services, and it may also be true to say that *"There will always exist at one end of the financial spectrum a key sector of lenders and institutions that is relatively informal"* (Ghate, 1992, p.13). The point emphasised here however is that, regardless of continuity or change in the overall scale of informal finance, the character of informal finance is undergoing continuous change, the ultimate effects of which are difficult to anticipate.

The history of the age-old institution of money-lending provides a useful window into one of the prime reasons for this change. Historically, the conduct of money-lending was closely tied up with ethnicity and/or caste. In most contexts, money-lending was primarily an inter-group rather than intra-group phenomenon. Most religious traditions in fact forbade as "usury" any form of intra-group lending with interest, even while tolerating the same between individuals of different groups. *"The original basis for the thoroughgoing rejection of usury was generally the primitive custom of economic assistance to one's fellows, in accordance with which the taking of usury 'among brothers' was undoubtedly regarded as a serious breach against the obligation to provide assistance..."* (Weber, 1978, p.584). To use language more familiar from contemporary social science, intra-group lending of money is discouraged because it is apt to strain the "moral economy", in which *"social norms...are directed towards reciprocity rather than individual profit maximisation"* (Ellis, 1993, p.52). Of course, if no interest is charged, then the transaction is merely an instance of reciprocity.

The ethnic basis of money-lending has visibly diminished over time. Moneylenders in Mumbai are now as likely to be ordinary local civil servants as Pathans (*Daily Excelsior*, 27 May 2001). Similarly, the interpretation of usury has shifted in most cultures, from being any charge of interest to only instances of *excessive* interest (Spiegel, 1987). More recently, the scrapping of usury laws in the name of financial liberalisation signals a further step in the

process of attenuating the application of the moral economy to inter-personal dealings in debt.³¹

The purpose of setting out this potted history of money-lending is to help us make sense of some of the changes observable in the Nagpur data, in particular the increase in use of loans from moneylenders, and the decline in taking of loans from friends and relatives. One way to think about this change is to assume the perspective of the lender. What is being revealed in this change is that where before a person would be disinclined to make a loan to an acquaintance or friend, or even relative, from the same community on anything but a casual basis, now this person can do so as a 'moneylender'. This still of course belongs to the category of informal finance, but it is a qualitatively distinct type of informal finance, the ramifications of which are as yet unclear. One very likely ramification is that the poorest community members will find one of their few sources of credit drying up, i.e. casual loans from friends and acquaintances.

The commercialisation and formalisation of savings clubs have quite different dynamics but also important parallels. In the *tanda*, an indigenous ROSCA practised among urban Mexicans and Chicanos living in the US, Vélez-Ibañez (1982) finds that the key distinction between non-commercialised and commercialised *tandas* is simply that, in the latter, the organiser earns a profit. As organisers become entrepreneurs and "subscribers" replace "members", the role of mutual trust and reciprocity becomes redundant. The local names for the two types of *tandas* is instructive: the non-commercialised *tandas* are known as *tandas vivas* (living *tandas*), whereas the commercialised ones are known as *tandas muertas* (dead *tandas*).

5. What can informal financial institutions offer formal financial institutions?

It is widely acknowledged that, notwithstanding their limitations, informal financial institutions have much to offer the MFI and banking sectors in their search to improve their ability to service low-income households and SMEs. This is so in two ways. First, elements of informal financial institutions can be strategically borrowed and adapted to suit the needs of the MFI or bank. And second, MFIs and banks can seek to form strategic links with informal financial institutions. We explore each of these two strategies in turn.

5.1 How formal sector financial institutions adapt features of the informal finance

Numerous cases exist of MFIs and banks that have borrowed and adapted strategic features of informal financial institutions, whether or not this borrowing was undertaken knowingly. These adaptations tend to centre around four main elements: i) accommodating small and frequent money transactions; ii) promoting regularity of such transactions; iii) making use of inter-personal relationships; and iv) reducing transactions costs, especially those borne by the client. Examples include the following:

³¹ In the imposing language of Weber, "We may note that every economic rationalization of a barter economy has a weakening effect on the traditions which support the authority of the sacred law.... The growing impersonality of the economy on the basis of the association in the market place follows its own rules, disobedience to which entails economic failure and, in the long run, economic ruin..." (Weber, 1978, pp.584-585).

