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The Impact of Classification on Policy

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Abstract

This paper outlines a system of classification that will be useful for analyzing and determining direct intervention and policy support to promote small enterprise development. Each of the three categories in the model represents a major subgroup along the small enterprise continuum -- survival activities of the poorest, microenterprises and small-scale enterprises. Each category suggests its own particular approach for direct intervention and policy support programs. Community development approaches for poverty alleviation are best suited for the survival group. Low levels of group-oriented credit and technical assistance are the usual programs for the microenterprise group, while individually targeted business development support characterizes the majority of small-scale enterprise development programs. Barriers to growth from each category to the next larger category are significant. Preliminary empirical evidence indicates that there is little natural growth out of a category to its larger neighbor. Policy support options should be similarly targeted for each category. The survival sector needs economic policies that encourage broad-based economic growth and provide incentives to raise rural, non-farm incomes. Microenterprise development is spurred by policies that increase aggregate demand for products in rural markets, eliminate bias in trade policies, encourage proper valuation of currency and reduce or eliminate administrative and regulatory bottlenecks. Finally, policies beneficial to small-scale enterprises are those that reduce penalties on graduation to the formal sector and those that provide incentives for growth into medium-sized businesses.

I. Introduction

In the past ten years, as we have worked in the field of small-scale and microenterprise development, all of us have spent a significant amount of time arguing over definitions in our work. How do you measure the size of an enterprise? By number of employees, assets, sales, location of workplace, participation of family labor, etc? Of what importance is it if a firm is in manufacturing, commerce, transport or other sectors? After all of the discussions that have taken place, we still find ourselves without any universal answers to our questions. Each person or organization has developed its own concept of small enterprise and works accordingly. It appears that despite the definitional differences, however, most of us still can recognize a small-scale enterprise when we see one. What is the problem then?

Obviously, there is differentiation in the field. Each enterprise has characteristics that make it different from its neighbor. Yet the human mind has a need to make order out of chaos. This need arises from the desire to understand and react to phenomena and eventually to influence them. We classify in order to simplify the multitude of choices; then, for analytical purposes, we use these classifications or models, rather than the existing, unordered reality.

However, our classifying of reality is not static. It changes as we gain further experience and understanding of the limitations of the models that we have constructed. As new data are accumulated, we are forced to alter our models or build new

ones. For those of us involved in the field of economic development, our thinking has changed significantly over the past two decades as we looked at small-scale enterprises.

Originally -- in the dark ages before the ILO studies in the '60s and '70s -- with the exception of Staley and Morse and very few others we saw nothing but an undifferentiated mass. When we discussed the major economic activities of developing countries, small-scale enterprise was relegated to the inconsequential activities of the poor. As time has gone by, the activities that the poor have engaged in have not changed as much as our perception of those activities. Through the major research efforts of these past decades -- the ILO/World Employment Program, Michigan State University, UN/Netherlands RSIE, etc. -- we have gained an increasingly broad and systematic understanding of the full dimensions and of the heterogeneity of this sector, and of its impacts on the economies of developing countries. The process of our intellectual development in this area in many ways has been one of using research and demonstration projects to enlighten ourselves in what was at least intuitively an interesting area for inquiry, gradually revealing an ever more complex landscape with far broader and deeper linkages into national economies, household survival strategies, and genuine broad-based economic growth than we had ever begun to imagine.

These introductory comments are intended to point out that we venture into this discussion of classification with humility and a realistic appreciation for the usefulness and limitations

of constructing models of the reality we are trying to study, and as donors, ultimately to affect. For whatever categories we may choose to use for analyzing SSE, we are bound to come up with exceptions. Moreover, with the acquisition of future knowledge we know we will wish just as certainly to repudiate whatever generalities we think we are "discovering" today.

The urgency of the need for a framework within which to classify and order our thinking about micro- and small-scale enterprise (MSE) development derives from the diversity in the origins of our current interest in the subject. James Boomgard¹ captures this diversity nicely:

"[In the 1970s, while searching for alternative strategies to 'trickle-down' development] with greater prospects for employment generation and far more equitable distribution of benefits, the experts began looking seriously at the potential of small-scale, labor intensive enterprises in both rural and urban areas. Small enterprise began to attract a growing amount of attention through a variety of approaches and with a variety of names -- cottage industry, household industry, the informal sector, Z-goods, the intermediate sector, appropriate technology and technological choice, and rural non-farm employment to name but a few. The approaches were similar when compared to the orthodoxy of development economics at the time. They shared a common interest in equity, but differed in their emphasis on growth versus employment and on what could or should be done to realize their implied objectives. Nevertheless, all were affected by the fact that there was little concrete evidence to document either the development importance of small- and microenterprises or the options for improving their performance through policies or programs."

