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ARIES

Assistance to
Resource Institutions
for Enterprise Support

Honduras
A Small and Micro Enterprise
Development Strategy

Volume I

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Directed by

Robert R. Nathan Associates, Inc.

March 18, 1987

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Submitted to: USAID/Honduras

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of the author(s) and should not be attributed to the U.S.
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ARIES

Assistance to Resource Institutions for Enterprise Support

The ARIES project is designed to strengthen the capabilities of support organizations in developing countries to implement small-scale and micro-enterprise development programs. ARIES builds on the work of the Agency for International Development's former Program for Investment in the Small Capital Enterprise Sector (PISCES) and Small Business Capacity Development projects. It works with intermediary support organizations that provide services to small and micro-businesses and industries, such as private voluntary organizations (PVOs), banks, chambers of commerce, management training centers, business people's organizations, and other developing country government and non-governmental organizations (NGOs).

The contract for this five-year project has been awarded to Robert R. Nathan Associates, Inc. (RRNA) with subcontractors Harvard Institute for International Development (HIID), Control Data Corporation (CDC) and Appropriate Technology International (ATI).

ARIES is core funded by the Bureau for Science and Technology's Office of Rural and Institutional Development (S&T/RD) and the Bureau for Food for Peace and Voluntary Assistance's Office of Private and Voluntary Cooperation (FVA/PVC). Mission funded technical assistance represents \$3.8 million, or almost three-fifths of the five-year budget of \$6.8 million.

The ARIES project has three major components -- research, training, and technical assistance -- designed to cross-fertilize each other. The applied research component focuses on economic, social, and organizational issues surrounding intermediary support organizations to inform AID missions and host country actions in this subsector. The training component includes design, testing, conduct and follow-up of training programs in such areas as finance, management and evaluation for PVO and NGO personnel. The technical assistance component provides short-term technical assistance to AID missions and intermediary organizations to assist small and micro-enterprise development.

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LIST OF ACRONYMS

ANDEMI	Asociacion para el Desarrollo de Microempresas
ANDI	Asociacion Nacional de Industriales
ANMPI	Asociacion Nacional de Mediana y Pequena Industrias
ASEPADE	Asesores para el Desarrollo
BIP	Industrial Bank of Peru
CADEHSA	Consejo Asesor de Recursos Humanos
CADERH	Consejo para el Desarrollo de Recursos Humanos
CCIC	Camera de Comercio y Industria de Cortes
CDI	Centro de Desarrollo Industrial
CDI/PTR	Centro de Desarrollo Industrial Programa de Tecnologia Rural
CIDE	Centro de Innovacion de Desarrollo Empresarial
DF	Development Finance, USAID
DP	Development Programs, USAID
EAP	Economically Active Population
EEPA	Development and Enterprise Analysis Project

EPA	Economic Program Analysis, USAID
FEDECAMERAS	Federation of Chambers of Commerce and Industry
FEHCIL	Federacion Hondurena de Cooperativas Industriales, Ltda.
FIA	Financiera Industrial y Agropecuaria
FOPRIDEH	Federacion de Organizaciones Privadas de Desarrollo Honduras
FUNADEH	Fundacion Nacional de Desarrollo Hondureno
GEMAH	Gerentes Empresariales Asociados de Honduras
GOH	Government of Honduras
HIID	Harvard Institute of International Development
HRD	Human Resource Development, USAID
IDB	Inter-American Development Bank
IDEA	Instituto Daniel de Enseñanza Administrativa
IDH	Instituto para el Desarrollo Hondureno
INCAE	Instituto Centroamericano de Administracion de Empresas
INFOP	Instituto Nacional de Formacion Profesional
NGO	Non-Government Organization
ODEF	Organizacion de Desarrollo Feminina
OEF	Overseas Education Fund
PADF	Pan American Development Foundation
PCGP	Productive Credit Guarantee Program

PISCES	Program for Investment in the Small Capital Enterprise Sector
PSP	Private Sector Programs, USAID
RD	Rural Development, USAID
RDF	Rural Development Fund
REID	Research on Entrepreneur Identification and Development Project
SME	Small and Micro Enterprise
WWB	Women's World Banking

EXECUTIVE SUMMARY

Methodology

The Honduras Small and Micro Enterprise (SME) strategy was developed through the combined efforts of USAID Mission Staff, Robert R. Nathan Associates, Inc. (RRNA) consultants, and local consultants, including representatives from Accion/AITEC and PADF (Pan American Development Foundation). USAID staff from Private Sector Programs (PSP), Rural Development (RD), Human Resources Development (HRD), Development Finance (DF), Development Programs (DP), and Economic Program Analysis (EPA) participated in this effort. Through research, field work, and workshops, the team collected and analyzed a wealth of information to design this strategy.

Research and field work addressed the following factors:

- . Characteristics of the sector
- . Policies affecting SMEs
- . NGO and governmental agency coverage of the sector
- . institutional capacity to support SMEs, including NGO and governmental implementing

institutions, training and technical assistance agencies, and "second-story" organizations

- . USAID support of SMEs
- . Other bilateral and multilateral donor support of SMEs

In two half-day workshops, the team discussed findings, conclusions, and objectives, and devised alternative management approaches to support a comprehensive SME program.

Definition of the Problem

The principal economic and social problems facing Honduras in the 1980s are extreme poverty and high unemployment. Per capita income in 1984 was US\$700 and income distribution is among the most extreme in the region. Unemployment is currently estimated at about 25 percent of the work force.

Employment generation is the top priority of President Azonca's administration. The USAID Country Development Strategy Statement stresses employment generation as a major component.

Definition of the Sector

Characterized by small family operations, labor-intensive adaptive technologies, and a lack of access to financial, material, and human resources, the small and micro enterprise sector in Honduras differs by degree rather than content from informal sectors in other developing countries. In Honduras,

there are nearly as many definitions of the informal sector as there are institutions working with SMEs. Our research suggests a definition based on number of waged employees and fixed, movable assets:

- . Micro enterprise: one to 5 employees and under US\$10,000 in fixed, movable assets
- . Small enterprise: up to 25 employees and US\$25,000 in fixed, movable assets

Using this definition and a conservative estimate, approximately 78,400 firms currently operate in Honduras and employ over 229,800 people. This represents approximately 21 percent of the economically active population (EAP). In Tegucigalpa alone, the informal sector is estimated to employ some 48 percent of the EAP.

SMEs exist wherever a population demands goods and services. They predominate in areas of high population density and growth. In Honduras, the majority of SMEs are located in the "growth corridor," an open "S" curve that extends from the North Coast to the southern part of the country.

Rationale for Expanded Investments in Support of SMEs

Employment

In Honduras, 21 percent of the economically active population is employed by SMEs. Ninety percent of Honduran industrial firms are small- and medium-sized firms employing over 50 percent of the total industrial force.

Small manufacturing firms are more labor-intensive than the larger-scale firms: fixed capital per worker is US\$125 for enterprises with less than ten employees, and US\$2,684 for enterprises with 50 workers or more. When assisted, small and micro enterprises generate considerable employment, in addition to maintaining jobs. The latter is critical in Honduras, where 14,700 people lost their jobs in the industrial sector between 1980 and 1984.

The cost per job created tends to be lower in SMEs than in larger-scale enterprise. Cost per full-time job generated in Honduras ranges from US\$1,500 to US\$13,100 for SMEs and US\$10,000 to US\$30,000 for new medium- and large-scale industry.

Value Added

A comparison of small and large rural-based manufacturing firms, using comprehensive efficiency measures, demonstrated higher capital productivity in firms employing one to five workers, at 3.57 value added per unit of fixed capital, than firms employing over 50 workers, at 0.28 capital productivity. Firms employing 11 to 49 workers obtained even higher capital productivity at 4.38.

Financial and Economic Rates of Return

Among a sample of small-scale industrial firms financed by FIA, investments in each firm show attractive financial rates of return, ranging from 35 to 130 percent, and higher economic rates of return, ranging from 38 to 163 percent. Financial information collected on selected firms in the commercial sector indicates that these businesses are

financially viable and can offer attractive investment opportunities.

Income Enhancement

Project beneficiaries improve their income in real terms as a result of expanding existing SMEs. Aggregate SME sales are up, as are net profits.

Savings

Small and micro enterprises are an untapped source of savings mobilization. Levels of savings exceeding US\$18,000 over a five-month period were found among micro entrepreneurs who had never saved before in a formal institution.

Capital flight is a serious problem in Honduras. Small and micro entrepreneurs do not have the means to make foreign investments, nor do they have access to foreign bank accounts. Their savings and earnings are re-invested in the domestic economy, first into the enterprise, and then into education for their children and home improvements.

Women

Although no survey data are available, it is estimated that women make up at least 50 percent of the informal sector. Women predominate in the smallest and least profitable enterprises. As one moves up the scale from micro- to small- to medium-sized enterprises, the participation of women entrepreneurs declines dramatically.

