



New Partnerships Initiative (NPI)
Small Business Partnership Task Force

*Small Business
Policy Environment Report:
The Role of the Private Sector
and PVOs/NGOs
in Policy Reform*

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

HIGHLIGHTS

- ▶ Small businesses are fundamentally important in broad-based and sustainable development.

- ▶ An emphasis on unbiased policy reforms is the most efficient means to support the large number of small and medium scale enterprises which are critical to meeting development goals.

- ▶ Direct technical support for individual small businesses has a mixed record of success, with numerous shortfalls. Moreover, the limited resources available for direct single enterprise support, in contrast to the large number of such firms, precludes direct support to the majority.

- ▶ Strengthening host country business associations-- including their partnerships with U.S. associations--is among the most effective approaches suggested for enhancing the policy dialogue and reforms, and providing standardized services to members.

ACKNOWLEDGEMENTS

Preparation of this report, like much of NPI's work, has truly been a team effort. As the primary drafter, Robert C. Young (detailed from the U.S. Department of Labor) has integrated significant inputs from numerous others: from USAID, Greg Baker, Melissa Brinkerhoff, Norm Nicholson, Elisabeth Rhyne, Don Sillers, and unknown others from Regional Bureaus; John D. Sullivan, the Center for International Private Enterprise; Russ Webster, Management Systems International; Nick Kulibaba, Abt Associates; Eric Nelson, Development Alternatives, Inc.; and Kristin Mitchell, formerly with Coopers and Lybrand. Editing was done by Danielle Roziewski and Joshua Ginsberg.

The opinions expressed are solely those of the author(s) and do not necessarily reflect those of the U.S. Agency for International Development.

THE SMALL BUSINESS POLICY ENVIRONMENT REPORT

CONTENTS

The Rationale for Small Enterprises: Their Role and Potential Contribution to Sustainable Development	2
An Appropriate Policy Environment for Small Enterprises and Growth	5
Small Enterprises, Business Associations, NGOs and the Demand for Reforms	9
Recommendations	11
Appendix: Exemplary USAID Global, Regional and Mission Small Business and Policy-Oriented Programs	i

July 3, 1996

**NEW PARTNERSHIPS INITIATIVE (NPI)
SMALL BUSINESS TASK FORCE**

**U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT
(USAID)**

INTRODUCTION

Background: USAID's New Partnerships Initiative (NPI) -- announced by Vice President Gore on March 12, 1995 at the World Summit for Social Development -- focuses on U.S.-host country partnerships to build grassroots capacity in three sets of host country institutions: nongovernmental organizations (NGOs), small businesses, and democratic local governments. NPI's goal is to accelerate sustainable economic, democratic and social development through local institutional capacity building, leading to host country "graduation" from donor assistance. NPI's embodiment of recent advances in development theory recognizes the critical economic and political roles of voluntary associations and local government in strengthening civil society and civic values vis-a-vis the development process.

Small Business Partnership: This component of NPI builds on a foundation of more than 30 years' close involvement by USAID in policy reform and structural adjustment. These economic reforms have helped liberalize the economies of developing countries and opened up opportunities for both large and small businesses. This brochure focuses on the policy environment necessary for successful small businesses and emphasizes the potential complementarity of three sets of democratic networks: small business associations, NGOs and local governments.

Purpose and Focus: NPI and the Small Business Partnership component aim to help USAID achieve its global goal of broad-based and sustainable development. The purpose of this Small Business Partnerships policy component is multifold, but critical to NPI's overall success in:

- strengthening the role and efficiency of small business in developing countries, by
- promoting appropriate policy and administrative reforms in biased or hostile business policy environments, to be accomplished by
- fostering both (a) U.S. and host country partnerships among business associations, local governments and pertinent NGOs and (b) complementary institutions vital to reforms, such as statistical agencies and policy institutes.

In many developing countries, distorted policy and regulatory environments limit the efficiency and growth of both small and large businesses. Poorly defined property rights, biased trade policies, and undue governmental favoritism and interventions in markets often discourage small businesses from investing in plant and equipment, limiting their efficiency and growth. Many larger enterprises, however, survive in such settings by seeking policy biases that protect them from competition by foreign and emerging domestic competitors. This pursuit of favoritism--rather than economic efficiency--in the policy process (often referred to as "rent seeking" by economists) limits the growth of incomes and can encourage corruption.

NPI's Small Business component has two foci: to identify and correct policy and regulatory distortions that particularly constrain small businesses; and to more actively engage NGOs, business associations, local governments and policy institutes in generating pressures for reform. NPI can help create enabling environments that will multiply opportunities not only for small-scale entrepreneurs, but for micro- and larger scale enterprises as well.

Defining "Small Business": For the purposes of NPI and its Small Business component, small businesses in developing countries are defined as those having more than 10 employees. 10 workers is the ceiling for USAID's definition of its "Microenterprise Initiative." USAID missions may determine, within broad parameters, the most practical upper limit for small business under the NPI framework.¹ NPI's Small Business component is separate from USAID's Microenterprise Initiative--building on, coordinating with and complementing those activities. Much of the analysis in this document applies to micro- as well as small-scale enterprises.

THE RATIONALE FOR SMALL ENTERPRISES: Their Role and Potential Contribution to Sustainable Development

A cornerstone of development: Successful long-term development must be built upon a number of linked cornerstones, including democracy, agriculture, sound economic policies and small enterprises. Yet the more dramatic and well-publicized large enterprises often overshadow their smaller brethren and diminish the public's appreciation of their contributions to development.

While their role may often be underestimated, *small businesses represent substantial potential--not only in their contributions to private sector development as "engines of growth," but also to both economic and political democracy.* The large number of people typically engaged in small firms represent not only key resources for productivity and growth. Small business may also lobby effectively for democracy, as well as for efficient and competitive economic policies that result in more equitable access to resources and a more level economic playing field. Without a broad base, as in small enterprises, economic concentration is more likely to similarly concentrate political power. Such an environment is less likely to result in those reforms necessary for dynamic growth and effective ballots. On the political front, democracy--or at least enlightened governance--is essential for prosperous small enterprises. Without it, biased policies typically undercut their economic and political contributions.