A reflection of this diversity in the why of MSE is the heterogeneity of the what of the MSE sector, in terms of size,

¹ Boomgard, James, et al. "A.I.D. Microenterprise Stock-Taking Desk Study" (Draft). U.S. Agency for International Development, February, 1989, p.8.

subsector, industry, location, technology level, linkages, entrepreneurial content, etc. As different as MSEs are from one another in all these respects, so must our approaches to promoting them -- directly or indirectly-- be differentiated.

In this paper our goal is to outline a system of classification that will be useful for analyzing and determining direct interventions and policy support for SSE. The model we shall use, which breaks down micro- and small-scale enterprises into three categories, is based on ideas developed in the position paper prepared for this workshop, as well as some new conceptual work being done under contract for USAID to generate a wholistic profile of AID's worldwide small-scale and microenterprise development program.²

II. Classifying Approaches to MSE Development

In view of the diversity found in the MSE sector described above, it is not surprising that donors have settled on a variety of approaches to promoting MSEs, have chosen to work with differing targets and subgroups, and have adopted numerous objectives for these projects. Collectively, the list of assistance options includes provision of: 1) services to MSEs such as training or technical assistance; 2) resources such as credit; 3) capacity building among institutions that retail these services/resources; and 4) policy/administrative reform

² Boomgard, et al, op. cit.

initiatives at both the sectoral and macro levels. A particular project, however, attempts to deal with a narrower focus, responding to unique business needs and a particular resource and policy environment. The framework described below classifies three general approaches to MSE development, differentiated essentially among only two criteria: developmental goals and target population. It is based on categorizing MSEs along a continuum of three categories: 1) survival activities of the poorest; 2) microenterprises; and 3) small-scale enterprises. Each will be discussed below, followed by the implications that they hold for direct interventions and policy support.

Survival Activities of the Poorest

The first category comprises persons commonly referred to as the poorest of the poor. These are people that are engaged in economic activities that provide the barest means of survival. They participate in very few productive activities, other than providing for some minimal means to keep themselves and their families alive. They occupy the extreme lower echelon of the informal sector where in many cases the only barrier to entry to this category is the marginality of the economic return for their efforts that would keep anyone with other choices from choosing this option. The income that they may earn is clearly not enough to provide for any investment in their families (human capital), homes or economic activities. This group might be called pre-entrepreneurial, although it is important to note that they are

involved in some form of economic activity. Since few developing countries have social security systems that will provide a safety net of last resort under these people, they have to engage in some form of income-generating activities to survive. The under-employed, overly abundant hawkers and vendors of most LDCs, subsistence farmers and many women's household activities would fit in this category.

These people are kept out of the microenterprise or otherwise more economically substantial sectors by a number of barriers to entry. These include: lack of skills, lack of experience or opportunity to gain experience, lack of financial resources, cultural/social barriers/norms, and lack of access to markets. In addition, this is the category in which will be concentrated a number of other people that Malcolm Harper³ noted are often excluded from the economic mainstream in a given country, including, e.g., refugees, the disabled, ex-offenders, women in some societies (simply because they are female, apart from other economic characteristics), or minority groups.

Microenterprises

The microenterprise group forms the next classification. For our purposes, microenterprises have the following characteristics: They employ roughly 10 or fewer full-time

³ Harper, Malcolm. "Training and Technical Assistance for Microenterprise." Paper prepared for the June 1988 International Conference on Microenterprise, Washington, DC.

workers. According to the Michigan State University studies⁴, they represent the largest percentage of employment in manufacturing in developing countries -- from 42 to 90 percent. The largest category of microenterprises -- from 42 to 68 percent -- are the family-based firms with a single worker. The smaller workshops are usually located in the home. The technology used is often traditional, based on widely existing technical knowledge, existing labor skills and existing raw materials supplies. Markets served typically are local.

The activities in this sector often correspond with the ILO version (rather than the Hernando de Soto version⁵) of the informal sector, although they are normally unregistered and seldom pay taxes or are regulated. Microenterprises are found extensively in rural settings, accounting for over fifty percent of rural manufacturing employment in many developing countries. In urban areas microenterprises are equally common, and frequently account for the majority of employment in the retailing, services and transportation sectors.

The threshold downward from microenterprise to survival is very permeable to the smallest and least economically capable members of this category. Bad economic times, family illness and

⁴ Liedholm, Carl and Mead, Donald. "Small Scale Industries in Developing Countries: Empirical Evidence and Policy Implications", MSU International Development Paper No. 9, 1987. Data references elsewhere in this section are from the same source.

⁵ de Soto, Hernando. The Other Path. (New York: Harper and Row, 1989.)

death, business failure, etc., may bring a household quickly back to the survival sector. The barrier to the small-scale enterprise category is more enduring. The barriers to entry here are the difficulties in amassing the particular resources necessary -- human capital, financial capital, market access, technology and overall business experience -- that are needed to operate a slightly larger, more dynamic business.