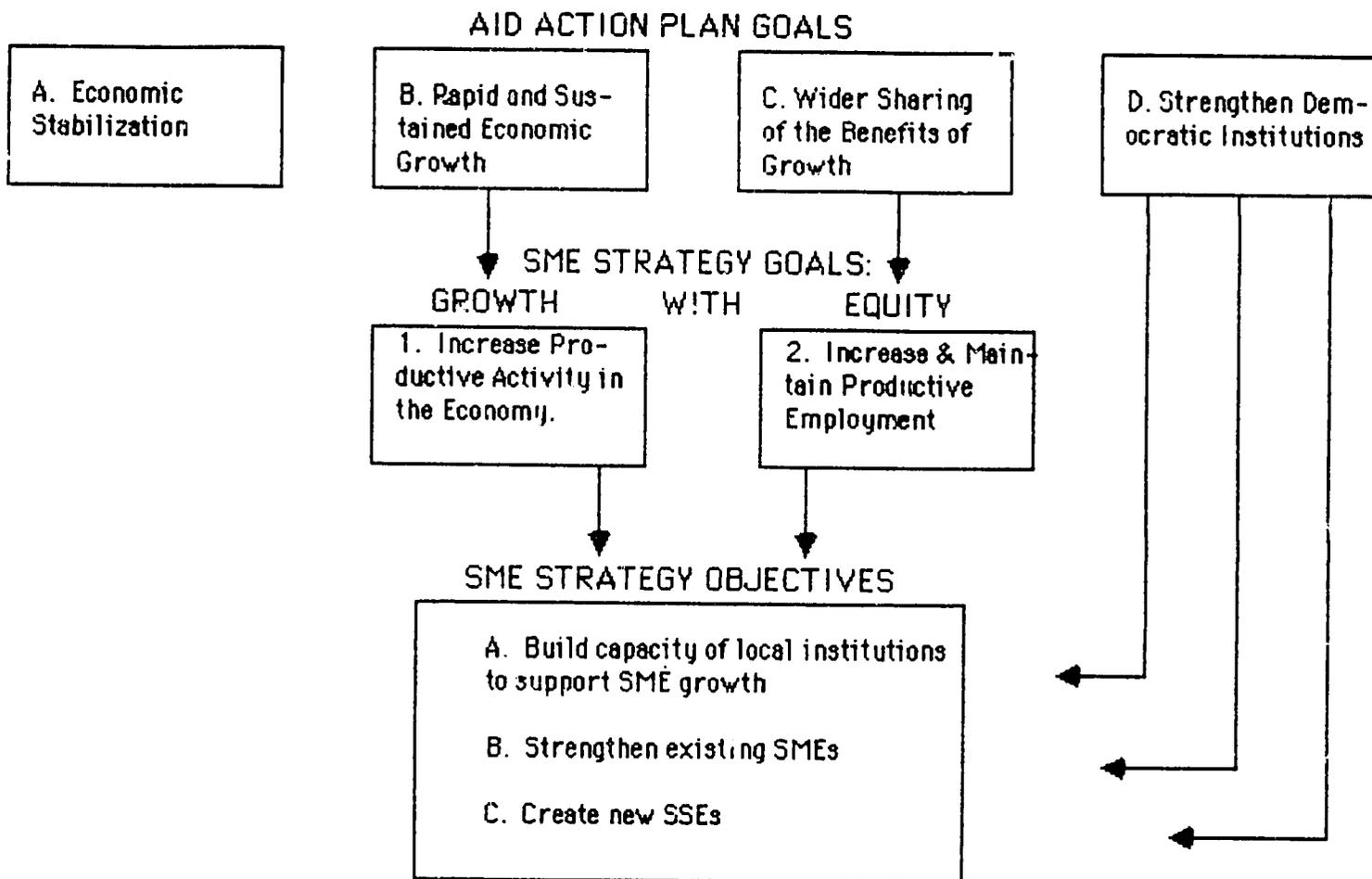
The Strategy: Growth with Equity

In the context of the USAID/H Action Plan and the Central American Initiative goals, support of the SME sector seeks sustained economic growth and a wider sharing of the benefits of growth. Concurrently, such support strengthens democratic institutions (private enterprise and private enterprise support institutions) and a pluralistic society by giving the working poor a greater stake in their economy (refer to Figure ES-1).

Generally, the development assistance community has supported the small and micro enterprise sector as part of a strategy for promoting both economic growth and more equitable development. Recent research and experience in SME development confirm the viability of this two-pronged strategy for supporting small-scale enterprise; thus far, however, equity rather than growth has been the major rationale for supporting micro enterprises. Small-scale enterprises contribute to the growth of the Honduran economy and to productive employment generation. The SME Strategy views support of micro enterprises as an important equity-producing counterpart to programs of economic growth. Micro enterprise support expands the income earning potential and job viability of the urban poor, especially women, by making self-employment a more tenable source of family income.

Honduras' high unemployment and skewed income distribution calls for an SME strategy that gives equal weight to growth and equity within the domestic economy. Monetary and human resources concentrated on export-oriented institutions must be balanced by development of the domestic economy and attention to potentially volatile social problems. If sustained economic growth is to occur, export-led growth

FIGURE ES-1.



must be balanced by enhanced backward linkages within the domestic economy and vertically integrated enterprise growth and support. In terms of social equity, an SME development strategy should both generate productive employment and maintain existing jobs. It should generate income and improve income distribution by providing wider access to resources. It should increase domestic production and investment by creating new small enterprises and strengthening existing small and micro enterprises.

Goals and Objectives

The specific goals of the SME strategy, then, are (1) to increase productive activity in the domestic economy, and (2) to increase and maintain productive employment (refer to Figure 1).

The strategy will pursue these goals through:

- (1) Building the capacity of existing local institutions that specialize in the support of SMEs, rather than creating new institutions or encouraging non-specialized institutions to initiate new programs
- (2) Strengthening existing SMEs in the "growth belt" within all subsectors, rather than concentrating investment in the industrial subsector or geographic areas with low population density and poor infrastructure
- (3) Creating new small-scale enterprise and new product lines, excluding new micro enterprise development

The Honduras SME Strategy proposed comprises policy, program, and research components. Each component addresses

key constraints on SME development in Honduras. These components of USAID/H support of SME development are:

- (1) Initiatives to address policy constraints at the macro and local levels, incorporated into the upcoming policy project, rather than a separate policy project for SMEs
- (2) Program initiatives that concentrate on integrated credit, technical assistance, and marketing packages utilizing existing human, financial, and institutional resources, rather than promoting individual project support assistance and creating new training facilities and/or new credit lines
- (3) Applied research, experimentation, evaluation, and information dissemination that complement policy and program initiatives

Next Steps

Major obstacles to achieving these objectives and specific initiatives USAID/H can take to address them are outlined in Tables ES-1, ES-2, and ES-3. Specific USAID/H initiatives can build upon advances made by local NGOs, government agencies, and USAID/H in promoting the sector. These include SME credit and technical assistance packages; association formation; the potential for joint ventures between large and small enterprises; policy dialogue projects; research, monitoring, and evaluation systems; and project design that promotes vertical integration of enterprises within the local economy. Potential program interventions are also included here, although the authors recognize that these must be developed and analyzed during the next steps of program design and project planning.

Several management approaches are analyzed in this report. The choice of a management approach will depend on

Table ES-1: Objective 1: Build the Capacity of Local Implementing and Training Institutions to Support SMEs

Constraints	Specific initiatives to address constraints	Interventions
1. Coverage of SME support institutions is low and disparate.	1. Increase coverage of SME support institutions.	1. Support new regional and contiguous expansion of existing SME support institutions. Focus SME support on a national level, emphasizing SME support in the growth belt.
2. Coordination among SME support institutions is low.	2. Promote collaborative efforts that encourage complementary inputs and enable organizations supporting SMEs to learn from each other.	2. Create interinstitutional program linkages. Develop uniform standards in design, monitoring, and evaluation systems. Develop longitudinal studies on impact. Develop uniform measures of size and activity for economic viability of firms.
3. Most institutions that support SMEs are involved in a broad range of development activities, inhibiting focused support.	3. Focus support on institutions that specialize in SME programs.	3. Develop a system to determine institutional capacity.
4. SME support institutions are overextended in staff size, capability, and budget. Institutional capacity to expand is limited by lack of computer-based data. Institutional financial management capacity is limited.	4. Assist SME support institutions in addressing their reluctance to expand their activities.	4. Develop institutional selection criteria; conduct serious institutional assessments. Build staff development into every project (business skills & financial management). Improve financial systems. Enhance computer capability. Develop self-sufficiency projections with institutions. Develop performance standards.
5. Training agencies not geared to the specific problems of SME support institutions.	5. Promote collaborative efforts between SME implementing agencies and local, regional, and international training agencies.	5. Conduct staff development needs assessment jointly with SME support institutions & training agencies. Investigate results of several local training modules and programs for extension agents & mid-management. Develop business extension agent concept; design training module. Develop CEO skills in management & fund-raising.
6. SME multi- and bilateral donor activity is limited, fragmented, and uncoordinated.	6. Take the lead in donor dialogue and coordination of SME support.	6. Follow-up on initial visits to continue dialogue through planning & analysis stage.

Table ES-2. Objective 2: Improve and Strengthen the Income Earning Potential of Existing SMEs

Constraints	Specific initiatives to address constraints	Interventions
1. Credit in the formal banking system is abundant but not accessible to SMEs.	1. Encourage creative collaboration between SME support institutions and commercial lenders.	1. Design a demonstration/experimental credit project for SMEs. Research possibilities of special credit windows within existing commercial banks & FIA; Research SME bottlenecks. Provide TA to banks.
2. Credit in SME support institutions is accessible but not abundant.	2. Provide directly or leverage credit funds to selected SME support institutions.	2. Coordinate with banks and other donors. Evaluate CDI/PTR experience in providing loans to NGOs for credit funds.
3. Most SME programs concentrate on industry; little attention is given to commerce and services.	3. Provide balanced assistance to industry, service, commerce, agro-industry and artisans.	3. Research assistance needs of SME industry, service, and commerce.
4. Training agencies not geared to specific problems of SMEs outside of production.	4. Promote SME support institution and training agency collaboration.	4. Identify SME support institutions successfully providing training to SME clients. Promote material exchange and inter-agency training service provision; scholarships.
5. Existing SME programs put little emphasis on market constraints.	5. Provide information, channels, and training to SMEs in market operations and responsiveness.	5. Investigate market systems that interact with SMEs. Evaluate marketing courses. Emphasize large/small joint ventures.
6. Macro and local policies (municipal) inhibit SME growth but little is known about SME specific response to policies and how policies may promote SME growth. No data collected or research done to enable a policy dialogue. No forum for SMEs to encourage in policy dialogue.	6. Support a government effort to develop national strategy to address SME problems. Support efforts to build representative institutions for SMEs to address socio-economic constraints and to represent SMEs before government and the broader society.	6. Encourage research and policy studies on SMEs to support policy project. Include SME policy issues in overall policy project. Coordinate with donors, trade associations and chambers on SME policy issues. Develop guidebook on SME policy issues.

Table ES-3. Objective 3: Create New Small-Scale Enterprises and Enterprise Activity

Constraints	Specific initiatives to address obstacles	Interventions
1. No research experimentation re: growth industries appropriate for SSEs, product diversification or modes of SME expansion, such as franchises.	1 & 2 Develop national research capability to collect analyze and disseminate information on topics relevant to new SSE growth.	1. Research growth industries, factors that affect firm expansion, product development & diversification.
2. No policy studies/research on combining export led growth with the development of domestic small scale "backward linkage" enterprises.	3. Increase access to investment capital for SSEs.	2. Research consistency of export-led growth with establishing small scale backward linkage enterprises for export industries.
3. Risk-adverse bankers and commercial lenders; no venture capital markets; no start-up capital for new small scale enterprises.	4. Support educational efforts and pro-active educational research.	3. Encourage experimental efforts in commercial lending institutions and joint ventures between large and small enterprises.
4. Lack of entrepreneurial spirit; risk-adverse behavior.		4. Investigate results of "entrepreneurship training". Experimental project with small number of businesses receiving concentrated attention/resources. Research investment patterns of SSEs & their responses to policies, programs and targets of opportunity.

whether USAID/H adopts the comprehensive strategy recommended here or a more discrete project approach to support the sector. Given the local context and the inappropriateness or weaknesses of organizations that might have been candidates to manage a SME development program, this strategy recommends that USAID/H rely on an outside contractor, as an extension of USAID/H, to manage the SME program while existing local institutions implement certain components of the strategy.