- *Daily deposit collection* – A number of banks in India, West Africa, and elsewhere have introduced daily deposit collectors, which operate in a fashion similar to West African *susu* collectors. The making of daily deposits is the extreme example of the principle of aggregating small amounts of money over time into a more useful lump sum. The making of daily deposits is especially important for informal operators, who often earn money on a daily basis. The fact that the deposits are collected also has the advantage of diminishing overall transactions costs, and especially those borne by savers. Most daily deposit collectors collecting on behalf of banks were initially wage employees, but as with the HFSC mentioned above, the trend is to rather remunerate the collector through commission on the volume of his collection, which is closer to the spirit of traditional *susu* collection systems.³² About one fifth of respondents in the Nagpur sample give over a fixed amount daily to a deposit collector.
- *Group solidarity* – Most of the MFIs operating in Kampala offer the majority of their clients credit through the agency of groups. The principle of the group-credit methodology, made famous by Grameen Bank in Bangladesh, is that the members' joint and several liability for their loans inspires "peer monitoring", effectively eliminating the need for conventional collateral.³³ In a more general sense, however, group-credit schemes can be thought of as harnessing the same sort of group solidarity and inter-dependence that lie at the heart of indigenous savings clubs. The link between group credit and such savings clubs is explicit for some MFIs, such as Faulu, Pride Africa, and the Uganda Women's Finance Trust in Uganda, and BASIX, a rural-oriented Indian MFI with a branch near Nagpur. These MFIs require members of newly formed groups to engage in regular saving for several weeks or months before they are eligible for loans. The purpose of this is in part to give time to the group to build up some collateral for the loan, but it also serves to inculcate the group cooperation and inter-dependence that are critical for future success. Group solidarity and inter-dependence are also arguably the fundamental premise of FINCA's Village Banking approach, as well as the Financial Service Association movement pioneered by IFAD. Some MFIs are little more than 'artificial ROSCAs', such as the Association Tontines de Nouna in Burkina Faso, and an initiative run by an NGO called WISDOM in The Gambia (Nagarajan and Meyer, 1996).
- *Fostering personal relationships and structuring incentives* – Personal relationships are central not only to indigenous savings clubs, but also to the business of traditional money-lending, where the moneylender prefers to lend to people he knows personally or vicariously through a broker. Some MFIs attempt to emulate moneylenders in this respect through their field officers. For example, BASIX uses as its primary point of contact with clients its Customer Service Agents, who work full-time with BASIX, but who rather than being employees are independent contractors remunerated on the basis of repayment percentage of 'their' clients. Some MFIs also depend upon existing clients to recruit new clients, the incentive being that the minimum group size must be restored when some members drop out in order for the remaining members to be eligible for future loans.

³² The efficiency gains of paying commission rather than a fixed wage can be staggering, as exemplified by the case of the HFSC, whose number of collectors dropped from 600 to 98 when the basis for remuneration was changed, notwithstanding an increase in business over that time (Seibel and Schrader, 1999).

³³ The story of the Uganda Women's Finance Trust is instructive in this regard, in that it initially started with individual loans, only later largely to replace these with group loans on account of applicants' tendency to lie about their assets. By contrast, FINCA-Uganda found that some people are averse to forming groups, especially the "elite".

Though certainly more benign, this strategy is not unlike that used by cash-loan agencies in South Africa, which offer cash rewards or discounts on outstanding loans to clients for each new borrower they recruit.

- *Continuity and stepping-up* – Moneylenders would prefer to make repeat loans to a small number of clients rather than once-off loans to a large number of clients. This continuity of contact with the same clients serves to reduce information asymmetries between the moneylender and his clients, thus improving the moneylender's estimate of the client's credit-worthiness. Alternatively, a moneylender may personally encounter the borrower through other interactions, e.g. as an input or goods supplier, landlord, etc. (The other side of the coin is the accusation that this continuity of interaction between the moneylender and the borrower is a sign of its exploitative character, by which the borrower is trapped in a cycle of debt.) Similarly, an almost universal feature of micro-credit programmes is that they employ a step-up system, whereby a client's successful repayment of a small loan signals eligibility for a subsequent larger loan. The principle here is that the client becomes better known over time in terms of her deeds. Some MFIs, such as the Uganda Women's Finance Trust, offer more than half a dozen steps, where the largest loan associated with the highest step is as much as six times larger than the smallest loan available at the first step. Moreover, having participated in a borrowing group through several successful rounds, a client may be deemed eligible by the MFI to "graduate" to an individual loan.