Small-Scale Enterprises

The final category for this discussion is that of small-scale enterprises (SSEs). SSEs are defined as businesses with roughly ten to fifty workers. Their contribution to employment in manufacturing is generally smaller than microenterprises, from 1 to 26 percent. Since these are larger firms, they depend more on hired workers who labor in workshops located away from the owner's home. More often small enterprises use some non-traditional or "modern" technology in some aspect of the transformation process. The products and services may range from simple to complex and similarly span a range of consumer types. The marketing patterns may be somewhat more complex, reflecting innovation in raw material procurement or in output sales.

Small-scale enterprises may be more economically efficient than microenterprises. Liedholm and Mead report that a direct relationship exists in some manufacturing industries between firm size and efficiency when firms of under 50 workers are compared. Returns per hour are lowest for one person firms in selected

industries in most countries they reported on. Within the small-scale enterprise sector, these returns consistently rise as the number of workers increases.

Small-scale enterprises are often viewed as being either formal or, more likely, on the margin of the formal sector. They may pay some taxes or be registered with the municipality. With increased size, they become more obvious, both to customers and suppliers and to government. Small-scale enterprises tend to be more urban-based than rural.

In the case of the small-scale enterprise category, the threshold between it and the microenterprise category may be somewhat fluid, particularly once an entrepreneur gains experience. Downturns in the economy may cause reductions in firm size, growth and profitability, but since the entrepreneur is not perched as closely to the edge as those in the microenterprise sector, the business is likely to have more resources to bounce back. Growth past the upper threshold requires an accumulation of resources as well as the appropriate incentives for business expansion. This point will be discussed in more detail later in this paper.

The three disaggregated categories of the low end of the enterprise continuum described above of course will contain some overlaps. Similarly, this classification also oversimplifies reality to an extent, and other factors may play an important role in different settings. These include: rural/urban location,

fundamental economic, institutional and cultural differences within and across countries, and sectoral/sub-sectoral differences. However, for the purposes of this paper, these three categories possess sufficient precision and uniqueness to sustain the basic points we wish to make. The next sections discuss the different strategies one would use in direct interventions and policy support based on these categories.

III. Direct Interventions

The purposes for making direct interventions to MSEs may run the gamut from basic employment and income generation, to enhancing business access to markets and technologies, to improving overall business productivity and efficiency and contribution to economic growth and national development. Importantly, one often observes in donor projects the objective of helping enterprises "graduate" from one class to another. While this objective may be a good one -- it is arguably one of the bases on which to build a sustainable economic growth dynamic -- in reality we are learning that systematically and willfully fostering graduation is much more difficult to accomplish than we first hoped. In fact the whole issue of limits to transition capability between the classes identified above will be seen to be the ultimate determinant and constraint on donor options for intervening in the MSE development process.

Viewed separately, each of the three categories of enterprise activity suggests its own particular approach for

intervention. Using Boomgard's terminology, the survival sector may be assisted by a community development approach; the microenterprise subset may profit most from a "marginalist" or "incrementalist" approach; and small-scale enterprise needs a proper business development approach. Differentiation into these three approaches will give us a means for clarifying much of the discussion that takes place regarding the right way to assist the various distinct categories comprising this sector, and, with luck, might even be useful for defining limits and providing direction for project and program design.

Community Development Approach

The goal of the community development approach is poverty alleviation and community growth. It is concerned with issues of broad social and economic development, usually within a specific locale or class within a society. Given the survival level of the participants, income generation in general -- rather than employment or productivity growth -- is a key focus in dealing with this group's economic needs.

Generally, community development approaches comprise integrated programs of social infrastructure development, credit, low-level technical assistance, and educational inputs (such as literacy and numeracy training). Much of the emphasis is on community projects that will benefit larger numbers of the population. Other components of these programs may include efforts specifically addressed to meeting basic human needs

requirements.

The income generation aspects of the community development approach may take several forms. Since many of the participants are considered pre-entrepreneurial, they are often given specialized training in job skills. In addition, some form of cooperative or group enterprise formation is often part of the program. However, as Jeffrey Ashe has pointed out, these types of enterprises are the most difficult to develop and costly to maintain in the long run.⁶ They have grave implications for donors in terms of recurrent cost finance requirements.

Enterprise development in this context seems to be more natural when it is focused on the experiences and resources that exist in the community. Many successful targeted women's projects often start with animal raising or food processing activities. These projects build on the margin of existing experience of the participants. Since they are smaller and incremental they are less apt to run into marketing and coordination problems that larger cooperative projects often face. However, depending on the locale, even these projects sooner rather than later often begin to encounter diminishing returns as market access and raw materials become constrained and/or new entries compete away capturable economic surpluses.