Small business' ability to perform these developmental functions is related to its role as an entrepreneurial training ground. Although entrepreneurs often first pick up experience work-

ing in another firm, the process of identifying a market niche, establishing a small business to fill it, and building a successful business serves as a valuable training ground for them.² Lacking formal credentials, many fledgling businesspersons would find it hard to obtain managerial position in a large firm. The flow of entrepreneurs emerging from a vigorous small business sector can greatly add to the economy's overall flexibility and growth potential.³

"Small is beautiful," sometimes! Research conducted for USAID points to the efficiency demonstrated by some small enterprises:

This review of the returns and economic profitability of small enterprises reveals that while in the aggregate they are efficient, their returns vary markedly among different types of producers. Nevertheless, some important patterns emerge. Small enterprises which are most likely to be economically viable tend to reflect some common patterns.... Prominent among these are (1) use of hired workers; (2) operations in workshops away from the home; (3) operations in larger localities; and (4) involvement in product lines with better economic prospects, such as tile, furniture, baking, and repair activities.⁴

Two other strong patterns were found in these analyses. First, the one person firm--which constituted more than half of the firms in five of the seven countries surveyed--generally had economic profits which were "close to zero or even negative." Second, economies of scale were common as returns per hour increased with the number of workers.⁵

More recent work for USAID, which reviewed survey data as well as substantial other related research, also identified economies of scale but found efficiency often tapered off among the largest enterprises:

...there is an evident relationship between size and productivity which, if not monotonic, at least involves an unambiguous jump in economic performance between the bottom of the size distribution and higher size classes. Total factor productivity most often hits its maximum in the middle size range, and less frequently in the upper size range; seldom is the highest total factor productivity found at the bottom end.⁶

Small firms are more efficient than large firms in several subsectors, including food products, clothing, furniture and building materials. Small businesses play an equally important role in many services, where economies of scale are often less important. In both manufacturing and services, small firms tend to be more oriented toward production to meet local tastes and needs, including the needs of those with middle- and lower-incomes for simpler, less costly products and services. Small businesses prevail particularly in rural areas, where they serve the needs of farmers and others with lower-incomes, producing farm implements, processing agricultural outputs, renting machinery, etc.⁷ Small businesses focus their attention on the needs of lower-income consumers and producers and, thereby, promote equity within developing countries.

While many of the smallest firms are more capital-intensive than larger firms, small manufacturing firms do tend to use more labor-intensive production techniques than their larger competitors.⁸ This pattern enhances the role of small businesses as a source of employment in countries with abundant and rapidly growing labor forces. In many cases, small businesses help absorb relatively less-skilled workers than those hired by larger firms. In both respects, small businesses may contribute not only to resource use and overall prosperity, but to a more equitable distribution of income and non-economic benefits in terms of social and political stability.

Some dynamics of small businesses: Given the above "static" benefits, one cannot fully appreciate the potential contribution of small firms without considering their dynamic role over the long-term course of development. In both rich and poor economies, small businesses typically have short life expectancies. The market winnows out all but those best-attuned to the needs of their customers. As a result, the few small firms that survive include some of the most dynamic and responsive to emerging demands in the local and international economies. Given a level playing field for new competition, over time, a few of the more successful and dynamic small businesses will emerge as medium- and large-scale businesses. However, the success rate of very small enterprise growth can be surprisingly low. In five African countries surveyed for USAID, only one percent of the firms surveyed in the early 1990s that started very small (1-4 workers) were able to grow into firms of 10 or more.⁹

Apart from the dynamics of individual enterprises over time, there is also an important dynamic to the small enterprise sector, as revealed by USAID-sponsored research:

The development role of the small industrial enterprise can be compared to that of the small farm. Both are important in early stages of development and both have some growth potential, which the government should encourage in the early stages of development for reasons relating to both efficiency and equity goals....But if development succeeds, both of them will eventually disappear.¹⁰

This virtual disappearance of the small-scale manufacturing sector takes this pattern: whereas cottage-shop scale businesses generally prevail in low income countries (roughly up to \$500 in per capita national income), small and medium scale workshops dominate in emerging economies (incomes roughly \$501 to \$1000), while larger scale firms are prevalent the more advanced economies (incomes over \$2000). The pattern of small successes in other sectors--such as trade and services--is more diverse.

A Policy Growth Trap for Small Enterprises? Perhaps as a result of both the policy structure and the demands on enterprise management as firms try to grow, few micro and small enterprises grow to become medium scale. A "missing middle" commonly appears in the distribution of enterprise employment by scale--many employees in the small, few among

the medium-sized, and more among the large. Micro and small businesspeople often appear reluctant or unable to expand their firms to a more efficient scale. A "policy growth trap" seems to frustrate improvements in efficiency by capturing economies of scale. Firms crossing a scale threshold typically are required to: begin paying minimum wages; operate within legislated constraints on the hiring, use and firing of workers; begin paying taxes; and abide by other administrative and legal restrictions.¹¹

To the extent that a growth trap does exist and that policies do constrain the growth of microenterprises into the substantially more efficient small and medium scale, aggregate economic efficiency and growth are diminished. Related reforms become a high priority. Indeed, research for USAID indicates that correcting such policy constraints may be the most important form of assistance for small enterprises available to donors and host governments:

The effectiveness of most of the promotional programs through which governments frequently try to foster the development of small and medium enterprises is questionable. Governments also affect small and medium enterprise development, often adversely, through their trade, exchange rate, fiscal, financial and labor market policies. Correction of such policy biases may be an effective way of promoting the growth of healthy small and medium enterprises [emphasis added].¹²

Summary of development rationale: Small businesses contribute significantly to employment, entrepreneurship, individual and aggregate income growth, democracy, and economic as well as political equity. Unfortunately, in most less industrialized countries, these contributions fall far short of their potential, due in large part to subtle and not-so-subtle constraints and biases in the policy and regulatory environment. Misconceived policies undercut development and place small firms at a distinct disadvantage against large and established firms. As the large number of small enterprises means that direct assistance to all of them is impractical, addressing these policy inadequacies is the most efficient approach to overall support for the sector.