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I. INTRODUCTION

Both the framework and content of this strategy for support of small and micro enterprise support in Honduras were developed by the USAID/H and the consultant team who researched specific topics relevant to SME support and participated in workshop sessions.

Report Organization

This report is divided into five chapters. Chapter I describes the methodology used by the team in formulating the SME strategy and defines the informal sector in Honduras for strategy purposes. Chapter II defines the principal economic and social problems confronting Honduras, describes support of SMEs during the 1970s, and develops a rationale for support of SMEs as a vehicle to address these problems. Chapter III discusses the major constraints on SME growth in Honduras.

Chapter IV is the centerpiece of the report, written to stand alone. Thus, other relevant sections of the report are summarized in this chapter and the strategy for USAID/H support of SMEs is developed. The chapter begins by discussing the strategy within the context of the Central American Initiative and the USAID/H 1988-89 Action Plan. It briefly defines a strategy and presents the goals, objectives, and focus of the Honduras SME strategy. The chapter then

discusses obstacles to achieving strategy objectives and specific initiatives. Potential program interventions are also presented, although the authors recognize that any specific program interventions must be developed during the stages of project identification and analysis.

Chapter V analyzes management alternatives for USAID/H support of SMEs. Again, the authors realize that management approaches are best developed at subsequent stages of project design. However, analysis can help USAID/H explore management options open to it.

The appendices are contained separately in Volume II.

Methodology

The Honduras Small and Micro Enterprise (SME) strategy was developed through the combined efforts of USAID Mission staff, Robert R. Nathan Associates, Inc. (RRNA) consultants, and local consultants, including representatives from Accion/AITEC and FADF (Pan American Development Foundation). USAID staff from Private Sector Programs (PSP), Rural Development (RD), Human Resources Development (HRD), Development Finance (DF), Development Programs (DP), and Economic Program Analysis (EPA) participated in this effort. Through research, field work, and workshops, the team collected and analyzed a wealth of information to design this strategy.

Research and field work addressed several factors.

Characteristics of the sector were assessed through a review of the literature, interviews with entrepreneurs, panel discussions with representatives of business sectors and knowledgeable observers, and analyzing the economic and financial rates of return of nine firms. An analysis of

migration patterns and income levels was also undertaken by DF, DF, and RRNA.

Policies affecting SMEs were analyzed based on a review of the literature and selected interviews by PSP.

Information was collected and analyzed on NGOs and government agencies working in the development of farm-based and urban non-farm SMEs to enable the team to determine the degree of nationwide sector coverage by PADF.

Criteria were developed to select nine implementing institutions for a more in-depth review. These were used to ensure a broad sample of organizations active in the support of SMEs by activity (industry, agro-industry, commerce, service, and artisans), location, gender of beneficiaries, size of enterprise, and program support provided. Maturity of the institutions, information available, and USAID relations were part of the selection criteria. RRNA and local consultants analyzed written materials and interviewed staff of implementing institutions to elicit information on eight broad categories of institutional capacity: coverage, organizational objectives, program methodologies and operating principles, management/administration, cost efficiency/effectiveness, self-sufficiency, constraints, and capacity to expand.

The organizations reviewed were: ANMPI (Asociacion Nacional de Mediana y Pequena Industrias), ASEPADE (Asesores para el Desarrollo), CADEHSA (Consejo Asesor de Recursos Humanos), CDI/PTR (Centro de Desarrollo Industrial/Programa de Tecnologia Rural, FEHCIL (Federation Hondurena de Cooperativas Industriales, Ltda., FUNADEH (Fundacion Nacional de Desarrollo Hondureno), IDH (Instituto para el Desarrollo Hondureno), ODEF

(Organizacion de Desarrollo Feminina, and Partners of the Americas.

Six technical assistance and training agencies were also reviewed by RRNA and local consultants. The selection criteria for this group were more directive, concentrating on agencies receiving USAID support and those with potential for support of SMEs and implementing institutions. The agencies reviewed were INFOP (Instituto Nacional de Formacion Profesional), GEMAH (Gerentes Empresariales Asociados de Honduras), CADERH (Consejo para el Desarrollo de Recursos Humanos), INCAE (Instituto Centroamericano de Administracion de Empresas), CIDE (Centro de Innovacion de Desarrollo Empresarial), and IDEA (Instituto Daniel de Enseñanza Administrativa).

RRNA also reviewed four "second story" organizations: those that do not directly implement SME programs, but support implementing institutions or institutions that could become second story organizations (because of their broad base, national coverage, or experimental programs). This review analyzed institutional capacity at this level and provided information on the number and quality of services available to implementing institutions through these mechanisms. The organizations reviewed were ANDI (Asociacion Nacional de Industriales), CDI (Centro de Desarrollo Industrial), C.C.I.C. (Camera de Comercio y Industria de Cortes), and FOPRIDEH (Federacion de Organizaciones Privadas de Desarrollo de Honduras).

In order to determine the extent of USAID support to the sector, differences in project objectives, and client and

geographical coverage, DF and DP reviewed active USAID projects that directly or indirectly support SMEs.

DF and PADF collected and analyzed information and interviewed multi- and bilateral donors. This familiarized the team with donor priorities, portfolios, and SME support strategies, and established a basis for future donor collaboration in support of the SME sector.

In two half-day workshops, the team discussed findings, conclusions, and objectives, and devised alternative management approaches to support an SME program. These workshops were facilitated by the Accion/AITEC representative and attended by representatives from PSP, DF, DP, RD, HRD, EPA, RRNA, and local consultants.

The Informal Sector: A Working Definition for Honduras

General Definition of the Informal Sector

There is considerable confusion as to what characterizes the informal sector, the people within it, and the small and micro enterprises they operate. The Director of the Mission indicated particular interest in outlining some of the key early experiences in SME support, advances made, and lessons learned in the 1980s. This section attempts to clarify these issues.

Definitions of small and micro enterprise abound, many dictated by the biases of the writer, the use of the definition, and the stage of development of the country or region in question. Small and micro enterprise activity is varied and

complex; an often-cited study identifies more than 50 different definitions in 75 countries (Georgia Institute of Technology, 1975: Blayney, Otero 1985).

Our definition of the informal sector first considers the social characterization of the sector: individuals and households -- the working poor. Second, the sector is defined in terms of the economics of income-producing activities and their characteristics. Finally, we suggest a typology of small and micro entrepreneurs and their enterprises to disaggregate the economic activities that are often lumped into the informal sector (Blayney manuscript, 1987).

People

Basically, the informal sector is made up of people and their households who could be broadly categorized as the working poor. One straightforward definition of this group is people and entire households who work long hours but do not earn the minimum wage. The sector may include individuals earning more than minimum wages or households with sufficient income to be considered "wealthy." The point is, however, that the informal sector is characterized by a social order, as well as an economic one.

The working poor have low levels of formal education. Micro entrepreneurs register the lowest literacy rates within this group. Most people in this sector also lack formal vocational training. Their skills are acquired through practice, through apprenticeship, or are passed down in the family (Anderson, 1982). Business ownership and management have traditionally been a male preserve, but increasingly,

women are gaining representation in business. Table 1 lists some general characterizations of micro entrepreneurs in Honduras.

Women in all Latin American countries represent a growing percentage of the urban labor force and are concentrated in home-based, cottage-type industries. Even in countries with a tradition of female seclusion, women account for a large proportion (30-50 percent) of those in home industry occupations (clothing, handicrafts) and own-account work (Blayney, 1980). In nearly all developing countries, women account for less than 20 percent of industrial employment.

Small and micro enterprises tend to be initiated by older men and women who perceive the firm as a permanent economic activity and a major source of long-term income (Kilby and D'Zmura, 1985; Moser, 1985). These people are not seeking higher paying jobs in the formal sector. In Colombia, two independent studies show that the vast majority of entrepreneurs have lived most of their lives in the urban setting where they operate their businesses; most have been in business for 15 or more years (Hernandez, Cubillos, 1984; Ashe, 1985).

Enterprises

A second approach to a working definition of the informal sector analyzes the characteristics of the small and micro businesses that make up a good proportion of the economic activities of this sector. Field research recently completed for the Inter-American Foundation and USAID Missions in Costa Rica and Honduras contributed greatly to the list of SME characteristics.

Table 1. Comparative Statistics on
Microenterprise Establishments

Characteristics of SME owners	Latin America	Caribbean
Age	39	40
Average percent women	15	32
Years of education	10	4
Average monthly	--	--
Earnings (\$ U.S.)	284	n.i.
Average % with other	--	--
Source of income	32	n.i.

Source: Kilby and D'Zmura. Countries used in sample are as follows: Latin America (Dominican Republic, Brazil, Honduras, Peru); Caribbean (Jamaica).

In such enterprises, the entrepreneur provides primary capital, labor, management, and marketing functions. Further, there is little differentiation between household and enterprise, between the family members and the work force. The work force is small, usually under 25.

The entrepreneur relies on an intensive use of labor, rudimentary technology, predominance of tools over machinery, little or no division of labor, and specialization of the work force. Often the entrepreneur is undercapitalized and uneducated regarding costing of inputs and pricing for sales.

The entrepreneur has little access to the factors of production, with the exception of labor. In general, SMEs do not meet the basic legal requirements for labor relations. Low levels of labor preparedness are common.

There is an absence of legal and supportive links with the state. For example, no taxes are paid; few, if any, services are received such as legal support, utilities, or human support services (job training, etc.).

By disaggregating the sector into three types of economic activity -- the market place (central markets), commerce (retail outlets, stores), and production (manufacturing-type businesses) -- and isolating eight variables that pertain to economic, financial, and social considerations, one can classify the characteristics of small and micro enterprise by business activity. Table 2 and the discussion below of the eight variables presented rounds out our working definition of the informal sector as comprising small and micro enterprises.