⁶ Ashe, Jeffrey. The PISCES II Experience: Local Efforts in Micro-Enterprise Development. (Washington, DC: Agency for International Development, 1985).

Community development programs usually have high costs per participant and are rarely self-sustaining if run by outside PVOs or NGOs. Some local grassroots approaches, such as the Sarvodaya movement in Sri Lanka, or the Bhoomi Sena in India's hill country, have been able to show significant accomplishments at lower unit cost levels. The credit program of the Grameen Bank of Bangladesh uses what they call a social development approach to their lending. They combine small initial loans (\$1 to \$10) with simple community development education (the so-called fifteen rules). In this way, they have reached women in the survival category quite effectively and in what appears to be a sustainable manner.

Graduation to running a microenterprise in some of these interventions is often an unstated goal. In others, such as the Grameen Bank Program, it is positively eschewed. However, given the costs involved in running a community development program and given the often marginal human capital, market and natural resource environments where they tend to be required, few such enterprises are ever seen to develop. The results, while not insubstantial in social and economic terms for the participants, are often harder to detect in broader economic or business development terms.

Marginalist/Incrementalist Approach

The marginalist/incrementalist approach is more focused than the community development approach on the particular needs of the

microenterprises. The overall goals of such an approach are to increase incomes and maintain jobs in microenterprises. In some cases there may be an expectation of increases in employment through new job creation, although this may be downplayed in some programs in relation to job maintenance.

There has been a variety of approaches developed for microenterprise assistance over the years. These approaches range from training and technical assistance alone on one end to credit alone on the other, with any number of combinations of the two (plus supporting institutional capacity-building) in between.

Owing to the costliness of technical assistance and training, and because of difficulties in demonstrating cost-effectiveness of such expenditures, much of the current thinking on microenterprise development seems to favor the so-called "minimalist" approach. In a minimalist program -- such as the Indonesian BKK or Accion/AITEC's programs throughout Latin America -- the emphasis is predominantly on credit, both through group and individual loans. In these programs, short term working capital loans of \$50 to \$1500 are given at market interest rates. Since the problem for the micro-entrepreneur is more often access to capital rather than cost of capital, the interest rates in these programs are set at market rates or higher. This helps to guarantee the financial sustainability of the program.

The Accion model uses group lending, solidarity groups and similar peer pressure mechanisms as the means to guarantee

repayment of the loan funds. These peer groups develop their own working procedures, leadership and programs. Group lending is more common at the lower income end of the microenterprise category and often incorporates some of the characteristics of the community development approach.

For businesses that are more well-developed and which employ other than family members or more than one or two employees, these projects frequently disburse credit to micro-entrepreneurs on their own (i.e., outside a group context), usually on the strength of a character-based rather than collateralized guarantee. This characteristic, shared with the business development approach, concentrates efforts on individuals, and attempts to respond to the needs of the business, rather than to those of a class of people. However, unlike in the business development approach, most lending, even among more viable microenterprises, is for working capital rather than lending for investment in fixed plant and equipment.

Graduation from microenterprise status to the small enterprise level seldom is seen to occur as a result of project effort; rather it appears to result more out of natural selection. Nevertheless, within their own "incrementalist" terms of reference, many firms have been shepherded through a limited growth process, have developed an increased ability to handle larger and larger loan sizes, and have also shown a continued maintenance of jobs and some small increases in new jobs. Still, since comparative data are not kept on unassisted firms, and

since some assisted firms (as may be expected) do not prosper along with the best performers, and most importantly, since graduation through the threshold into the dynamic small business category seems so rare, one must be circumspect in judging the overall cost-effectiveness of this approach.

Business Development Approach

The business development approach is perhaps the oldest one used in small enterprise development. Its goal is to increase employment generation and income growth through promoting businesses into a sustainable growth dynamic. On an individual basis, it hopes ultimately to graduate clients to the formal sector and the institutions that exist there.

More so than the microenterprise approach, the business development approach provides its beneficiaries a concentrated, individualized package of technical assistance, training and credit resources. The national development foundation approach in Latin America and the Caribbean offers credit of up to \$5,000 to \$6,000 along with classroom training in business-related skills -- accounting, marketing, technology assessment and business management. Oftentimes, individualized technical assistance is available to overcome particular problems of that enterprise or subsector of enterprises.

Credit is a more important component of business development programs that deal with firms closer to the microenterprise end of the scale. As the firms gain more experience with using

larger amounts of credit and develop a credit history, many are able to access commercial credit from the formal banking system. In Honduras, local banks with surplus liquidity in search of new business borrowers contacted the small business development organizations for referrals of potential customers. Once a business hits this size, it is often to its advantage to use commercial credit because the terms frequently are longer and interest rates lower.