This list does not exhaust the features endemic to informal financial arrangements that have been found useful to MFIs and banks. What it seeks to illustrate is that a number of these features are amenable to being borrowed and adapted, and that these adaptations can take many forms. The other lesson is that the deeper our understanding of informal financial institutions, the greater the possibilities for introducing still more innovations in MFIs and banks.

5.2 Linking formal to informal financial institutions

There have been many calls among micro-finance practitioners and others for formal sector financial institutions to forge strategic links with informal financial institutions (e.g., Heidhues and Schrieder, 1999; Goodland *et al.*, 1999; Aryeetey, 1998; Seibel and Parhusip, 1992).³⁴ At a relatively abstract level, the call for linking is motivated by the hope that it can go some way to correct for fragmentation in financial markets, which leads to allocative inefficiencies (Aryeetey *et al.*, 1997). A compatible but more hands-on rationale for developing linkage strategies is that '*linkage banking*', as it is sometimes called, will enable formal financial institutions to reduce transactions costs and partially address information asymmetries that otherwise frustrate their efforts to engage with the poor.

The purpose of the discussion that follows is to convey an idea of the scope of possible linkage strategies that have been mentioned in the literature, identify a handful of linkage experiments that have been attempted in different parts of the world, and, where possible, assess the success or potential of such strategies.

³⁴ This is not to be confused with a separate discussion about the manner in which MFIs and commercial finance institutions (e.g. banks and insurance companies) can form links between themselves. See e.g. Hussain *et al.*, 1998.

The strategies that have been identified in the literature for forging links between formal sector and informal financial institutions include:

- *Savings accounts for savings clubs* – Many banks have introduced savings products specifically designed to accommodate indigenous savings clubs. The rationale is clear: insofar as large amounts of money are mediated through ROSCAs and ASCAs, in principle these clubs represent a huge opportunity for banks to take in additional deposits, without incurring the same transactions costs as would apply to individuals. A number of commercial banks in South Africa introduced such accounts in the late 1980s or mid-1990s, but most of these have been discontinued. Verhoef (2001) relates the example of how First National Bank terminated its "People's Benefit Scheme" due to lack of demand, and ascribes this lack of demand to insufficient marketing, as well as the fact that the Scheme was overly complicated. One interesting feature of the Scheme was that it was designed to permit group members to borrow against the collateral of the group's savings; however, Verhoef indicates that the minimum allowable loan size was too large for most of those who were or might have been attracted to the scheme. Another limitation of these schemes may be that for ROSCAs, which typically far outnumber ASCAs in a given country, most (if not all) of the money that is collected is immediately passed on to one of the members, such that the groups as such command only a relatively small amount of money. In South Africa, as well as in Kampala and Nagpur, members of ROSCAs are disproportionately likely to open individual savings accounts anyway, thus the relative importance to a bank of accommodating group accounts is modest.
- *Self-help group onlending* – By 'self-help group onlending', we mean the practice whereby a bank lends money to a self-help group which in turn onlends that money to its members. The most significant linkage initiative involving self-help group onlending is the PHBK project in Indonesia, which dates to the late 1980s. Since its inception, PHBK has experimented with a number of different variations on the basic model, for example using NGOs or rural banks as intermediaries rather than linking to the self-help groups directly. The growth of the PHBK project has been impressive, albeit depending on some amount of subsidisation. As of September 1996, 6,800 self-help groups, 183 'social intermediary' support institutions, and 410 banks were involved (McGuire *et al.*, 1998). At that time, the total number of clients (based on an average of 11 members per group) was more than 75,000, which is not large relative to Indonesia's total population. Assessments of economic performance vary. McGuire *et al.* report a cumulative repayment rate of 96.4%, while Meyer and Nagarajan (1999) indicate that, based on an extensive evaluation performed in 1997-98, half of the borrowing groups were in arrears. It is not clear, furthermore, whether the self-help groups are truly onlending to their members in the usual sense of the term, or rather whether theirs is a conventional group-liability arrangement. A similar initiative undertaken in India under the auspices of NABARD, the apex institution for rural credit, has also shown promise, but is far from achieving cost recovery if one takes into account the heavy reliance on donor-funded NGOs for training and support to groups (McGuire *et al.*, 1998).
- *Adapting ROSCAs to be mutual guarantee associations* – A similar approach involves the linking of ROSCAs to a bank as 'mutual guarantee associations' (MGAs), such that the bank would consider the members credit-worthy by virtue of their membership to the ROSCA-like group. Balkenhol and Gueye (1994) studied the potential of introducing such an approach in West Africa, but came to the conclusion that its feasibility is limited by the fact that the organisational principles according to which ROSCAs and MGAs function

are fundamentally different. Despite a proposal from the Savings Bank of Togo in 1987, it is not clear whether such an experiment was ever attempted in West Africa.