Table 2. Variables of Small and Microenterprises
by Sub-Sector

Characteristic	Market place	Commerce	Production
Income	Very low	Moderate	Good
Credit record	Weak/fair	Good	Good
Capital accumulation	None	Simple	Simple/ sufficient
Savings	\$50 U.S.	\$50 U.S.	\$100 U.S.
Business organization	Very weak	Weak/mod.	Good
Sex	Mostly women	Mix	Mix
Level of education	Very low	Moderate	Good

Source: Material obtained by R. Blayney in visits to six countries in Central and South America.

Income

Market women and street vendors usually earn the least among the micro entrepreneurs studied and are generally the poorest. Upon examination of a sample of project beneficiary credit application files, a definite trend is discernible among the participants. Market women and vendors are at the lowest end of the income spectrum. Petty commerce (street stalls), commerce (stores), and production entrepreneurs generally follow, with incomes approaching "moderate" categories. As a given project progresses, some of the commerce and production entrepreneurs demonstrate significant income improvement and register income levels considered "medium and above" in their respective countries.

Credit Record

The smallest enterprises, with the most limited clientele, often have the poorest credit records. Among entrepreneurs with good credit records, those operating an unsuccessful enterprise will shift to or add a business activity, pursuing a broader market. For example, the market women with successful credit records and enterprises offer new or out-of-the-ordinary products and improve the appearance of their market stalls.

Capital Accumulation

The micro enterprises with no accumulation of capital are the enterprises that do not produce sufficiently to set aside any capital to reinvest. In some cases, the entrepreneur consumes all revenues in maintaining the business and providing a living for his or her family. Usually the street vendors and home-located stores and restaurants fit into this

category, although any enterprise just starting would have little, if any, capital accumulation. Generally, a level of simple accumulation is found among the service enterprises and small-scale production enterprises that have been in business for extended periods of time.

Capital accumulation indicators are extremely important. All of the small and micro entrepreneurs interviewed in a six-country research project in 1986 were self-financed with capital "set aside for reinvestment." Commercial bank credit is often inaccessible due to tight liquidity and/or extraordinary application demands and procedures. The money lenders charge upwards of 20 percent per day for the market women and petty vendors, and 15 to 20 percent monthly for the more established businesses.

Savings

Many of even the smallest micro entrepreneurs interviewed had a savings account. In Colombia and the Dominican Republic, a savings account, although very limited (US\$100 or less), is required for project participation. Savings are seen by the poorest mainly in terms of a "psychological comfort." Savings accounts among different types of enterprises or subsectors of micro and small enterprises follow the same trends experienced with the preceding indicators -- the smallest, low-income, lowest capitalized, least market-viable enterprises have the smallest savings accounts.

Business Organization

Some of the smallest enterprises are managed by people that do not regard their "daily work" as a business. The common business functions of purchasing materials, production,

accounting, and marketing often reflect the entrepreneur's attitude toward the enterprise as much as his or her knowledge and experience in the business. Business organization is generally stronger among the more well-to-do, the larger production enterprises, and the better educated or trained entrepreneurs. There are, of course, many exceptions, e.g., the market woman who consistently maintains an excellent selection of fresh produce and flowers, borrows and pays back money each day, keeps all customer credit in her head, feeds a family of ten on her income alone, and wants to know how to improve her business.

Gender

Women make up the vast majority of people working in the market place or central markets. They also represent the majority of those who sell merchandise with the lowest profit margins. Household restaurants, outlets, or shops for produce and home items, found in the poorer communities, are nearly all operated by women. Commerce, such as retail stores, has more men owner/operators than women. Production enterprises, such as shoe manufacturing, woodworking, ceramics, clothes manufacturing, and assembly, are owned/operated by both sexes. Gender lines are often drawn by type of product. Woodworking and shoe manufacturing are male-dominated; ceramics is mixed; and clothes making depends on the item -- men's pants and suits are made only by men, whereas other men's garments and women's and children's clothes are nearly all produced by women.

Level of Education

Generally, entrepreneurs with the least formal education or business training are found in the market place. Commerce

and production entrepreneurs usually have more formal education and more exposure to business operating skills through training in formal sector jobs and/or specific business training opportunities. Survival in business or the capacity to operate a business successfully depends to a considerable degree on one's personality and experience. Not everyone should be in business.

Often those who are in business operate much more effectively when they have been exposed to learning opportunities that develop both their self-esteem and assertiveness in dealing in the business world. Training in basic business principles and their practical applications also improve an entrepreneur's chance of success.

Small and Micro Enterprise in Honduras

The previous section presented a general definition of the informal sector. This section develops a definition of the informal sector specifically for Honduras to provide USAID/H a basis for developing a focused plan of action.

Definition and Size of the Sector

The work carried out by the SME strategy consulting team in Honduras leads to a preliminary definition of SMEs based on the number of waged employees and fixed, movable assets (machinery and equipment). A micro enterprise has one to five employees and under US\$10,000 in fixed, movable assets; a small enterprise can have up to 25 employees and US\$25,000 in fixed, movable assets.

Small-scale enterprises are the most important subsector of Honduras' manufacturing sector. An estimated 37,000 firms employ fewer than five persons (World Bank, 1986). A preliminary number of existing SMEs in Honduras can be estimated by type: industry (mostly small and producing food products, furniture, other wood products, etc.); artisan industry (mostly micro enterprises producing shoes, clothes, and food products, etc.); and commerce/service, both small and micro. As with artisan industry, the vast majority of commerce and service enterprises are micro-scale (Table 3). This exercise illustrates the enormity of the small and micro enterprise sector and points out a dimension of the sector (artisan-industry, commerce/service) that has been overlooked by USAID/H in both policy support and direct project intervention.

Transportation and construction are other important subsectors of the economy employing large numbers of persons in small or micro enterprises. 1985 Central Bank figures estimate a labor force of nearly 48,000 for construction and just over 44,000 for transportation. Besides employing a significant percentage of the economically active population, this subsector makes a positive economic and financial contribution to the Honduran economy.

Location of SMEs in Honduras

Small and micro enterprises exist wherever a population demands goods and services. SME density is highest where both population and incomes are highest. SMEs will be found along an imaginary line from the source of product inputs (supply) to the final market (demand).

Table 3. Estimated Number of Small and Micro Enterprises
by Selected Sub-sectors and Labor Force

Type of enterprise	Number of firms	Labor force
Artisan-industry	37,000	92,500
Industry	1,100	16,500
Commerce/Service	40,300	120,800
Totals	78,400	299,800

Sources: Central Bank, 1985 EAP of 1,105,200 by subsector, World Bank, Small Business Development Project Paper, Survey Material (1985) San Pedro Sula.

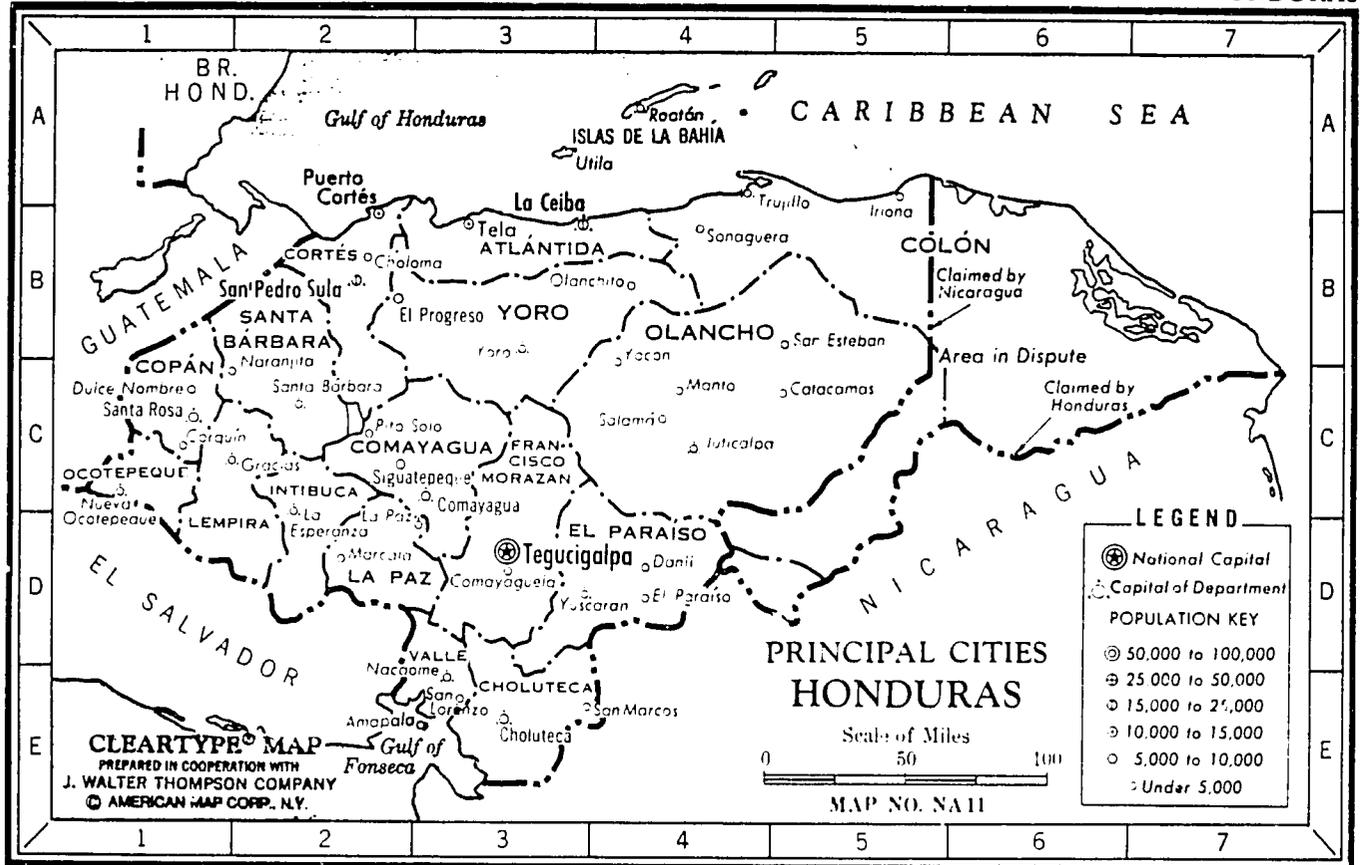
When mapping Honduras for population concentrations, agricultural potential, similar family income characteristics, and in- or out-migration patterns, the team defined four major zones: Southwest, Central, North, and East.