The Carvajal Foundation offers only limited amounts of credit and instead focuses on a comprehensive thirteen-week training and follow-up technical assistance program. In working with larger small and microenterprises, their approach features training in business management skills as the key to creating successful enterprises. The follow-on, individualized technical assistance helps the entrepreneur in the workplace, and deals with the specific problems that he or she is confronting.

At the larger end of the small business development spectrum, programs practice a greater degree of selectivity in choice of clients. Feasibility proposals and other types of studies and references often are prerequisites for obtaining loans. These programs have greater costs per participant which often are justified by the potential of greater benefits. However, due to the high costs per beneficiary, ultimately fewer firms can be assisted in a given year and program sustainability can be threatened by a relatively low number of defaults on the credit side.

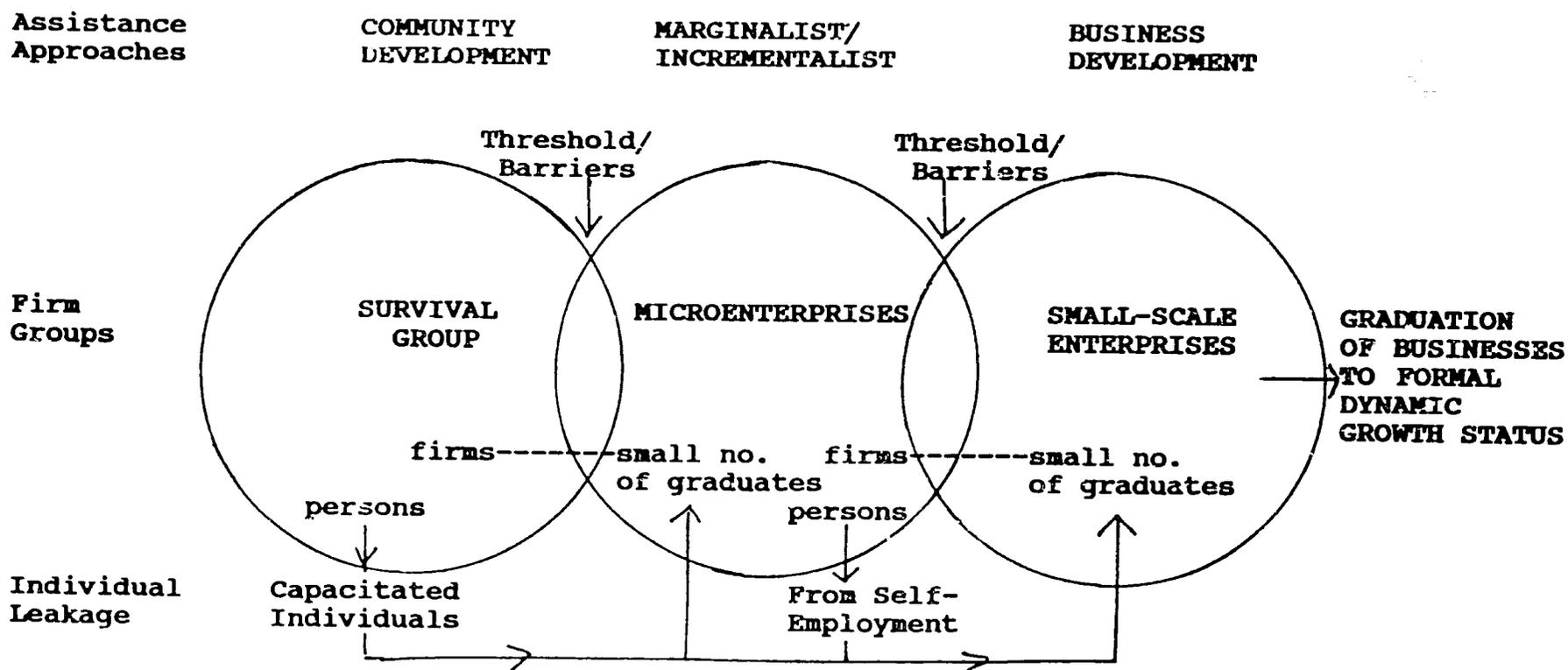
Like other MSE development programs, those business development programs that focus on one or two objectives and attempt to use market forces rather than fight them off appear to be more successful. The industrial estates concept is one example of too comprehensive an approach which tends to have a high failure rate and is unsustainable in the long run. The Carvajal program, which charges participants for the majority of the cost of the training and technical assistance that they receive, is more sustainable.