AN APPROPRIATE POLICY ENVIRONMENT FOR SMALL ENTERPRISES AND GROWTH

A sound macro policy environment, one that is basically "market-friendly," is increasingly recognized as fundamental to sustainable development.¹³ Not only are prudent policies important for overall economic growth, but evidence is gradually emerging that they are also important for prosperity in the small enterprise sector. Recent evidence from Kenya and Jamaica, for example, suggests that when the overall economy prospers, the small enterprises are also significantly more prosperous, compared to when the macro economy is less healthy.¹⁴

Accordingly, key policies for such an enlightened macroeconomic business environment, and conducive to more viable small enterprises, include:

- ▶ **stable governance**, with private-sector driven economic growth high on the agenda, and without which development will be seriously hamstrung if not stillborn;¹⁵
- ▶ **improved legal, regulatory and judicial systems**, conducive to the conduct of modern business and with appropriate recognition of the importance of property rights;
- ▶ **responsible fiscal policy**, yielding low budget deficits and adequate balance between public and private sector resource mobilization;
- ▶ **constrained monetary policy**, with minimal inflation and market-based interest rates;
- ▶ **antimonopoly policy**, to assure that market entry is not unduly restricted by regulations, that small businesses have the right to enter into competition with large firms;
- ▶ **liberalized trade policy**, with low and relatively uniform tariffs and minimal administrative barriers, to take advantage of foreign trade's powerful modernizing effects;
- ▶ **exchange rates**, basically set by free market forces and enabling the repatriation of foreign earnings; and
- ▶ **prices of inputs, land, labor and capital being relatively free** to adjust to changing market pressures of supply and demand.

Beyond these macro business climate concerns, small businesses typically are also concerned about sectoral policies, often because the structure of such policies tilts the playing field against them. But before going on to elaborate policy biases, additional comments are appropriate on financial policy because of its role as a vital oil that eases transactions and because finance is a priority concern expressed by both small and large enterprises.¹⁶

In financial markets, USAID's experience is that commercial banks should become the main source of external funding for small business. For banks to fulfill their potential in this area requires a much greater degree of competition in the banking sector, fostered by a shift in banking regulation to permit free entry by any bank that meets appropriate standards of capital adequacy. Upgrading the skills of banking regulators/supervisors can play an important role in this process.

USAID's experience also suggests that financial services should focus on the short term. Often, small businesses need short-term credit and efficient money transfer services more than they need long-term credit. Effective techniques can be adapted from USAID's extensive experience in microenterprises credit.

In contrast, the track record of donor-supported venture capital projects focused on small businesses has been uniformly discouraging. The transaction costs and capital market conditions that are necessary for venture capital make it difficult below medium-scale, and limit its viability to relatively well-developed policy environments and countries.

Policy biases in many sectors and in most developing countries place small businesses at a disadvantage vis-a-vis large firms.¹⁷ These biases limit the ability of more efficient firms to emerge, compete with established businesses, and contribute their potential to national income:

- ▶ **Financial policies**, as mentioned above, are fundamental to a sound macro climate, but when ill-conceived they may cripple the growth of small business. For example, interest rate ceilings on loans prevent banks from raising rates to cover the higher unit costs of small loans and the greater perceived risks of lending to new customers. As a result, banks prefer to deal with large, established businesses, while even promising small enterprises are starved of institutional credit. Meanwhile, barriers to entry in the banking system keep costs high and discourage the cultivation of new clients, including small businesses.
- ▶ **Agricultural policies** are vital to small business. Agriculture often depends on small enterprises for their inputs and processing their outputs, short-changing agriculture in turn compromises small enterprises by cutting both the demand for their outputs and the supply of their inputs.¹⁸ Eliminating widespread urban biases and establishing sound and strong agricultural policies are virtually essential for the efficient takeoff of very low income countries.
- ▶ **Foreign trade policies** often undercut small business. As examples, import license requirements and the official allocation of foreign exchange made scarce by an overvalued exchange rate make it hard for small manufacturers to get the imported inputs they need.
- ▶ **Legal, regulatory, and judicial policies** can inefficiently and inequitably stifle would be small investors. Licensing requirements can preclude new entry into sectors deemed "overcrowded." Subjecting business decisions to bureaucratic approval in these and many other areas presents irresistible opportunities for official corruption,

and gives established firms the chance to collude with officials to keep new competitors out.

- ▶ **Land laws and urban zoning rules** impose minimum size restrictions for business sites that are out of the reach of small firms, while complicated land titling laws make it difficult to develop and obtain secure tenure to land. Small businesses that operate in violation of these rules find it difficult or impossible to obtain water, power, and sewer hookups. Access to urban services is made more difficult where subsidized pricing for those services limits funding for system expansion to meet new demand. Small businesses, particularly in transition economies (such as those shifting from a socialist to a market orientation), have difficulty obtaining secure and appropriate working space, and in using their property as security for loans. Accordingly, USAID has concluded that in most countries, policy reform efforts for small business should focus on these land, property rights and collateral reforms, the solutions for which involve both legal reform and municipal-level planning.

- ▶ **Labor market policies** can be de facto advantageous to small firms, for instance, when small firms are exempted or ignored in a policy's administration. However, when minimum wage and severance pay requirements, for example, are enforced on small firms they can impose sharply rising costs on enterprises trying to emerge from the micro or small enterprise end of the business spectrum. Imposed on top of abrupt cost increases due to rising visibility to tax authorities, both effects constitute a substantial barrier to enterprise growth and reinforce the policy growth trap

While the above policy constraints and biases typically confront small enterprises, it must be acknowledged that some historic policy distortions have been corrected in some developing countries in the context of ongoing stabilization and adjustment programs: import and investment licensing and foreign exchange controls, for example, are much less widespread than in the past. However, many other more subtle barriers typically continue to burden small businesses, even in countries that have undertaken macro policy reforms.