The lowest average annual rural family incomes have been registered in the Southwest. They range from US\$589 in the Copan, Ocotepeque, Lempira, and Intibuca regions to US\$639 in Valle and Choluteca. Generally, income levels in the Central zone are higher. Excluding El Paraiso, income levels range from US\$693 in Comayagua and Francisco Morazan to US\$710 in Olancho. The highest income levels are found in the North, where family incomes range from US\$913 in Santa Barbara, Cortes, and Yoro to US\$998 in Atlantida and Colon. Average annual family incomes in the North are almost twice as high as those in the poorest areas of the Southwest (see Figure 1).

All the zones bordering El Salvador are areas of emigration, whereas Cortes, Yoro, Atlantida, and Colon are areas of immigration. The majority of the country's immigrants follow this pattern; San Pedro Sula and Tegucigalpa constitute important growth poles in their own right. The area in Honduras with the highest population density and growth is indicated on the map, forming a "growth corridor" north to south in an open "S" shape (Hernandez, PCR, 1986). (See Figure 2.)

FIGURE 1. MAP ONE

HONDURAS



DEPARTMENTS
(17 Departments)

Name of department followed by population in thousands, to nearest thousand, then location on map.

Atlántida, 64.	B- 3
Choluteca, 107.	E- 3
Colón, 35.	B- 5
Comayagua, 68.	C- 2
Copán, 96.	C- 1
Cortés, 126.	B- 2
El Paraíso, 7.	D- 4
Francisco Morazan, 190.	C- 3
Intibuga, 59.	C- 2
Islas de la Bahía, 7.	A- 4
La Paz, 51.	D- 2
Lempira, 91.	D- 1
Ocotepeque, 46.	C- 1
Olancho, 84.	B- 4
Santa Bárbara, 96.	B- 2
Valle, 65.	D- 3
Yoro, 99.	B- 3

Total HONDURAS 1,369.

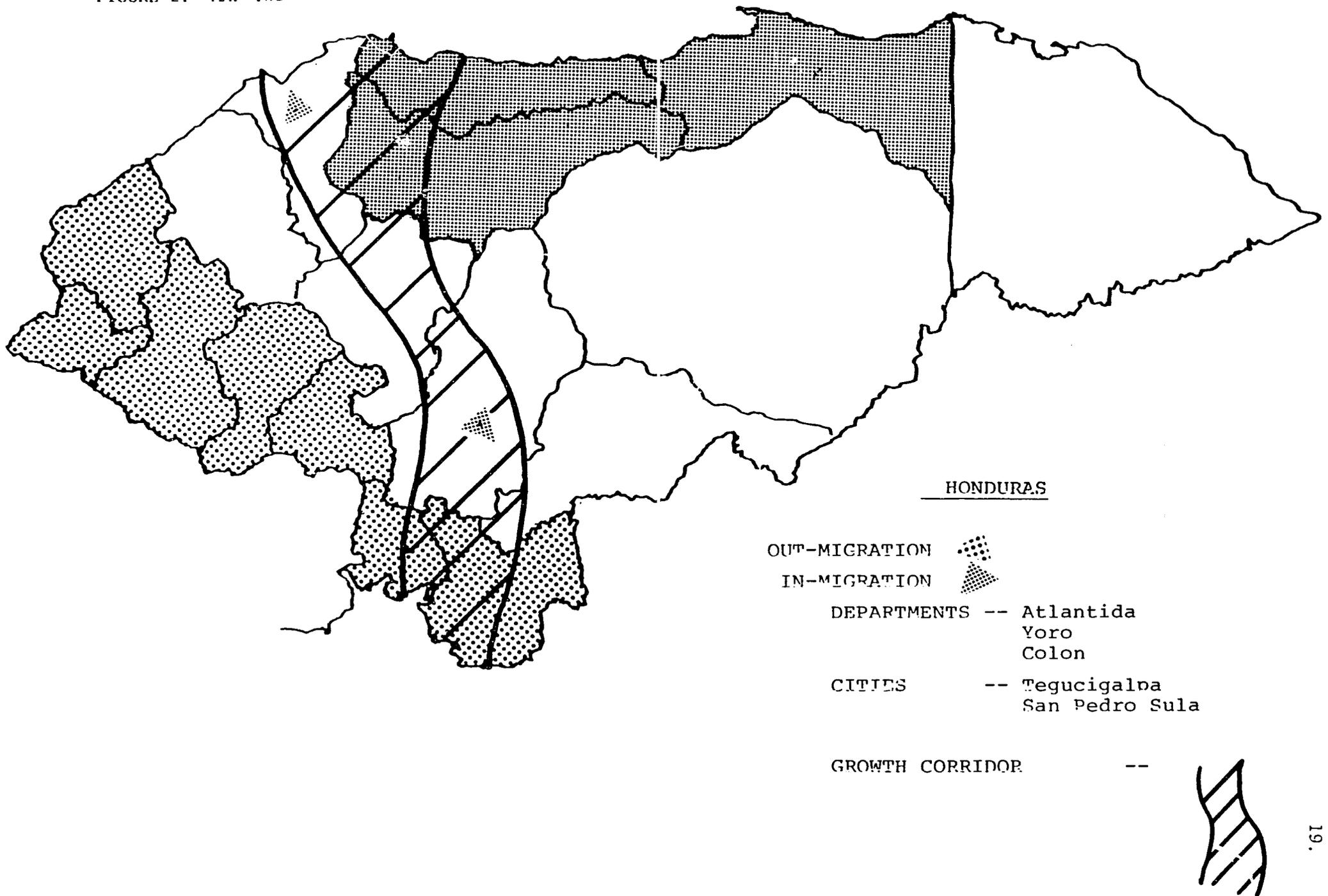
CITIES

Name of city followed by population in thousands, to nearest thousand, then location on map.

Amapala, 3.	E- 3
Catacamas, 2.	C- 5
Choloma, 3.	B- 2
Choluteca, 7.	E- 3
Comayagua, 5.	C- 3
Comayaguela, 3.	D- 3
Corquín, 3.	C- 1
Danlí, 4.	D- 4
Dulce Nombre, 3.	C- 1
El Progreso, 9.	B- 2
El Paraíso, 3.	D- 4
Gracias, 2.	C- 1
Iriona, 3.	A- 5
Juticalpa, 3.	C- 4
La Ceiba, 17.	B- 3
La Esperanza, 2.	D- 2
La Paz, 4.	D- 3
Manto, 1.	C- 4
Marcala, 1.	D- 2
Nacaome, 3.	E- 3

Naranjito, 3.	C- 1
Nueva Ocotepeque, 4.	C- 1
Olanchito, 3.	B- 4
Pito Solo, 1.	C- 2
Puerto Cortés, 12.	B- 2
Roatán, 1.	A- 4
Salamá, 1.	C- 4
San Esteban, 2.	B- 5
San Lorenzo, 3.	E- 3
San Marcos, 3.	E- 3
San Pedro Sula, 21.	B- 2
Santa Bárbara, 3.	C- 2
Santa Rosa, 6.	C- 1
Siguetepeque, 5.	C- 2
Sonaguera, 3.	B- 4
Tela, 13.	B- 3
Trujillo, 3.	A- 4
Tegucigalpa, 72.	D- 3
Utila, 1.	A- 3
Yocon, 1.	B- 4
Yoro, 2.	B- 3
Yuscarán, 1.	D- 3

FIGURE 2. MAP TWO



II. SUPPORT OF SMALL AND MICRO ENTERPRISES (SME)

Characterized by small family operations, labor-intensive adaptive technologies, and a lack of access to financial, material, and human resources, the informal sector in Honduras differs by degree rather than content from informal sectors in other developing countries. This chapter presents the principal economic and social problems facing Honduras in the 1980s. It then summarizes USAID's early program responses and the Government of Honduras' (GOH's) current response to the key problems of high unemployment and low family income. The chapter concludes with a rationale for expanded investments in support of SMEs.

Definition of the Problem: The Honduran Context

The principal socioeconomic problems facing Honduras in the 1980s are extreme poverty and high unemployment. The country is the poorest in Central America and ranked among the poorest in the Western Hemisphere. Per capita income reached only US\$700 in 1984. Income distribution is among the most extreme in Latin America (as a percent of national income, highest quintile 67.8; lowest quintile 2.3 -- World Bank, 1986). Rural Honduras is in worse condition; 60 percent of families earn annual incomes below US\$250, or less than US\$50 per person (USAID/H FY 1988 Action Plan for Honduras, May

1986). It is estimated that in 1985 over 80 percent of this group earned below the calculated poverty line income of \$230 per capita.

Honduras' population of 4.3 million is growing at 3.4 percent a year, straining available resources and contributing to the unemployment problem. The World Bank estimates unemployment in Honduras at about 25 percent of the work force. Malnutrition is severe and infant mortality is reported at about 8 percent of live births. Adult literacy is 42 percent and about two-thirds of the population is inadequately housed.

According to the Central Bank, the Honduran economy recovered from the oil shocks of 1974-75 to register significant gains in real GNP growth in the late 1970s (over 7 percent per annum). This period of rapid economic growth was followed by stagnation in the 1980s. The world recession, deteriorating domestic terms of trade, a drying up of commercial bank lending, and the adverse political climate in Central America all contributed to the economic slowdown. GDP growth decelerated in 1980-85 to less than 1 percent per annum and real income dropped by 5 percent. Agriculture began to recover in 1983, but manufacturing continues to be hampered by weak demand and continued scarcity of foreign exchange.

Early Responses -- Program Shifts
from the 1970s to the 1980s

The economic and social problems confronting Honduras in the 1980s, though more severe, are similar to those confronted by other countries in the region. Assistance programs addressing high unemployment and low income shared a similar design, focus, and approach throughout Latin America.

Prior to the 1970s, USAID concentrated on assisting small and medium industry through capitalization, technical assistance, technology transfer, training, policy dialogue, promotion services (in investment and exports), and economic support (commodity import programs and balance of payments support). These resources were channeled through a variety of delivery systems: central governments, government agencies, parastatals, non-profit organizations, and private for-profit enterprises (RRNA, 1985).