- *Bank accounts for money collectors* – The phenomenon of professional money collectors, of which the best known example are the *susu* collectors of West Africa, vividly reveals the cost imposed by market fragmentation (Soedjede, D., 1995). A typical situation is one where a client makes daily contributions of a fixed amount to the collector over the course of a month, at the conclusion of which the collector returns the client's accumulated savings minus one day's contribution. This amount withheld is the collector's payment for the service provided. That clients exist at all is testimony to the value some people place on being able to have their money collected and guarded (from themselves as well as from others); that they do not earn a positive return on their savings suggests that their collectors are either not successfully intermediating that money as lenders, that they are not themselves earning a positive return on savings accounts in the bank, or that there is insufficient competition among collectors. The obvious comparison is to those who make daily deposits to deposit collectors linked to banks in India, or to the HFSC in Nepal. While many independent money collectors make use of banking facilities (Goodland *et al.*, 1999; Steel *et al.*, 1997), it appears banks are not doing as much as they might to attract their custom.
- *Moneylender onlending* – Ghate (1992) mentions that of professional moneylenders operating in Asia, some are effectively onlending funds that they have borrowed from banks. However, the extent to which this happens is difficult to gauge because such onlending is typically in contravention of official policy, and thus is undertaken "surreptitiously". By virtue of the fact that it is not generally permitted, it probably also occurs less frequently than it ought from an efficiency perspective. Ghate argues that not only should such onlending be allowed, it should be encouraged. One instance where this has been attempted is the Praja Naya Niyamaka (PNN) scheme, initiated in 1988 in Sri Lanka through two state banks. The essence of the scheme is that individual moneylenders are eligible for loans at concessional rates, provided they subscribe to a broad set of principles bearing on the terms of their onlending activities.³⁵ A variation of this approach is that moneylenders, whether professional or part-time, are employed as agents of the bank, earning a commission on the basis of loan portfolio performance.

As shown by this non-exhaustive list, there are indeed many promising possibilities for linking formal and informal financial institutions. Notably, however, although some of these basic approaches were piloted more than 10 years ago, it is not clear that any have dramatically impacted the financial landscape encountered by informal operators and low-income households. While it is beyond the scope of this study to present a comparative review of these attempts, we offer a tentative interpretation as to why this is so, based on a limited number of interactions with MFIs and banks in Uganda and India.

First, formal sector institutions – including MFIs – make conservative use of previously-formed savings clubs or self-help groups. Where this is most striking is the relative infrequency with which MFIs lend to such groups, not to mention actively recruit them. On the face of it, one might expect MFIs that practice group-lending to have a policy of deliberately trying to attract existing groups, given that the strength of their solidarity is demonstrable. However, MFIs do not have such a policy (with the important exception of

³⁵ Unfortunately, published accounts of the experience with the PNN scheme appear to be rare.

BASIX), and the one MFI that previously did have such a policy abandoned it. The problem this latter MFI encountered was that, *ex ante*, it could not tell what the true nature of these groups were, and some groups that presented themselves as mere savings clubs turned out to be "under political control". While this is not to say that MFIs have a policy of discouraging groups that come to them, the primary way in which borrowing groups are formed is for a person who makes an inquiry to be told by the MFI to go identify people with whom to form a new group. Interestingly, some MFIs actively encourage such newly formed borrowing groups to form their own ROSCAs, because this can assist the group members in times of crisis, and thus facilitate repayment of the loan to the MFI.