Direct support for small business has a mixed record of success, with numerous shortfalls, on which USAID's Microenterprise Initiative has illustratively commented:

Non-financial programs tend to be expensive and in most cases will be unable to cover costs through fees for programs....Such programs may need to experiment with new techniques to increase their efficiency.¹⁹

A USAID project reviewing policies affecting small businesses concluded similarly:

The effectiveness of most of the promotional programs through which governments frequently try to foster the development of small- and medium-scale enterprises is questionable.²⁰

An emphasis on policy reforms is recommended as the most effective means to support small and medium scale enterprises because of the large number of small-scale enterprises, the high cost of providing services to them, and the very limited donor and host country resources, particularly for lower income countries. That is not to say that small businesses in developing countries are never constrained by the absence of effective supporting institutions. Instead, the concern is that, given very tight resources for very low income countries, such support can be overdone and wasteful. In the Indian case, for example, most analysts agree that India's excessive support for small enterprises has reduced the growth of output and employment.

Important additional activities in which small business should be involved can be very conducive to the modernization of an economy but are not elaborated here as they do not fall within the domain of the enabling policy environment. Among these would be programs such as: the establishment of industry standards and efficient ways of enforcing such standards; and the alleviation of numerous information constraints, about market opportunities, at home or abroad, improved management and production techniques, and other basic planning information.²¹

SMALL ENTERPRISES, BUSINESS ASSOCIATIONS, NGOs, AND THE DEMAND FOR REFORMS

A strong demand must exist for policy change in order for reforms even to be considered, much less implemented. Without a crescendo of demand for reforms, those with vested interests in the current regime are likely to perpetuate the status quo indefinitely. A concerted demand for new policies may be mobilized from a variety of sources: policy analysts in the bureaucracy, donors, academics, or a wide variety of nongovernmental constituency groups within the country, including business of all sizes, frustrated would-be exporters, labor or any of a potentially broad spectrum of special interest NGOs.

The nature of the reforms sought may determine which business association one attempts to mobilize for support. On the one hand, associations dominated by large enterprises may be valuable in promoting macro policy reforms, as may associations of small scale enterprises. On the other hand, when the purpose is to identify and address policy and regulatory barriers favoring larger businesses, one key lesson learned is that the most effective way to identify and eliminate such biases is to help small businesses organize their own voice in the policy process.

A number of the business networks and association partnerships which USAID has helped establish are working quite well, through organizations such as the West African Enterprise Network (which includes considerable attention to policy issues) and the U.S. Chamber of Commerce's Center for International Private Enterprise.²² Yet there has not yet been a strong survey of such experience, say, comparable to that done for successful microenterprise loan programs,²³ that searches for those characteristics that enhance and those that diminish the effectiveness of such programs.

USAID's Advisory Committee on Voluntary Foreign Aid (ACVFA) has already given serious consideration to the role of NGOs in promoting reforms. Among the 1993 ACVFA report's conclusions were the following:

NGO's can be highly effective advocates for policy reform. They frequently represent large, vocal and well-informed constituencies, and their positions tend to mirror more accurately the diversity of a society than do government structures.

Most importantly, a vigorous independent sector is an essential building block of democracy. NGO's understand the nuts and bolts of citizen participation. Their work promotes citizen involvement at the local level and serves to strengthen representative democracy from the bottom up [emphasis added].²⁴

ACVFA's 1990 Report also stressed the role of PVOs and NGOs in the policy dialogue, and the potential of partnerships to enhance that process:

American PVOs should work toward the formation of solid relationships with their NGO colleagues in the developing nations. These bridging relationships are essential for those organizations that intend to continue field-level operations, and they provide credibility and a powerful base of support to advocacy and public policy groups [emphasis added].²⁵

Complementary policy reform activities -- beyond direct support to enhance linkages between business associations, local governments, and PVOs/NGOs here and abroad -- may substantially strengthen the impacts of approaches using business associations and NGOs.

In many instances, donors have found themselves stymied in trying to promote reforms, and have turned to other organizations for assistance. Among the diversity of other effective resources, beyond those referred to above, which have provided support for reforms are the International Center for Economic Growth (ICEG) and a variety of U.S. universities, including California (Berkeley), Chicago, Harvard, and Michigan State.²⁶

More generally, USAID's long-term engagement in the policy dialogue and lessons learned relating to a wide variety of conditions, suggest a variety of supportive tactics to enhance the business climate, including the following:

- ▶ **Better political and institutional analysis, with stakeholder and "political mapping,"** are "particularly useful in stimulating and focusing participation in policy reform."
- ▶ **Capacity building diversity, rather than USAID's more customary approach of turning to a solitary "policy champion,"** was found to be substantially more effective. This would involve the use of more than one advocate, bolstering institutions at all levels, inside and outside government, and engagement in the many dimensions of policy reform: policy monitoring, analysis, evaluation, lobbying, advocacy, and basic institution building.
- ▶ **Conferences and other fora, used extensively, may be quite effective as reform instruments, providing "opportunities for people who don't normally get together to discuss things, or ... whose positions tend to isolate them, to get input from a variety of sources."**
- ▶ **In authoritarian climates participatory approaches are possible, when designed with a sensitivity for the implications of the program. No one-size-fits-all prescription suffices in policy reform. Country specifics require tailored policies.²⁷**

Because many who consider the policy problem recommend leaving such issues in the hands of the World Bank, comment must be made concerning USAID's involvement in the reform dialogue. The two most basic arguments for a USAID role are: (1) Many have pointed to evidence that the most efficient route to effective and permanent policy reform is not to "buy" such reforms with large grants or highly subsidized credit, but instead to persuade the host country that such reforms are in their own interest; and (2) In contrast to the more richly endowed multilateral financial institutions, USAID is reputed to play a far more active role in promoting vigorous and broad-based policy dialogue, often because of its substantial strength in field staff. This role is reflected in the above listing of approaches to reform that USAID has found effective.

RECOMMENDATIONS

Business association development in developing countries: Increased and strengthened U.S./host country business association ties are an effective means to promote market and democracy friendly policy reforms. Such ties help to both improve the business climate as well as providing profit-generating linkages between U.S. and host country economies. Learning works best when it's business-to-business, and especially within the same sector. Businesspeople learn more from each other than from trainers or consultants. Business-to-business learning also leads to identifying expanding market opportunities.

Business associations linked with NGOs and local governments in the policy dialogue: NPI's impacts through developing country business associations should be substantially enhanced by association collaboration in the policy dialogue with NGOs and local governments. All of these parties will generally have an interest in reforms that facilitate the modernization and growth process, and NPI will substantially augment its impact by facilitating such collaboration.