Capital markets constraints -- low liquidity in regional banks, access to credit, lack of collateral -- were considered the most important stumbling blocks for medium and small industry. With the exception of a small percentage of projects strictly comprising technical assistance and training (vocational training, university curriculum development) or infrastructural development (construction of learning institutions), the bulk of USAID's assistance to industry was designed to expand the capital markets in developing countries through three schemes: direct lending, rediscounting, and loan guarantee funds (Blayney, Otero, 1985).

These projects provided funds to national institutions through (among others) private industrial finance corporations (IFCs) and national central banks to rediscount loans made by public and private lending institutions. USAID also served as a partial guarantor of loans by commercial lenders with the Productive Credit Guarantee Program (PCGP) in selected countries in Latin America. While successful examples of these types of support projects exist, certain problems were endemic. For example, government policy stipulating interest rate ceilings and other controls discouraged local investment

and hampered public and private institutions from mobilizing domestic savings.

The direct lending mechanisms and the guarantee and refinance schemes assisted hundreds of smaller manufacturing industries that may not have secured financing otherwise. However, overall results were mixed, primarily due to cumbersome bureaucratic requirements imposed by central banks. In addition, although both public and private entities were involved in direct lending, the public entities made few or no requirements for return on investments, which lessened their efficiency and their ability to raise domestic savings from private sources.

In spite of USAID's efforts to relieve the critical problems of small and medium enterprises through capital support, technical assistance, and incentives for public and private institutions to lend to SMEs, these projects chiefly reached the larger among the enterprises targeted. The smaller, low-income entrepreneurs in commerce and services and the micro entrepreneurs were left out altogether (Blayney, Otero, 1985).

In the 1970s, USAID, the World Bank (Urban Division), the Inter-American Development Bank (Small Projects), and other donors recognized the weaknesses of earlier approaches. They began to realize the important role of small and micro enterprises providing productive employment and earnings opportunities in developing countries. In 1978, the Office of Rural and Institutional Development of the Bureau for Science and Technology launched a \$5 million project, "Small Enterprise Approaches to Development." It was designed to improve the agency's understanding of the small-scale

enterprise sector and to increase its capacity to formulate, implement, and evaluate projects that generate productive employment among the poor. At the time, preliminary analysis indicated that a growing number of the poor, especially urban dwellers, initiate economic activities to employ themselves and produce incomes for their families.

Three sub-projects were planned under this project. The first, under the guidance of Michigan State University, explored policy issues relevant to small and micro enterprises. The second, headed by Development Alternatives, Inc., developed a comprehensive methodology for impact evaluation which was used to evaluate small and micro enterprise projects in Indonesia, Peru, and Burkina Faso. The third sub-project (1) studied existing small and micro enterprise projects to assimilate lessons regarding their implementation and (2) initiated demonstration projects for testing improved methodologies. This third sub-project, the most relevant to the Honduras SME Strategy, was called "Program for Investment in the Small Capital Enterprise Sector," and was known as PISCES, Phases I and II (Blayney, Otero, 1985).

The findings of PISCES Phase I, contained in 23 case studies of projects in 13 countries, systematically documented assistance approaches that (by providing resources, especially credit, technical assistance, and training) seemed to be reaching the poor and enhancing their economic activities. This phase isolated characteristics of project design and implementation that appear to contribute to project effectiveness among the very smallest enterprises (PISCES, 1981). PISCES II involved private organizations and USAID Missions in the design and implementation of four demonstration projects of assistance to micro enterprise. These projects took

different approaches which, when compared, could yield insights on (1) how best to assist micro enterprises, (2) the use of demonstration projects to determine if these projects reach micro entrepreneurs, and (3) the degree of project effectiveness.

Currently, following the PISCES I and II experiences, several projects are being implemented through the Enterprise and Employment Development Division in the Office of Rural Development of the Bureau for Science and Technology (S&T/RD/EED).

- . The Employment and Enterprise Policy Analysis (EEPA) project (1) identifies policy and regulatory factors hindering private sector performance, job creation, and entrepreneurial behavior and (2) promotes policy dialogue and initiatives to address these hindrances.
- . The Research on Entrepreneur Identification and Development (REID) project is an action-research initiative designed to refine a set of entrepreneurial characteristics. These characteristics will guide a pilot training program for entrepreneurship development.
- . The Small Enterprise Approaches to Employment project and the Microenterprise Support Institutional Development project will provide technical support, research, and training services to strengthen host country institutions that assist small and micro enterprises.

GOH Response to the Problem

The priorities of the GOH as set forth in the 1986-89 National Development Strategy are: stabilizing the economy without a devaluation, while strengthening the economic process and distributing the benefits of growth equitably;

developing the Honduran private sector and decreasing dependence on the state; increasing agricultural production; increasing exports; creating employment opportunities; and addressing low life expectancy and the problems of the primary education system.

The GOH, donor community, and private sector focus their development efforts on exports -- agriculture and industry. Export-led growth is crucial to the generation of foreign exchange and stable exchange rates. It should lead to increased domestic and international investment in Honduras. However, GOH export policy is skewed heavily in favor of large business and inhibits the increase of productive activity in the domestic market. External aid and domestic human resources, including public and private institutions, are concentrated on export. Small and micro enterprise support has nearly been abandoned. Development of the domestic economy and attention to potentially volatile social problems of Honduras are often overlooked.

The major donors in Honduras have concluded that (1) the overriding macroeconomic policy question is how to accelerate growth and employment creation on the magnitude required by the country's demographic structure, and (2) the economy can only be reconstructed through faster economic growth and by switching to more labor-intensive production methods. The small business sector is considered extremely important in achieving balanced economic growth and employment.

Rationale for Expanded Investment
in Support of SMEs

Policy analysts and program planners do not argue the importance of investment in SMEs. Rather, they debate how to

justify the returns to the economy of SME program investments. Are investments in SME programs justified in economic, as well as social impact, terms? A review of recent studies provides empirical evidence that investment in the sector can be justified using conventional financial and economic measures. The discussion below is based on evidence from the region and research carried out by the strategy team in Honduras.

Employment

Virtually all the aggregate studies and most industry studies reveal that small-scale industries generate more employment per unit of scarce capital than their larger-scale counterparts. The available evidence on relative capital productivity is somewhat limited and more mixed. In the majority of countries where such comparisons have been made, however, the overall output generated by small industry exceeds that generated by large industry (Liedholm, Mead, 1986).

The Fundacion Carvajal's project in Cali, Colombia, surveyed 236 firms that received credit through the project. Among these firms, employment increased 33.4 percent, an average in firm increase from 3.8 to 5.8 workers. The increase varied according to subsector; commerce registered a 75 percent increase, while industrial firms showed a 27 percent increase in jobs (IDB, 1985). Survey results of the Industrial Bank of Peru showed that 6,150 jobs were generated through loans to small entrepreneurs. This figure translates into an average of 2.5 jobs created per firm. Of these, 65 percent were full-time, paid jobs (Goldmark, et. al, 1983).

These figures underestimate the true employment impact of the projects, which also help sustain the jobs of owners and family members. Job maintenance is critical in Honduras, where 14,700 people lost their jobs in the industrial sector between 1980 and 1984 (CONSUPLANE, 1985).

The capacity of small and micro enterprises to generate employment is particularly important in light of the magnitude of the sector in Honduras. In an examination of 13 countries, including Honduras, employment distribution in manufacturing by size of firm demonstrates that nearly 60 percent of total manufacturing employment is found in firms with fewer than ten employees (Liedholm, Chuta, 1979).

Available empirical evidence indicates that, in the aggregate, small manufacturing enterprises are more labor-intensive than larger ones. In Honduras, labor intensity (K/L -- as fixed capital per worker) by size of enterprise demonstrated costs of US\$125 for enterprises with one to ten workers; US\$250 for enterprises with 11 to 49 workers; and US\$2,684 for enterprises with over 50 workers (Liedholm, Mead, 1986; 1980 data).

Specific examples can reinforce the assertion that small and micro firms, when assisted, generate considerable employment. A recent evaluation of FUNADEH revealed that 73 percent of the firms surveyed showed increases in employment, with an average of just over one new job created per loan extended to small industries (Heinzen, 1986).

Cost of Jobs Generated

Most calculations of job creation include a variety of cost inputs, such as direct investment costs, subsidized

capital costs, the cost of providing technical assistance in program planning and implementation, the costs of administering a credit and training program, and related job training or enterprise management assistance. Obtaining uniform and accurate measures of these variables is difficult. Their inclusion raises the "real costs" of generating full-time jobs or their equivalent in the SME sector (Blayney, Otero, 1985).

The data in Table 4, drawn from SME projects, show a range of investment per job created. Note that costs of job creation within the small production or industry-focused projects -- ADEMI, FIA, and FUNADEH -- are considerably higher than the new job costs of WWB working with commerce and service micro businesses. A new full-time job in medium to large industry can cost anywhere from US\$10,000 to 30,000, depending on the type of industry and its capital intensity.

Value Added

In Peru, between 1975 and 1981, the Rural Development Fund (RDF) of the Industrial Bank of Peru (BIP), a development bank, disbursed approximately 6,200 loans, totaling over US\$42 million, to about 3,000 small entrepreneurs. Annual value added at the time of the survey was US\$16,000 per firm (average size of loan in this program was about US\$2,500). Each loan dollar extended was found to produce, on the average, \$.29 increase in gross income per year. Sales increased at an average of 31 percent annually; net profits went up about 54 percent annually (Goldmark, et al., 1983).

In Honduras, data measuring value added in relation to financing among enterprise suggest that small rural-based

Table 4. Loan Amount Per Job Created in
SME Projects

Project	Size of enterprise	Loan per full-time job
ADEMI (Dominican Republic)	Micro	\$US 1,650
WWB (Colombia)	Micro	800
FIA (Honduras)	Small	2,100 to 13,100
FUNADEH (Honduras)	Small	3,600
CDI/PTR (Honduras)	Agricultural (Seasonal)	4,140
	Microbusiness (Permanent)	1,500
	Microbusiness (Seasonal)	650

Source: NGO project files and follow-up interviews.

manufacturing firms outperform larger enterprises in the same manufacturing sector (Liedholm, 1985).

Comparing large and small enterprises using comprehensive efficiency measures in Honduras demonstrates higher capital productivity (4.38 value added per unit of fixed capital) among industries employing 11-49 workers than among industries employing one to ten workers (3.57). However, the real loser was industry employing over 50 workers, demonstrating a 0.28 capital productivity (Q/K) (Liedholm, Mead, 1986).