Integration of the Framework

Figure 1 illustrates the relationships among the above three size categories. The three small circles represent respectively the survival, the microenterprise and the small-scale enterprise categories. What is most important to note is that while there exists some overlap at the margins of these three subgroups -- as explained above -- for the most part the boundaries of each circle where it intersects its neighbor represent thresholds which are protected by barriers to entry. Some project approaches are specifically designed to bridge these barriers, as in the case of attempting to make community or social investments among survival group members in order for them to develop into micro-entrepreneurs or to "leak" out of the system as skilled employees of larger businesses, or attempting to graduate SSEs into the dynamic, growth-oriented formal sector.

On the other hand, the marginalist approach seeks primarily

Figure 1. Classification of Enterprise Development Approaches



Community Development: Strengthen survival group in place, and to maximum extent propel them toward larger firms as more capable wage-workers and as embryonic firms across the threshold into the microenterprise group.

Marginalist/Incrementalist: Strengthen majority as microenterprises while using low-cost business development interventions to propel more capable microenterprises across threshold into SSE category.

Business Development: Relatively more costly interventions to begin formalization, gain access to formal institutions, enter into growth dynamic.

to improve performance and efficiency of microenterprises as microenterprises, which leads to the often-seen preference for sustaining assistance such as credit. Credit on its own can foster growth up to frontiers bounded by more expensive interventions such as new technology acquisition, professionalism of management and new market development -- inputs for the most part best allocated to SSEs potentially possessing relatively more dynamism.

As indicated above, the boundaries/thresholds are generally only semi-permeable; it is much easier to fall back to a previous category than it is to grow out of any particular one. Especially given the precariousness of life in the survival and microenterprise groups, one would expect to find more fluidity in these thresholds. As the enterprise grows and is more able to exist as an entity apart from the household economy, it gains further stability. Even so, all small-scale enterprises (as many larger firms) are dependent upon the entrepreneur/manager, and the fate and future of the enterprise rests upon the serendipity of this person's health, wisdom and commercial/market instincts.

Different types and combinations of institutions are called upon to deliver the different service and other support packages corresponding to these three approaches. Donor projects which provide resources, strengthen intermediary institutions concerned with these respective target groups, and address policy and other environmental constraints (see below) will likewise differ in accordance with the different objectives and group needs

suggested by the framework.

IV. Recent Findings on Growth and Barriers to Entry

Much of our knowledge about micro- and small-scale enterprise comes from static, cross-sectional studies of the sector. Although much valuable information has been gained from these studies, we know little about the crucial birth, transitional, and death processes of enterprises that define the dynamic dimensions of life in this sector. A recent study from Michigan State University, conducted by Liedholm and Parker⁷, has given us some first pieces of documentation and some new insights in this area.

Liedholm's survey and analytic work on non-farm small-scale manufacturing has covered the full spectrum of enterprise, from self-employed/family/cottage industry on up to traditional SSEs and occasionally medium-scale industries. In an analysis of historical micro-data on individual firm growth, which heretofore has not been explored in the MSU survey data, Liedholm and Parker have determined that few enterprises naturally grew from micro to small to medium. For example, as Table 1 indicates, the large majority of microenterprises in African countries for which data are available remain in that size category. Relatively few are observed to graduate across the thresholds illustrated in Figure

⁷ Liedholm, Carl and Parker, Joan. "Small Scale Manufacturing Growth in Africa: Initial Evidence" (Draft, December, 1988). Cited with permission of the authors.

1. Similarly, the majority of small-scale and medium-sized firms do not grow out of a "seed-bed" of yet smaller firms, but tend to originate as larger firms. On the other hand, in India, with its longer history of proactive support for small-scale enterprise development and with a far more robust and dynamic economy than is found in most African countries, graduation was seen to be a far more frequent phenomenon.

Table 1. Origins of Modern Small and Medium Private Manufacturing Firms (with 11 employees or more)

Region/ Country	Year	No. of Firms in Sample	% Originated as Micro (< 10 employees)	% Beginning with 11 or $>$ employees
<u>Africa</u>				
Nigeria	1965	64	43.7	56.3
Sierra Leone	1975	42	30.1	69.9
Rwanda	1987	28	10.7	89.3
Botswana	1982	20	20.0	80.0
<u>Asia</u>				
India	1979	244	65.6	34.4
Philippines	1978	47	48.9	51.1

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Source: Adapted from Liedholm and Parker, op. cit., p.26.

The likelihood of growth also varied according to locale. In Sierra Leone growth within class -- not to mention across class-size thresholds -- was observed to be distinctly less frequent in towns under 20,000 people than it was in towns greater than 20,000. This pattern of greater enterprise growth as one moves from rural to urban areas appears to be related to the possibilities each environment offers. Barriers to growth

are most severe in rural areas and resources increasingly become somewhat more available in urban areas. Our observation that the survival category is generally located in rural areas -- while on the other end of the continuum, small-scale enterprises are found in urban areas -- is reinforced by this finding.