Privatization of business associations: In countries where industry or trade associations are dominated by the state, donors should work to fully privatize such associations, or when that is impossible, develop parallel, fully private organizations representing the interest of their members and train them in techniques used by U.S. organizations to foster membership loyalty and support ("back-selling").

Strengthening of the policy dialogue: A more vigorous, more public and more sophisticated approach to the policy dialogue is critical. Invigorating and spreading the involved network should include participation by the public, private, business, agricultural, labor, media, academic and NGO communities. But that will require improved host country media, institutions and fora to support a higher quality of information exchange, as discussed in the previous section above. This means better data, more analytical resources for sample surveys and rapid assessments, staff training, fora, publications, and information technology (computer, report copying, information access, and telecommunications equipment).

Policy reform strategies: Clearly both the macro policy constraints and the small business bias reforms are priorities. Ideally, both levels of policy reforms would be pursued simultaneously. If, however, an initial priority must be determined, it must be for macro reforms. If the macro economy is broken, then the prospects for growth in the small business sector are greatly reduced. USAID should, in this instance, focus its efforts more towards encouraging the needed macro reforms.

This can be done in two ways. First, assistance can be provided directly to ministries that are responsible for analysis and implementation of policy and legal reform. However, the success of such undertakings will depend heavily on the commitment of government, as well as the pressures brought to bear by other donors and the international financial organizations. A second strategy of strengthening local nongovernmental organizations (including business associations, private sector policy institutes, university research centers, etc.) may effectively promote the macro reform agenda. Assistance can come in the form of organizational development, improving research capability, and improving advocacy functions. This strategy comes from the belief that policy reform--even at the macro level--can proceed more rapidly by involving a broader base of beneficiaries.

Democracy and governance: Expressing concerns about economic reforms does not imply downplaying the importance of reforms in democracy and governance. As argued above, without a stable and reasonably enlightened administrative environment, little economic or small enterprise sectoral success can be anticipated. In this vein, USAID will need to place increasing attention on the problem of coordinating reforms in the economic as well as the democracy/governance arenas. This has often been difficult in the past, but will be critical to the effectiveness of NPI.

Donor collaboration: As it implements NPI in the area of small business, USAID should work carefully to assure that USAID is well coordinated with other donors. This will be especially important in the policy arena, where the leverage brought to bear on reforms, and its impact, will be substantially greater if the donor community is well synchronized. Absent coordination, for example, some donors or host countries might support policies and activities that so excessively favor small businesses as to create a growth trap.

Evaluation of donor experience in business networking and association development: An evaluation should be carried out which looks at the characteristics of donor support to business associations and networks. The purpose would be to identify those characteristics which typify and distinguish the successful from the unsuccessful activities to develop business networks and associations. The evaluation might learn from the recent review of the characteristics of successful microenterprise finance institutions.²⁸ Considering successful and failed cases of business association development would enable identification of both characteristics of winners as well as factors that seem to cause losers.

Evaluation of policy reform networks and tactics: A review of evaluations of policy reform networks should be considered, to assess whether it is necessary to update what is known about the best means of pursuing policy reforms. Experience that well might be reviewed includes that of some relatively popular USAID policy reform projects, including: Implementing Policy Change (IPC); Institutional Reform and the Informal Sector (IRIS); the International Center for Economic Growth (ICEG); the Enterprise Network of West Africa; the Center for International Private Enterprise (CIPE); and the Consulting Assistance for Economic Reform (CAER/HIID) Projects.²⁹

APPENDIX

EXEMPLARY USAID GLOBAL, REGIONAL AND MISSION SMALL BUSINESS AND POLICY-ORIENTED PROGRAMS

BUREAU FOR GLOBAL PROGRAMS, FIELD SUPPORT AND RESEARCH

USAID's "Global Bureau" maintains a substantial portfolio of activities aimed at promoting a healthy economic and regulatory environment, one with unbiased policies, conducive to the growth of small as well as medium and large businesses in developing countries. These policy activities include: macroeconomic/sectoral restructuring in areas such as financial sector, privatization, and investment/export promotion; institution building for participation in policy formulation, such as empowerment of business associations and economic think tanks; and the Microenterprise Initiative's support for a variety of institutions, particularly financial, but not excluding those that focus on advocacy. Several of the Global Bureau's prominent policy programs have been well received by their USAID and host country collaborators. Many of these "Global" programs utilize both U.S. and host-country NGO capacities to deliver critical policy related assistance. Among the more prominent of these Global activities are the following:

- **The Consulting Assistance for Economic Reform Project** (now "CAER II", for which the Harvard Institute for International Development [HIID] is the prime contractor), offers advisory services to strengthen USAID's capacity to assist developing nations to introduce and maintain appropriate economic policies at the macro, sectoral and project levels.
- **The International Executive Service Corps**, which last year fielded nearly 1000 retired U.S. business executives to provide management training and to link developing country firms to U.S. know-how, is also now engaged in developing host country business associations and linking them to their U.S. counterparts. These associations, as argued above in the basic text, can play vital roles in the reform process.
- **The non-profit Financial Services Volunteer Corps** has been a successful, cost-effective vehicle to provide high-level Wall Street and U.S. government talent to Eastern Europe and the former Soviet Union countries seeking policy reforms to restructure their critical financial sectors.

- **The Institute for International Education**, with participation from over one hundred U.S. universities, fields Masters Degree candidates who spend 10 months between their first and second years of study assisting small businesses and business associations. Their case studies are rapidly becoming an integral part of the course curriculum in U.S. graduate schools, and the graduates are in demand by U.S. companies seeking to expand contacts in developing countries.
- **The Institutional Reform and the Informal Sector** project (the University of Maryland is the prime contractor) helps build the institutional capacity of local counterparts to engage the government in the policy process.
- **The Financial Sector Development Support Project** deals with improving financial sector policies that affect the establishment, growth and efficiency of both large and small enterprises.
- A series of small grants to U.S. manufacturing associations is promoting ties between U.S. small businesses and counterparts in developing countries, seeking job creation in both the U.S. and the developing countries and a dialogue with considerable potential for policy reforms.