Financial and Economic Rate of Return

The most reliable indicators (and significant measure for economic impact) of a firm's performance are the joint use of capital-labor ratios with capita-output ratios and, especially, the rate of economic profit realized by an enterprises' investment (Juan Butari, EPA, 1986).

Financial and economic viability of investments in the small business sector depends on the specific type of industry, firm size, location, and the market being served. However, based on information collected for a group of FIA loan beneficiaries in Tegucigalpa and San Pedro Sula, investments in each of these small industrial firms show attractive financial rates of return. The figures range from 35 to 130 percent. From an economic viewpoint, investments in these firms are even higher -- IRRs range from 38 to 163 percent.

Financial information collected on four small and medium-scale firms in the commercial sector demonstrated that there

are financially viable businesses in this sector that can offer attractive investment opportunities. This brief analysis indicated the level of business handled by small commercial operators in the traditional Honduran marketing system, which handles an estimated US\$200 million per year in San Pedro Sula alone (see Appendix A).

Income Enhancement

Project beneficiaries improve their income in real terms as a result of the expansion of small and micro enterprises. Time series data confirm that incomes improve with time in the project (Colombia and the Dominican Republic). In addition, it was discovered that project beneficiaries and their families improve their standard of living over that of non-profit participants. Production enterprises, as a subsector, create the most real income growth and invest the most in fixed assets -- machinery and equipment -- as compared to the market and street vendor subsectors.

The performance of the enterprise in the aggregate shows that sales and net profits improve with the influx of new capital. For example, in a survey of FUNADEH credit program participants, 96 percent of the respondents claimed that business was making more money as a result of the loan. Forty-six percent claimed that business was making a lot more; 38 percent a little more; and 12 percent double (Heinzen, 1986).

Savings Mobilization

Small and micro enterprises are an untapped source of savings mobilization. Based on a worldwide survey of SME

project beneficiaries who had never saved before in a formal institution, surprising levels of savings were found among micro and small entrepreneurs, whether savings were accrued through a mandatory or voluntary savings program (Kahnert, 1983). One World Bank study points out that, in general, we may be underestimating the poor's propensity to save because, in all cases where a loan is used to buy equipment and machinery, the income generated and used to pay back interest and principal on the loan is not counted as "saved," when in fact it is part of the value added by the borrowing enterprise (Kahnert, 1985).

This finding is reinforced by experience in Honduras. For example, in five months of operation (August-December 1986), 475 micro entrepreneurs enrolled in the ASEPADE-CREDISOL and -CREME programs have generated over US\$18,000 in savings (ASEPADE Quarterly Report, 1986). In the Dominican Republic, ADEMI was able to enroll 662 micro entrepreneurs in a savings program for the first time. Savings accounts totaled over US\$100,000 during a two-year period (ADEMI Annual Report, 1984).

Capital flight is a serious problem in Honduras. Every entrepreneur of means has a substantial amount of dollars in foreign banks or investments (interviews with executives of "big eight" accounting firms, Honduras, 1986). A preoccupation of project officers in the World Bank is how to structure industry loans to prevent medium and large industrialists, the end users of the loans, from opening foreign banking and/or savings accounts with major portions of the loans.

Small and micro entrepreneurs do not have the means to make foreign investments, nor do they have access to foreign

bank accounts. Their savings and earnings are re-invested in the domestic economy. The single largest use of additional income and savings among Inter-American Foundation SME project participants was re-investment in the enterprise, followed by education for their children and home improvements (Blayney, manuscript, 1987).

Women

In most Latin American countries, as in Honduras, women constitute a sizable percentage of those working in the informal sector. This sector is growing rapidly in Honduran urban centers (Choudhuri, Till, 1986). In Tegucigalpa alone, the informal sector is estimated to include as much as 48 percent of the EAP. Although no survey data are available, informed observers estimate that women make up at least 50 percent of this informal sector. Most likely the figure is higher (J.R. Martinez, 1986). This proposition is substantiated by 1983 migration and 1985 census data indicating that (1) rural-to-rural migrants tend to be families, while the largest percentage of rural-to-urban and urban-to-urban migrants are single women with or without children, and (2) the urban female population has increased -- women outnumber men in the urban areas by 7 percent, while men outnumber women in the rural areas by 5 percent.

Informal sector activities attract women because they require little education, few skills, and only a small capital investment, and are often compatible with household responsibilities, especially if the enterprise is operated out of the home. Women's participation in the informal sector is concentrated in enterprises with less growth potential and less income (White, 1986).

Data collected from nine Honduran SME support institutions substantiate female entrepreneurs' relatively low income earning power. Women predominate in the smallest and least profitable enterprises of the informal sector: sewing, food preparation, and market vending. Women have low levels of formal education and limited access to training programs. Moving up the scale from micro to small to medium-sized enterprises, the participation of women entrepreneurs declines dramatically. For example, ASEPADE's credit program CREDISOL is aimed primarily at micro commercial enterprises and 66 percent of its clients are women. Another ASEPADE credit program, CREME, is aimed at micro industrial enterprises; 37 percent of the clients are women. The client base of FUNADEH, which supports small industrial enterprises, includes 35 percent women. FEHCIL, which supports cooperatives comprised of small industrial producers, counts 30 percent women among its cooperative groups. Only 10 percent of ANMPI members, a trade association of small and medium industries, are women.

Women participating in the Honduran urban informal sector as market vendors share several characteristics. Their families are usually exclusively dependent on the woman's income for subsistence. Fifty-four percent are single mothers or women who have been abandoned by their mates. Forty-six percent of those who are married have husbands who do not contribute to the family income. The women's working capital is obtained from informal sources at high interest rates. Their supplies are obtained from intermediaries at high prices, leaving little profit margin. Their earnings are used for the families' daily consumption, reinforcing a cycle that is difficult to escape (N. Martinez, 1981).

Small and micro enterprises in the informal sector have played an important role in providing self-employment opportunities for women and in contributing to the household incomes of the urban poor where the woman is often the sole income earner in the family. A SME support strategy for growth with equity needs to consider women's active participation. Women are increasingly present in the urban labor force, especially in the informal sector. Women are stable and significant (often the only) contributors to family income.

III. CONSTRAINTS ON SME GROWTH

This chapter identifies major constraints on SME growth in Honduras. It discusses the underlying causes of these problems and their implications for SME growth. Because SME support institutions are the most important mechanisms through which to support SME growth as a productive force in the economy, we analyze these institutions, the assistance packages they employ, and the particular constraints institutions face in extending and improving service delivery to SMEs. We discuss financial intermediation and market constraints, policy framework at the macro and municipal levels, and survey relevant research in Honduras. Finally, we discuss problems of attitude.

Problems of Institutional Support

The Sample

Approximately 25 private and governmental organizations offer business assistance services to non-farm SMEs in Honduras (see Appendix G). As part of the SME strategy review, the team analyzed nine implementing institutions with SME program components, six training and technical assistance agencies with business assistance programs, and four "second story" organizations providing services to the sector (see Appendix B). For the purposes of this analysis, "second

story" organizations were defined as those that do not directly implement SME programs, but manage general assistance programs for SME support organizations or, because of their broad resource base, have the potential to do so. The team analyzed these organizations' current capacity to support SMEs and their potential to expand.

The strategy team also reviewed current bi- and multi-lateral donor support to the sector and current USAID support of SME development (see Appendix C and D). The organizations reviewed are listed in Table 5.

Models of Program Assistance

Four program components are widely found in SME assistance programs: financial assistance, technical assistance, training, and social promotion. Having reviewed the literature on SME assistance programs, the Harvard Institute for International Development (HIID) identified six principal models used by a large number of implementing institutions. These six models provide an analytical framework within which we can assess the characteristics, advantages, and disadvantages of the models currently employed by SME implementing institutions in Honduras. Eight of the implementing institutions reviewed are discussed with reference to these six models and the three levels of beneficiaries served -- (1) subsistence with limited potential for growth, (2) micro with some basic skills and limited potential for growth, and (3) micro and small with basic skills and potential for growth (these beneficiary levels are adopted from PISCES).

Table 5. Implementing Institutions

Name	Type	Client focus	Geographic area	SME focus
<u>SME Program and Implementing Institutions</u>				
ANMPI	Private trade association	Small/medium industry	SPS/Teg	Yes
ASEPADE	Private/PVO	Micro: commerce & industry	SPS/Teg Cholulteca	Yes
CADESHA	Private trade association	Commerce	Teg.	Not exclusive
CDI Government	Small/medium	National industry	Not exclusive	
CDI/PTR	Government	Agro-industry	National	Not exclusive
FEHCIL	Private co-op federation	Industrial co-operatives	National	Yes
FUNADEH	Private/PVO	Small industry	SPS	yes
IDH	Private/PVO	SME farm & non-farm	4 regions	Not exclusive
OEF	Private/PVO	Women's small/medium business	SPS	Yes
Partners	Private/PVO	SME training integ. rural dev.	National	Not exclusive
<u>Training and Technical Assistance Agencies</u>				
CADERH	Private	Vocational ed. trainers	6 regions	Indirect
CIDE ^a	Private university	Students	Teg.	Potential
GEMAH	Private	Large/medium enterprise	SPS/Teg.	No
IDEA ^a	Private for-profit	PVO staff	Teg.	Potential
INCAE	Private	Organizations/enterprise	National	Yes
INFOP	Government	Enterprise/employees	National	Yes
<u>"Second Story" Organizations</u>				
ANDI/PYME	Private trade association	SMEs	National	Yes
CCIC	Private chamber of commerce & industries	Large/medium	SPS	No
CDI	Government	Small/medium industry	National	Yes
FOPRIDEH	Private: PVO consortium	Broad based PVO clients	National	No

a. Organization recently established, not yet in operation.

Table 6 compares the general characteristics of the models with the specific models of program assistance used by the implementing institutions reviewed. Costs of the implementing institutions were reviewed and then rated in comparison to one another. Other categories reflect the organizations' actual operations. The category "overall effectiveness of SME support" compares the following indicators of institutional effectiveness: coverage, organizational objectives, program methodologies and operating procedures, management and administration, cost efficiency and effectiveness, self-sufficiency, major limitations, and capacity to expand.

Table 7 presents more detailed information on the implementing institutions' support service packages and credit operations.