Second, there are in fact good reasons to suspect that banks are particularly ill-equipped to deal directly with groups, whether savings clubs or self-help groups, and whether pre-existing or not. Bennett *et al.* (1996) identify the "single most important factor contributing to group financial performance" as the source of funds for the loans: if funds are sourced locally, e.g. from the savings of the local community, then performance is good, but if the resources are wholly from the outside (or perceived as such), then performance tends to be poor. The underlying principle is the groups' sense of "ownership", which means both identification with the financial service, and also "responsibility for its performance". Where this sense of ownership is strong, then rules are taken seriously and are enforced, including those relating to repayment schedules and liability. However, even if a bank is known to mobilise savings from the same community as the applicant group, the sense of ownership is likely to be very dilute. The PHBK and NABARD-supported initiatives in Indonesia and India, respectively, appear to rely extensively on NGOs to support self-help groups, to the extent it is not clear the initiatives have the potential to break even. The more significant point, however, is that the reliance on this support would appear to negate the principle that linking to self-help groups or savings clubs can lower transaction costs and ensure high repayment rates. The necessity of this ongoing NGO support leads one to suspect that these groups lack the resilience and self-sufficiency that characterise non-linked traditional savings clubs.

The limitations mentioned above relate principally to the delicate dynamics that arise when groups are involved. The irony is that, although the group liability model has become the bread and butter of the micro-finance sector, *informal* groups are intrinsically difficult to work with. Perhaps the most succinct way of expressing this is to say that any contrivance to link formal sector institutions to low-income households via the intermediation of informal finance groups is bound to disturb those groups, and thus imperil the attempt.

Linkage strategies that involve individual-based informal finance are less problematic. The main problem seemingly is that we do not have better information about the extent to which these linkages happen already, e.g. the extent to which moneylenders are in actuality onlending capital borrowed from banks, and *susu* collectors are depositing their clients' savings in bank accounts. Here the real question is whether formal sector financial institutions are adequately accommodating to these spontaneous arrangements.

Two counter-examples help illustrate the complexity of the linkage question. First, we recall the strategy employed by BASIX whereby independent Customer Service Agents are remunerated entirely on the basis of the repayment performance of the loans they originate. These Customer Service Agents effectively play the role of moneylender intermediaries, except that they are not in fact recruited from the ranks of moneylenders. The strategy appears

to be very successful, and yet, once again, the role that could in principle be played by an actual informal financial institution is rather played by a surrogate.³⁶

The second example comes from an NGO based in Nagpur, the Indian Institute of Youth Welfare, which works with youth as well as women of all ages. Previously, the Institute borrowed money from banks that it lent to women to help them develop their enterprises. The Institute eventually abandoned this practice due to unsatisfactory repayment by the women. In its place, the Institute adopted a new strategy, whereby it trains women in the use of banking services so as to prepare them to approach commercial banks directly, and simultaneously intercedes with selected banks to encourage them to be accommodating to the women. Thus far the Institute has assisted dozens of poor and illiterate women overcome the feeling of intimidation that previously inhibited them from obtaining banking services. The point of this little homily is that, with relatively modest effort, the Institute has succeeded in empowering one of the most disadvantaged groups in Indian society to access bank services directly, without pursuing a linkage strategy at all. (Of course, the limitation of this approach is that it does not create a collateral substitute.)

These few paragraphs cannot substitute for the full comparative analysis merited by an issue as complex as formal-informal linkages. However, in comparison with strategies to adapt selected features or principles of indigenous informal financial institutions, the strategy of seeking financial deepening through linkages with actual informal institutions appears clumsy and limited. Those linkages that are truly promising do not require banks or MFIs to introduce contrivances, rather only to liberalise their policies such that moneylenders and savings collectors can use their services in a manner that best suits them.

6. Synthesis and conclusion

Informal operators depend to a large extent on informal finance in order to finance their enterprises. If one includes gifts, informal loans, and informal savings (i.e. savings that are not kept in a bank), then the figures for the Kampala sample are that informal finance was relied upon by 85% of respondents, and accounted for 57% of the start-up financing by volume. For the Nagpur sample, the figures are 74% and 57% respectively. If one applies a narrower definition, whereby one excludes savings kept at home on the grounds that no 'institution' (however broadly defined) was involved, then the figures for the Kampala sample are that 46% of respondents used informal finance, and 44% of the financing by volume was through informal finance. For the Nagpur sample, the comparable figures are 54% and 51%, respectively. The conclusion is that, regardless which definition is employed, informal finance accounts for the majority of financing that is used by informal operators to start their enterprises, and in any event is far greater than financing from formal sector institutions.