BUREAU FOR AFRICA

The Bureau for Africa supports small business development in Africa through its bilateral Mission funded activities as well as from its centrally funded programs in Washington. Virtually all USAID Missions currently have private sector projects that support either directly or indirectly small business development. Most projects have a policy reform component. These activities are designed to provide a more hospitable business environment and focus on trade and investment policies, administrative procedures, tax policies and access to foreign exchange.

- Through the **Implementing Policy Change Project**, the Africa Bureau has supported the development of the **West African Enterprise Network**, a regional association of over 200 entrepreneurs who have joined together to improve the enabling environment for private sector development. The network constitutes a strong private constituency with vested interests in implementation of reforms conducive to private sector development and engaged in dialogue with national and regional leaders. As examples: in Mali, Network members advised the government on tax policy, reviewed draft legislation, and now has regular meetings with the National Assembly; and the Burkina Faso Network has gained representation at all National Assembly debates regarding proposed legislation affecting the private sector.

- The Bureau for Africa's **"EAGER" Project (Equity and Growth through Economic Research)** has provided support for policy dialogue, research and reforms through the International Center for Economic Growth, the International Development Research Center, the African Economic Research Consortium, HIID, Associates for International Resources and Development, with an emphasis on U.S.-host country collaboration and the active involvement of Africans in the research.
- In Ghana, the **Trade and Investment Promotion Program** aims to remove obstacles facing non-traditional exporters through assistance to both the public and private sectors. While the private sector component emphasizes firm-level development, the public sector component addresses policy and regulatory constraints through targeted technical assistance, institutional strengthening, public education, and conditionality requirements.
- In Kenya, the **Kenya Export Development Support (KEDS) Project** has had a significant impact in expanding the non-traditional agriculture sector and opening new export markets for Kenyan producers. Under KEDS, USAID provides technical assistance to both the public and private sectors to establish a supportive policy environment for firms to enter and expand their international linkages. Since the project's beginning, non-traditional exports have increased so that they are now only exceeded by tourism and tea as generators of foreign exchange, while the number of export-oriented manufacturers has increased tenfold, or 200 (many of which are small), with 40,000 workers.
- USAID/South Africa's **Black Integrated Commercial Support Network's** objective is to help small South African companies become suppliers to large corporations, encourage and support franchising, and help black entrepreneurs gain equity shares in mainstream enterprises. Other USAID private sector activities in South Africa assist small businesses through support to business, professional, and community-based organizations. The assistance is designed to increase their advocacy and research capacity and to promote international exposure and collaboration.
- Under USAID/Tanzania's **Finance and Enterprise Development Program**, a policy reform agenda has led to the opening of seven private financial institutions; a fully unified, market-based foreign exchange rate; and a stronger central bank more independent of government political pressure.
- In Uganda, USAID's **Agricultural Non-Traditional Export Promotion Program/Project (ANEPP)** was launched in 1988 to increase the range and value of non-traditional exports through both policy reform and enterprise assistance. As part of

this project, an Export Promotion and Development Unit was established to encourage policy reform and assist entrepreneurs in developing non-traditional agricultural export businesses. Through ANEPP, USAID has played a prominent role in efforts to liberalize Uganda's economy, thus bringing new entrepreneurial opportunities to the private sector. Reforms completed include: lowering of tax and tariff rates, liberalization of foreign exchange, deregulation of fixed prices and abolition of government monopolies, and repeal of trade licensing which ended restrictions on imports.

Since the project's inception, non-traditional agricultural exports have increased from less than US\$9 million to nearly US\$143 million in 1993. Many small-scale growers and exporting businesses have benefitted from this increased export activity; for example, 100 grain exporting firms have been established since the reforms were implemented.

BUREAU FOR ASIA AND THE NEAR EAST

ANE's approach to small business development has been primarily through support for policy and institutional reform. In the economic growth sector, ANE technical assistance is helping mobilize and broaden access to domestic capital markets. Such markets generate capital and create systems for financing new, small businesses. In addition, highly targeted technical assistance is helping several ANE countries overcome structural constraints to small business development. In the health and population sector, ANE is concerned with the broad policy and institutional environments in which health programs operate. The policy dialogue includes financing and better allocation of resources for preventive care and private provision of services. Successful policy reform often requires decentralizing resource control and encouraging private service delivery, thus supporting the growth of small businesses.

ANE's approach to small business development through policy reform has led to some impressive results:

- In Sri Lanka, Indonesia, the Philippines, and India, USAID supports the development of capital markets to mobilize foreign and domestic capital and improve the efficiency of its allocation. In Sri Lanka, firms on the Colombo Stock Exchange created 4,500 jobs in 1995, for a total of 20,000 jobs since 1990 when USAID assistance to the sector began. Preliminary evidence also indicates that possibly 400,000 jobs have been created by firms raising capital on the Jakarta Stock Exchange since 1990, even more than in Sri Lanka in relation to the labor force.
- In Bangladesh, USAID-supported policy and institutional changes to privatize the import and distribution of fertilizer created over 110,000 jobs, increased food grain

production, and lowered consumer prices. Many poor people benefited directly as their main food source remains grain. These changes were critical to Bangladesh achieving rice self-sufficiency.

- In India, USAID helped develop the country's housing finance system. In 1979, one company provided \$2 million of housing loans. By 1992, over 270 private companies provided nearly \$500 million in loans through over 300 offices. More than 50% of all the beneficiaries have been households below the median-income level. A quarter of all borrowers were low-income families.
- In Morocco, USAID has assisted small business associations to become stronger advocates for their members' business interests, as well as to lobby for business reform and market opportunities. In the area of agribusiness exports, USAID assistance has promoted business development, export promotion and U.S.-Moroccan trade. The number of small and medium-sized enterprises registered annually is expected to increase from 16,000 in 1994 to 17,000 in 1996.
- The US-Asia Environmental Partnership, USAID'S flagship environmental program in Asia, supports a biodiversity activity which is specifically directed to working with local communities, NGOs, and the private sector in developing "small enterprises" that will help preserve local biodiversity. The US-AEP will soon start a cost share program with the Asia Foundation for NGO-Business Partnerships, which is intended to help NGOs and enterprises work together in solving environmental problems.