Growth from micro- to small-scale enterprise also apparently depends on the type of business. Seventy percent of machine tools, printing and shoemaking firms in India that are presently small-scale grew from micro-sized firms. Other industries report smaller growth rates.

Finally, within the microenterprise category, Liedholm and Parker report that in India, the larger microenterprises (those with 6 to 10 workers) are more likely to grow than the smaller microenterprises.

V. Policy Support

Maximizing the enabling environment while minimizing elements of policy and administrative hostility to micro- and small-scale enterprise development have emerged over the past years as fundamental building blocks and indispensable complements to direct technical assistance for increasing growth and development options for the sector. However, the goals of policy support must be carefully crafted in order to assist those enterprises that need it without harming other enterprises. In short, leveling the playing field must be the objective while at the same time not introducing any equally ill-advised or counter-

efficient preferences for MSEs.

Much is now known about biases that exist within the financial, economic, trade and regulatory frameworks that favor larger private and parastatal enterprises. However, in our enthusiasm for promoting MSEs we must be careful not to be instruments of the creation of new barriers to growth in other parts of the economy. In their assessment of the poor performance of the non-crony private sector in the Philippines, Biggs et al talk about the phenomenon of the "missing middle", i.e., the paucity of efficient, growth-oriented medium-scale enterprises⁸. While there are many reasons for this distributional anomaly, some of the blame must be borne by policies that either favor small enterprises or otherwise inadvertently provide incentives to them to remain small, even when other underlying economic forces and technical efficiency signals are militating in favor of growth.

This issue is explored widely throughout the modern literature on policies in relation to business development. For this paper we wish to note at this point that the three small enterprise categories that we have been discussing each may have its own distinct policy set.

As with the respective direct interventions that may be appropriate for the three categories, different policy regimes

⁸ Biggs, Tyler, Levy, Brian, Oppenheim, Jeremy, and Schmitz, Hubert. "The Small Business Policy Direction Study", 1987, available from USAID, Washington, DC, Publication No. PNAAY168.

and approaches need to be developed to complement each. The next sections will discuss the policy implications that flow from the MSE classification used in this paper, focusing on aspects of the policy environment that are necessary for each, but which are also neutral with respect to the needs of the other sectors.

Policies for the Survival Sector

Policy options for the survival sector are broad-based and relatively non-specific. Essentially, those economic policies that encourage broad-based economic growth within a country are the policies that will affect this sector the most favorably. Only by increasing aggregate demand will the overall benefits be spread to this part of the economy.

Particularly in the rural areas, government policies that complement the community development approach will increase options. In most developing countries this will require policies that provide incentives to agriculture and which raise non-farm incomes and derivatively the demand for non-agricultural goods and services. Emphasis on policies that promote health care, education, infrastructure, transportation, and market development in rural areas are also likely to have positive results. Absent such a supportive economic and social environment, supply-side interventions directly focused on raising production or productivity in MSEs will be at best redistributive and more likely simply ineffective and non-sustainable.

In addition to general demand increases, urban-focused

policies, such as shelter, transportation, decentralization, etc., similarly can impact the urban survival sector, through opportunities for housing improvement, expanding markets for wage goods, and other "following" activities responding to the phenomena that accompany urbanization.

Finally, as a result of greater population demands, urban areas may experience scale or agglomeration economies which allow for lowering transactions costs in community economic development or pre-entrepreneurial assistance programs. Upgrading of human resources complementary to generally supportive urban policy initiatives can create a "bootstrap" synergy which enables more opportunity for "graduation" into sustainable microenterprises.

Policies for Microenterprise Development

According to Liedholm and Mead, expenditure elasticities of rural households for the products of small and microenterprises are quite high. Thus, to the extent they increase aggregate demand for products produced and available in rural markets, the policies that were discussed in the previous section will serve to increase incomes for micro-entrepreneurs, their families and employees.

Trade policies also may have an important effect on this sector, mostly negative. Import duties and quotas are likely to distort internal demand. These policies often are put into place in order to protect certain large industries in a country with little regard for their effect on the smaller ones. In addition,

import duties on consumer goods often penalize small producers which use such goods, purchased on dutiable secondary markets, while favoring larger businesses which import capital goods and raw materials duty-free for direct use.

Perhaps the greatest policy distortion that affects this group is overvaluation of currency. Overvaluation provides disincentives to domestic industries to produce because it makes foreign-produced goods cheaper. The negative impact at the margin on more fragile, and less import-intensive microenterprises is relatively much greater than for larger businesses that have a means of offsetting this distortion. A floating exchange regime will eliminate this effect to the advantage of the more numerous smaller businesses which use fewer foreign capital goods or raw materials.