The provision or mediation of start-up financing represents the most important means by which informal finance is of assistance to informal operators. It does not erase the decent work deficits that tend to characterise the informal economy, but it at least improves people's

³⁶ In fact the recruitment of Customer Service Agents is a delicate affair. On one occasion, the manager of BASIX's Wardha branch near Nagpur, concerned that rapidly expanding operations of the branch required more Agents, departed from standard practice and placed an advert in the local newspaper. Although the remuneration basis was clearly explained to those who responded to the advert and who were eventually 'taken on' as Agents, the mere fact that the opportunities had appeared in the paper as 'job adverts', attracted entirely the wrong sort of person to perform this vital function. This was a mistake the manager was careful not to repeat.

flexibility in choosing activities that best suit them, and this includes escaping wage employment in cases where the decent work deficits may be even worse. Having initiated their enterprises, moreover, informal operators often later rely on informal financial institutions for additional business loans, or to assist with safeguarding savings and regulating cash-flow. These possibilities further enhance the flexibility of informal operators who are already within the informal economy, for example by assisting them in relocating to a more advantageous location, or expanding the range of products or services on offer, or changing the enterprise altogether. The flexibility that characterises informal finance makes it especially well suited to serve the needs of informal operators.

To some extent, informal operators are especially likely to look to informal financial institutions to meet their needs for financial services because they cannot access services from formal financial institutions such as banks and insurance companies. When seeking loans, for example, most banks require that the applicant offers some form of loan collateral, but more generally than this, formal financial institutions often prefer to do business with people with formal sector employment, that is, who can demonstrate a regular income.

On the other hand, the use of informal financial services is often a matter of preference to informal operators, because of their convenience or familiarity. Many informal operators work alone, meaning that there is nobody to mind the business when they are waiting in a queue at the local Post Bank branch. Moreover, some informal financial services are qualitatively different to their formal sector counterparts. For example, savings clubs, as was argued above, are not merely poor people's analogues to savings accounts in a bank, but rather are a device for promoting motivation and discipline to savers (even those having savings accounts), and are valued as such.

6.1 Trends in informal finance over time

There is evidence from the Nagpur sample of a gradual increase over time in the use of bank credit and a corresponding decrease in use of informal finance. Those getting access to bank finance in general are able to borrow much more than those still relying on loans from moneylenders or friends/relatives, suggesting that the limited increase in accessibility to bank finance is having the effect of differentiating informal operators, or perhaps even helping the bank-financed minority to graduate to the formal economy. For the Kampala sample, it was difficult to establish any such trend, because the vast majority of enterprises were started relatively recently.

However, in both the Kampala and Nagpur cases, it is clear that the major changes in respect of informal finance have to do with the composition or nature of informal finance itself, rather than the extent of informal finance relative to formal sector finance. We have characterised the change in informal finance as a combination of formalisation and commercialisation. We mean by "formalisation" in this context a process by which flexible arrangements based on inter-personal trust and familiarity are partially supplanted by 'impersonalised' rule-based, arm-length arrangements.

The primary example of this, stemming mainly from the field research in Nagpur, is the apparent replacement of loans from friends and relatives, with loans from moneylenders, where the moneylenders in question are oftentimes still friends and relatives. By the same token, the field work in Kampala revealed an ambiguity between loans from friends/relatives, and those from moneylenders. The explanation offered for this ambiguity is that a process is

taking place in Kampala similar to that evident in Nagpur – though perhaps at an earlier stage – whereby economic interactions among friends and relatives that were previously based primarily on the principle of reciprocity are giving way to transactions that allow for profit, including the charging of interest.

The other informal financial institution examined in some detail was the indigenous savings club. Drawing largely on secondary information, it was argued that a parallel process is taking place with respect to savings clubs, wherein arrangements that were previously based on mutual trust among members of the same community are being eclipsed by entrepreneur-initiated schemes. These latter developments sometimes assume different forms from the original savings clubs, and sometimes in doing so provide a very valuable service, not least to informal operators. However, even when the basic form of the savings club appears to be retained – as with the chit fund companies in India that evolved from traditional community-based chit funds – important elements are lost. Most significant of these is the highly personalised character that had contributed both the stability and efficacy of the original clubs. In addition to the 'impersonalisation' of savings clubs, their commercialisation lends itself to abuse and fraud, sometimes on a wide scale. This process further erodes the conditions that had favoured indigenous savings clubs.