BUREAU FOR EUROPE AND THE NEW INDEPENDENT STATES

The Bureau places heavy emphasis on establishing a fair, transparent and efficient business environment and focuses on capital market improvements and legal/regulatory reform. An important part of the program is working with national and local government to improve government-business relations and to encourage a supportive business environment. Missions actively monitor the business environment to provide feedback, and policy advice is an important component of the program. To expand this, policy feedback projects actively work with firms and business associations to encourage communication and structure information on experience and problems. Encouragement is given to local business associations both for policy advocacy and for the provision of business services to small entrepreneurs. Linkages between local associations and international organizations are likewise encouraged.

Illustrative effective approaches to small enterprise and market-oriented policy reform activities in the ENI Bureau are as follows:

- In Poland, USAID technical assistance aided the development of a national policy on small and medium enterprises (currently being reviewed in the Parliament), and in the formation of a Polish Foundation for the Promotion of Small and Medium Enterprises.
- In Hungary, USAID funded a U.S. non-profit organization (**Center for International Private Enterprise**), working with several local groups, to conduct research, publish results, and organize national seminars on policy and legal reforms critical to improving the environment for private sector development.
- In Bulgaria, USAID is focusing its assistance on ten municipalities in the country which have the demonstrated commitment and resources to advance, both economically as well as democratically. Part of this assistance will help in educating local government officials about how to improve the local environment for small and medium enterprises, attract investment, and strengthen the participation of businesses and non-governmental organizations in development efforts.
- In Albania, USAID assistance has helped in the formation of a national association of private farmers. This association has become an important advocate for reform of the legal regime which affects farming and the agribusiness sector.
- In Poland and Bulgaria, USAID has played a key role in supporting the introduction of collateral law and the establishment of property registries, reforms which are vital to streamlining private sector transactions.

BUREAU FOR LATIN AMERICA AND THE CARIBBEAN

Support for microenterprise and small business development is one of the key action items under the Summit of the Americas. Small businesses play a major role in contributing to output, employment and the sharing of economic benefits within the region's economies.

USAID's support for small business in Latin America takes three forms: (1) technical assistance and training projects for microenterprise; (2) support for agribusiness cooperatives, often with a view to bolstering non-traditional exports; (3) institutional strengthening projects which channel small business technical assistance and training through local trade associations and small business groups, thus helping bolster sustainable institutions in the process; and (4) policy projects which, by strengthening developing countries' enabling environment, create a more favorable business climate for the growth of small enterprise.

At the country level, small business programs take a variety of forms. Some examples include:

- In Bolivia, for example, some 60,000 small entrepreneurs have taken out loans totalling \$30 million and they have paid them back. The **Bolivian Bank**, created through USAID's support, is now self-sustaining with a \$60 million portfolio and extends more loans than any other financial institution in the country.
- Ecuador: USAID/Ecuador provides \$3 million to **Fundacion Ecuador** which has produced studies and agreements with the government to both liberalize foreign investment regulations as well as to deregulate state restrictions on microenterprise growth.
- Honduras: The \$6.5 million **Small Farmer Agribusiness Development Project** has directly affected some 2,800 farmers with administrative and financial strengthening of local agribusinesses.
- Jamaica: The \$2 million **Small Business Export Development Project** provides technical assistance, training and market information services to small businesses and agricultural producer groups while simultaneously improving the Jamaica Exporters Association's capacity to effectively deliver services to its members.
- Guatemala: The **Private Enterprise Development Project**, among other activities, has supported creation of a management training center for small businesses, and its graduates have formed an association to mutually support each others' efforts. The mission's Cooperative Strengthening Project has promoted technical and policy reforms which have led to increased access to credit by small businesses.

ENDNOTES

1. Considering the World Bank and OECD definitions, it is not unreasonable to include firms with up to 100 workers, but also taking into consideration dimensions such as technology, managerial techniques, human resources, relations with the external environment, and the characteristics of the industry in which the firms are operating.
2. An analysis of black entrepreneurs in Zimbabwe, other than those in the service or microenterprise sectors, two thirds of the sample had previous experience before establishing their own firms, and eighty percent of those had 10 years or more. Ralph Bradburd and Brian Levy, "Zimbabwe's New Entrepreneurs: An Emerging Success Story?" Regional Program on Enterprise Development, World Bank, October 1995, p.7.
3. In five African countries, nearly a quarter of all micro and small enterprise employment had come from enterprise expansion, and the increase in employment in micro and small enterprises averaged 43% of the increase in the labor force. Donald C. Mead, "The Contribution of Small Enterprises to Employment Growth in Southern and Eastern Africa," *World Development*, Vol. 22, No. 12, 1994, p. 1887.
4. C. Liedholm and D. Mead, *Small Scale Industries in Developing Countries: Empirical Evidence and Policy Implications*, MSU International Development Paper No. 9 (East Lansing, Michigan: Dept. of Agricultural Economics, Michigan State University; 1987), p. 89.
5. Liedholm and Mead, pp. 20 and 83.
6. Donald R. Snodgrass and others, *Industrialization and the Small Firm: Patterns and Policies*, final report to USAID of the Employment and Enterprise Policy Analysis Project (Cambridge, MA: HIID; 1994, and forthcoming in published form), p. 36..
7. In their discussion of farm-nonfarm linkages, Steven Haggblade, Peter Hazell, and James Brown report, building on similar findings in Asia, "If rural nonfarm enterprises are to achieve their full potential for income generation and economic decentralization, policy makers will need to redress common pro-urban policy biases." "Farm-Nonfarm Linkages in Rural Sub-Saharan Africa," *World Development*, 1989, pp. 1173-1201. This is similar to the conclusions of the World Bank's *World Development Report 1991: The Challenge of Development*: "A clear lesson of experience is that high productivity in agriculture is especially important for industrialization and growth -- and is feasible [p.72]."
8. "Capital-intensity" is used here in the sense of the capital-to-labor ratio, and "labor-intensity" in the sense of the ratio of labor-to-output. For related evidence, see Snodgrass and others, p. 34-36, and Liedholm and Mead (1987), p. 65-67.
9. The countries surveyed were Botswana, Kenya, Malawi, Swaziland and Zimbabwe. Donald C. Mead, "The Contribution of Small Enterprises to Employment Growth in Southern and Eastern Africa," *World Development*, December 1994, p. 1885.
10. Snodgrass and others, p. 43.
11. As did an ILO team in 1973, an HIID team visiting the Philippines in 1987 "noticed that the size distribution of industrial enterprises has a 'missing middle' many small enterprises and quite a few large ones, but a paucity of medium enterprises. ... The team calculated that if a small enterprise was evading sales tax and paying its workers less than the minimum wage, it could easily face an 85% tax on marginal profits if it grew large enough to have to start paying sales tax and the minimum wage." See: ILO ("the Ranis report"), *Sharing in Development: a Programme of Employment, Equity and Growth for the Philippines* (Geneva; 1974); Snodgrass and others, work cited, p. 46-7 and chapter 6; and more concise discussion in Robert C. Young,