Another aspect of the policy/administrative environment that affects microenterprises substantially, and which we have only recently begun to recognize fully, is the impact on all businesses -- but particularly smaller ones -- of registration requirements and other legal and property rights and procedures. Hernando de Soto has vividly documented for Peru the barriers placed in front of any business wishing to register and comply with the basic requirements of the law.⁹ In many (though not all) countries, regulations that permit the easier establishment of a business, that protect basic property rights and which

⁹ de Soto, Hernando. op. cit.

deliver businesses from certain forms of governmentally-imposed insecurities would facilitate the entry, growth and maturation of even the smallest microenterprises sustainably into the formal sector.

Policies for Small-Scale Enterprises

The policies that affect small-scale enterprises include many of those mentioned above plus others that more specifically relate to the growth dimension of SSEs. They generally fall into two groups: those policies that place penalties on, or inhibit graduation to, the formal sector, and those policies that affect growth to medium-sized businesses.

Biggs, Grindle and Snodgrass¹⁰ note the preponderance of firms on the edge of small-scale formal status that appear not to grow. As reported in the previous section, Liedholm and Parker more recently noted that in many African countries one does not see the growth from micro- to small-scale that one sees in parts of Asia. Both sets of authors attribute the blame to "lumpy" penalties that prevent graduation to the formal sector. These penalties are the very high costs that constitute the barriers to entry of registration and legalization. These barriers may take the form of high marginal tax rates and onerous registration requirements (ala de Soto), and the potentially dramatic

¹⁰Biggs, Tyler, Grindle, Merilee, and Snodgrass, Donald. "The Informal Sector, Policy Reform and Structural Transformation" USAID/EEPA Discussion Paper No. 14, July, 1988.

financial impact of sudden adherence to minimum wage and labor laws. As long as the business was small and not recognized, it was not covered by the above constraints or it simply ignored them. For example, in the Philippines, the marginal tax rate for a small business that entered the formal sector for the first time was calculated to be at least 85 percent.¹¹

The second category of policies of greatest concern to SSEs consists of those not necessarily related to the formal sector but which similarly affect the growth of businesses from small to medium size. Foremost are policies and laws designed to promote small enterprises by "favoring" them with special benefits and concessions such as tax exoneration, government procurement preferences, exemption from export/import licensing, etc. The penalty here, not just for the affected firms but for the economy as a whole, can be substantial, especially when firms perceive internal rewards for subordinating long-term vertical growth efficiencies to short-term pay-offs which accrue to them as a result of market distortions.

Finally, financial and economic policies that interfere with the performance of credit markets, otherwise misallocate scarce resources or provide interest rate subsidies, may adversely affect small-scale enterprises more than others. Since these enterprises must compete with larger, more powerful ones, policies that limit the availability of credit will affect them

¹¹Biggs, Grindle, and Snodgrass. op. cit., p.61.

the most. Unlike microenterprises whose needs are smaller and where formal credit plays a less important role, these firms cannot meet their credit needs through alternative means as easily. Therefore, when the crunch comes, they may be affected first.

VI. Summary/Conclusion

The classification of small-scale enterprises into the categories of survival, microenterprise and small-scale enterprise has given us a method for differentiating key underlying characteristics which in turn suggest "treatments" appropriate for dealing with their needs, both through direct, supply-side interventions and indirectly through policy and/or regulatory reform. Division into these categories also implies that there are no right or wrong reasons for supporting a particular group. Rather there are merely different reasons for assisting each of these subgroups, and the objectives of the assistance must relate both to the real constraints experienced by businesses in these groups and the sustainability of the short-term benefits that donor resource transfers and other interventions often appear to stimulate.

The model that we have outlined also provides a means of differentiating those programs which are designed to work within a category and those programs designed to stimulate firms to cross the critical thresholds between categories. By utilizing this differentiation, donors have a greater analytical ability in

matching their assistance strategies with the conditions in a particular time and place.

Given the appropriateness of matching strategies for assistance with needs and donor comparative advantage, this paper has not prioritized between direct interventions and policy/environmental reform efforts. It is clear that the policies that are the most helpful are those macro-policies which raise overall levels of demand in the economy, and, at a sectoral level, those which serve to level the playing field, rather than creating new distortions which favor other particular groups. Policies of the latter type are particularly important when the objective is to assist small enterprises. These policies should not inadvertently preclude growth into larger, more efficient enterprises.

A final point that bears repeating is that graduation is difficult, particularly in countries with stagnant economies, and may occur rarely if firms are not assisted. Even then, sustainability of gains is not always assured. This finding sounds a cautious note concerning the prospects for our ability as donors to influence the growth and graduation rates of enterprises. At the least, more studies of small-scale enterprise dynamics are needed to confirm this conclusion as well as studies of the effectiveness of intervention programs in helping to increase the natural success rates of enterprise growth across critical size thresholds.