6.2 What informal financial institutions can offer formal financial institutions

Although informal financial institutions enjoy clear advantages over banks when it comes to servicing informal operators and low-income households, informal financial institutions face their own limitations as to the depth and quality of services they can provide. As an example, informal financial institutions often fail to intermediate between borrowers and savers; informal moneylenders are therefore short of capital (raising the opportunity cost of what capital they do have, and thus of the interest rates they charge), while savers are not afforded as high a return on their savings as should be possible. Another concern is that the informal finance sector is subject to change over time, and indications are that in some cases the social conditions that make informal finance possible and efficient are in secular decline.

One of the most significant development interventions to assist informal operators is the improvement of access to formal sector financial services. That this is an important initiative is clear from the Kampala survey, wherein a large number of informal operators managed to finance their operations only through immense personal sacrifice. Broadening access to formal sector financial services is achieved both through the intervention of the ever-growing number of micro-finance institutions, but it can also involve reforms of banking practices to make banks more accessible to low-income households and informal operators. In both cases, two of the most important strategies to increase outreach revolve around informal finance. Firstly, many MFIs and some banks have strategically tried to simulate or adapt features of informal financial institutions, thereby solving problems that informal financial institutions seem to cope with, but which traditionally have stymied formal sector financial institutions. Secondly, MFIs and banks have occasionally attempted to link up with informal financial institutions, the idea being that formal sector financial institutions can reach low-income households and informal operators through the mediation of informal financial institutions. Both of these approaches have some promise, but both also face significant limitations.

According to our analysis, the adaptation by MFIs and banks of features seen in informal financial institutions is the more promising. The fundamental problem with the second strategy involving cultivation of linkages is that linkages between formal sector

institutions and informal sector institutions tend to distort the latter. Somewhat surprisingly, it would appear to be more efficacious to artificially contrive the necessary inter-personal relationships and incentives, than to try to harness existing associations. Thus, for example, it is generally preferable for a lending institution to hire agents who earn on commission than to recruit actual moneylenders. It is better for an MFI to encourage the creation of new borrowing groups according to its preferences, than to try to accommodate existing groups, because the latter may come with histories and dynamics that are not conducive to loan repayment. It is no wonder that entrepreneurs, who start chit funds and commercialised burial societies, recruit their members as individuals rather than trying to capture existing groups.

6.3 Gender and the question of informal versus formal finance

There are large disparities in women's and men's use of different types of financial services. For example, women are more apt to depend on friends and family for loans than other sources, and in particular tend to make less use than men of moneylenders and commercial banks. Secondly, women invest less to start their enterprises, and tend to borrow less than men from corresponding sources (including from friends and families). Thirdly, women are more likely than men to borrow from MFIs. And fourth, as has often been noted in the literature on ROSCAs, women are more likely to participate in indigenous savings clubs.

The conundrum is this. On the one hand, women are on the whole better served by informal financial mechanisms than formal ones, especially in terms of credit access. On the other hand, women fare worse than men even within the realm of informal finance, i.e. they receive smaller loans from friends and relatives than men, are less likely to obtain credit from moneylenders, and even the gifts they receive for business purposes are significantly smaller than those received by men.

It is also probable that the evolutionary process within informal finance is largely to the disadvantage of women. This is most clear in the context of savings clubs and burial societies. The commercialisation and formalisation process outlined appears to have a strong gender dimension, whereby indigenous savings clubs and burial societies that comprised predominantly women, are gradually 'captured' by entrepreneurs who are mainly men. These entrepreneurs often start with the largely female clientele, but as the example of chit fund companies in India shows, they tend to turn their attention to the recruitment of male subscribers, not least because men tend to have more money. Sometimes the service provided to women is nonetheless very valuable, as is generally the case with *susu* collectors in West Africa. Other times, however, entrepreneurs' commitment to good service is rather variable, as with burial society entrepreneurs in Southern Africa and East Africa, or chit fund entrepreneurs in India.

To summarise, informal finance will no doubt continue to be important for women entrepreneurs. However, the fact of its inherent limitations and not altogether favourable evolution serve to reinforce the importance of the mission of MFIs and banks in improving their service to such entrepreneurs. The women-oriented group-lending schemes of Kampala's MFIs, and the bank-linked daily deposit collectors in India are examples of where this is happening already.

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