"Enterprise Scale, Economic Policy, and Development: Evidence on Policy Biases, Firm Size, Efficiency and Growth," ICEG Occasional Paper No. 52 (San Francisco, ICS Press: International Center for Economic Growth; 1994).

12. Snodgrass and others, p. 55.

13. See, for example, the World Bank's *World Development Report 1991*, e.g., pp. 1 and 8-9; David Lindauer and Michael Roemer, *Asia and Africa: Legacies and Opportunities in Development* (San Francisco: ICS Press; Harvard Institute for International Development and International Center for Economic Growth; 1994), e.g., pp. 12+, 99+, and 243+; and the UNDP's *Human Development Report 1993*, pp. 30+, all of which refer, for example, to the importance of stable macroeconomic and liberal foreign trade policies.

14. See Carl Liedholm and Donald C. Mead, "The Dynamic Role of Micro and Small Enterprises in the Development Process," GEMINI Action Research Program 1: Final Report to USAID (Bethesda, MD; Development Alternatives, Inc.; September 1995), and Lisa Daniels, Donald C. Mead and Mull Musinga, "Employment and Income in Micro and Small Enterprises in Kenya: Results of a 1995 Survey," a report to USAID (Bethesda, MD; Development Alternatives, Inc.; September 1995).

15. With a recent series of Sub-Saharan political-economic tragedies well in mind (e.g., Liberia, Somalia, and Rwanda), the director of the Bureau for Africa's Office of Sustainable Development, an economist, has stressed the importance of the political dimension to development: "The fundamental issue is governance, and if democracy or political liberalization does not lead to improved governance, then development will not succeed." Jerry Wolgin, "New Wine, New Bottles: A New Paradigm for African Development," in "USAID Presentations at the African Studies Association Meeting, Toronto, Canada, November 3-6, 1994," (USAID, Bureau for Africa, Office of Development Planning, 1994), p. 12.

16. Of course, a variety of policies provide vital energy to the production and transaction process, including policies in human resources, infrastructure, communications, legal, regulatory and judicial systems, democracy, and governance. Nevertheless, because surveys reflect the importance of finance to small and large enterprises, financial policies are given extra space here.

17. For a relatively thorough discussion of policy biases and their impacts on enterprises and their scale, see Snodgrass and others, work cited, or the more concise discussion and references in Robert C. Young, work cited.

18. See footnote 4 for comments on the role of agriculture in economic growth. Findings such as Steven Block and Peter Timmer's are central to such discussions: "...the realization that agriculture is central to the growth process of developing countries is relatively recent. ... the growth effects of public investment in agriculture are substantially greater than those from investments in non-agriculture." "Agriculture and Economic Growth: Conceptual Issues and the Kenyan Experience," CAER Discussion Paper (Cambridge, MA: Harvard Institute for International Development; 1994).

19. G/EG/MD, "What Are Microenterprises and What Activities Does the USAID Microenterprise Initiative Support?" [n.d.], p. 2. With regard to financial services for small businesses, as pointed out in the earlier discussion of financial markets, the best strategy is a set of financial policies yielding substantially more competition in the banking sector, so that commercial banks become the main source of external small business credit. As indicated, such policies would be led by free entry for any bank meeting appropriate standards of capital adequacy, with upgraded skills for bank regulators/supervisors.

20. Snodgrass and others, work cited, p. 55.

21. In Taiwan, for example, part of the credit for its rapid emergence into a modernizing economy is given to its variety of supporting institutions providing information concerning efficient training, technology and markets. See the brief discussion of the Taiwan case in Young, work cited, or the more elaborate discussion in Snodgrass and others.

22. "CIPE" has sometimes found itself frustrated in trying to build healthy business associations and in several instances has found an effective alternative to be building "think tanks" to research and dialogue on such reforms.

23. Robert Peck Christen, Elisabeth Rhyne and Robert C. Vogel's, "Maximizing the Outreach of Microenterprise Finance: The Emerging Lessons of Successful Programs," report for USAID/G/EG by the Harvard Institute for International Development's CAER Project, January 1995.

24. Advisory Committee on Voluntary Foreign Aid, "International Development and Private Voluntarism: A Maturing Partnership," (ACVFA; 1993), p. 9.

25. ACVFA, "Responding to Change: Private Voluntarism and International Development," 1990 Report, p. 36.

26. The International Center for Economic Growth (ICEG), with its worldwide network of 300 or so correspondent policy institutes, largely in developing countries, newsletters, regional conferences and distribution of distinguished author publications, has also been praised by USAID's regional bureaus for policy reform networking and information dissemination. ICEG has effectively promoted reforms by using highly participative public fora and expert exchanges; with experienced and well-known participants from a cross-section of perspectives from countries with demonstrable successes.

27. Larry Cooley, in the Participation Forum, "Topic: Participation in Policy Reform," Session 3, April 21, 1994, summary (Washington, D.C.: USAID/PPC).

28. Christen and others, work cited.

29. Contractors for the projects are: Management Systems International (MSI) for both IPC and the "Network," Institute for Contemporary Studies for ICEG, the University of Maryland's IRIS Center for IRIS, the U.S. Chamber of Commerce for CIPE, and the Harvard Institute for International Development for CAER.