The Models

Model 1: Individual financial assistance, often adopted by banks and large government programs for enterprise assistance. This model can be designed for beneficiaries at all three levels of enterprise development, although it is one easily and successfully directed at level 3 entrepreneurs (those with basic skills and potential for growth). This model, however, does not require a large or highly skilled staff. Its potential for scaling up is considerable.

The weakest point of this model appears to be its limited ability to assist clients in making the best possible use of loan capital. Institutions using this model must take particular care with client selection and the potential for default and failure rates (Grindel, et al., 1986).

Table 6. Models of Program Assistance

Model type	Cost	Beneficiary level	Staff skill	Labor intensity	New or established	Beneficiary commitment	Comparative overall effectiveness
<u>Model 1</u>	Low	1-3	Simple business	Low	Established	Low	
(No organizations in Honduras currently employ this model.)							
<u>Model 2</u>	Mod	1-3	Business com. dev.	Mod	New & established	Low	Mod
ANMPI	High	3 & above	Business	Low	Established	Low	Mod
CADEHSA	Low	2-3 above	Business	Low	Established	Low	Mod
FEHCIL	High	1-3 above	Co-op	High	New & established	High	Low
<u>Model 3</u>	Mod-high	2-3	Business	High	Established	Mod	
FUNADEH	Low	3 & above	Business	Mod	Established	Low	High
IDH	Mod	1-3	Promotion	Mod	Established	Mod	Mod
CDI (industry)	High	3 & above	Business	High	Established	Low	Low
CDI/PTR	High	1-3 & above	Business diverse	High	New & established	Mod	Mod
ASEPADE	Low	1-3	Promotion	Low	Established	Low	High
<u>Model 4</u>	High	3 & above	Business	High	Established	High	
OEF	High	2-3 & above	Business	High	Established	High	Mod
<u>Model 5</u>	Mod-high	1-2	Comm. dev.	Mod	New & established	high	
ASEPADE	--	--	--	--	--	--	--
CREDISOL	Low	1-2	Promotion	Low	Established	Mod	High
<u>Model 6</u>	High	1	Specialize	Mod	New	High	
CDI (artisan)	High	--	Technical	High	--	High	Low

Table 7. Nine SME Implementing Institutions in Honduras
1986 Credit Program Operations
In Lempiras (\$051 = 2 mps. 2)

Name	Years in operation organization	Credit program	In-house		External training	1986 loans extended	Amount	Average	Interest rate	Arrearage	Savings mobi- lization
			T.A.	Training							
ANMPI (2)	15 years	3 months	Yes	No	Yes	24	11,750	500	12%/yr	0	Yes
ASEPADE ^a	10 years					365	185,300	500-600	2%/mo.	16%	Yes
CREME (3)		2 years	Yes								
CREDISOL (5)		2 years	Yes	Yes	No	743	378,300	500-600	2%/mo.	20%	Yes
CADEHSA (2)	2 years	2 years	No	No	No	(only commodity credit extended)			0	0	No
CDI (3)	8 years	8 years	Yes	Yes	Yes	187	1,900,000	10,000	11-17%	53%	No
CDI/PTR (3) ^b	6 years	6 years	Yes			54	304,800	5,600	16%	20%	No
FEHCIL (2)	10 years	3 years	Yes	Yes	No	18	295,000	26,800	12-15%	30%	No
FUNADEH (3) ^c	3 years	15 months	Yes	No	Yes	176	1,267,000	7,200	17%	2.3%	No
IDM (3) ^d	7 years	5 years	Yes	Yes	No	196	634,000	3,235	16%	29%	No
OEF (4)	1½ years	6 months	Yes	Yes	No	11	45,000	4,100	16%	11%	No
Partners	SME credit program not yet in operation										

- a. Data for a five-month period: Aug.-Dec. 1986, except arrearage, which is cumulative.
b. Included only loans to SMEs.
c. Data for the 12 month period: October 1985 - September 1986.
d. 49 percent of the loans are for agriculture.

Currently, in Honduras, no one SME implementing institution uses this model, although FONDEI and FIA were originally intended to operate in this manner. In practice, however, their procedures have become complicated, burdensome, and subject to over-analysis. They have taken a conservative attitude toward portfolio growth to prevent default rates and adhere to credit requirements.

Model 2: Integrated financial assistance and technical assistance/social promotion, designed to provide services to individual entrepreneurs and encourage group action to resolve common problems. According to HIID, Model 2 is similar to the first model except that as part of a credit application or monitoring process, entrepreneurs receive individualized assistance and become members of groups that meet to discuss and resolve similar problems. Community development and group cohesion goals are emphasized and groups may cooperate to acquire access to raw materials or necessary inputs.

Model 2 programs incur lower costs than programs based on more complex models. This model includes income generation components for the institutions involved. It is appropriate for all three levels of entrepreneurs and new or established businesses. It calls for staff trained in basic business skills and social promotion skills. This model has a limited capacity for growth, since staff must be maintained commensurate with the services offered.

Currently, FEHCIL, ANMPI, and CADEHSA utilize an approach to SME development based on this model. However, these institutions emphasize organizing for group economic services, rather than specifically for social services or community development. While Model 2 accommodates all three levels of SMEs, its effectiveness varies with specific subsectors or

industries, due to the varied problems and needs of commerce, service, and industry-based enterprises. In Honduras, institutions employing Model 2 work with established, rather than new, business. No determination can be made on the cost efficiency of this model in Honduras, as compared to others, since only three institutions reviewed use this model, including the most cost efficient (CADEHSA) and one of the least cost efficient (FEHCIL).

Model 3: Integrated and sequenced financial assistance, technical assistance, and training for individuals. Credit, extension, and training are options for borrowers. This model incurs higher cost because of the need to subsidize technical assistance and training. It is most appropriate to entrepreneurs in levels 2, 3, and above (micro and small with basic skills and limited and good potential for growth), and established rather than new businesses. It requires staff trained in business practices and teaching.

According to HIID research, programs based on this model may encounter difficulty in providing effective technical assistance and training, as they have little leverage over the client once a loan has been granted. Drop-out rates for extension and training may be high unless both are of high quality and relevant to the entrepreneurs.

Currently in Honduras, two implementing institutions take an approach to SME development based on Model 3 (FUNADEH and IDH); two combine Models 3 and 5 (ASEPADE-CREME and ASEPADE-CREDISOL, respectively); and one combines Models 3 and 6 (CDI). IDH provides an entire package of technical assistance, training, and credit. FUNADEH provides technical assistance and credit, but organizes training with other institutions in an effort to keep costs down. ASEPADE and CDI

use a combination of models, each directed to different client populations.

While researchers have attributed low administrative costs and default rates to successful implementation of this model in other countries, in Honduras the experience is mixed. Organizations with the highest default rates and highest administrative costs (CDI) and the lowest administrative costs and delinquency rates (ASEPADE and FUNADEH) employ variations of this model. Generally, Model 3 is considered relatively expensive because of the need to subsidize technical assistance and training. However, implementing institutions such as ASEPADE and FUNADEH have the lowest administrative costs of all organizations reviewed in this sample. FUNADEH attributes its lowered administrative costs to the use of outside training resources for both business training and specialized production technical assistance.

Technical assistance provided by these institutions is seen as an integral (and mandatory) part of the loan application and recuperation process. Hence, a degree of leverage over the borrower is maintained and the drop-out rate for technical assistance is negligible. Training in all programs is voluntary and free. It is estimated that over 50 percent of the borrowers avail themselves of these services.

Model 4: Integrated and sequenced training, technical assistance, and financial assistance for individuals, with an emphasis on training as the most important need of SMEs. In this model, only after a required training and technical assistance sequence has been completed do entrepreneurs become eligible for credit. This model also incurs high costs. Riskworthy clients are effectively identified; as a result, credit programs are more able to assist the enterprises more

likely to survive and grow. Model 4 is most appropriate for entrepreneurs in Level 3 and above, and for established rather than new businesses. A relatively large staff is required for each business assisted, which stresses business skills as well as entrepreneurial motivation. This model requires a high level of commitment on the part of beneficiaries.

In Honduras, ASEPARE employs Model 5 in the CREDISOL program, which extends credit to micro entrepreneurs engaged in commerce. The program has been quite effective in reducing its delinquency rate, generating savings, and increasing the credit fund through interest earned. While social promotion is essential to the functioning of the program, staff training in business skills is being sought to increase program effectiveness. If this model is to generate growth in addition to maintaining micro enterprises at their current levels, its ultimate success will depend on a staff with both social promotion and basic business skills.

Model 6: Training, primarily job skills training, is widely used by a number of government training agencies. This model incurs high costs and considerable investments in buildings, equipment, specialized training, and staff salaries. Subsidies by government and donors are usually required. It is most appropriate for reaching Level 1 beneficiaries and new enterprises.

CDI employs Model 6 in its artisan development program, which has had little success in establishing new enterprises for trainees or breaking even on the artisan sales outlets.

Other Factors

Analyzing approaches to SME development based on characteristics, advantages, and disadvantages inherent in models

employed is useful to determine how effectively implementing institutions can assist clients and what kinds of clients they can assist. However, the experience in Honduras suggests that other factors are more important in determining an organization's capacity to foster SME development.

The successful "models" employed by implementing institutions in Honduras are dynamic; to respond to changing circumstances and lessons learned from previous experience. While these institutions generally do not change their basic program approach, they become hybrids and composites as they grow. The older implementing institutions currently operating effective programs have changed over the years and have developed "composite profiles" (ASEPADE). Those whose programs have not been effective have maintained their traditional SME assistance models (IDH and CDI). The newer organizations and programs (OEF, FUNADEH, and ANMPI) rely on outside agencies for either training or credit in order to reduce costs and specialize in particular aspects of service delivery.

The factors in determining an organization's capacity to foster SME development are outlined below. Universal factors include:

- . The institution's ability to respond to change based on established priorities and strategic planning, within the institutional mandate and outside of donor influence
- . The institution's ability to recruit and keep qualified staff and provide staff development opportunities
- . Strong executive leadership as well as solid program management

Factors specific to Honduras include:

- . The institution's ability to specialize in SME assistance
- . Staff trained in business skills, as well as social promotion, if required by the program. Programs with the highest delinquency rates did not have staff trained in business skills.
- . Rapid loan application procedures. An inverse relationship was noted between the time required/thoroughness of analysis during the application phase for small amounts of working capital and the delinquency rate. The longer the turnaround time and the more thorough the analysis, the higher the delinquency rate.
- . Factors such as group responsibility, membership requirements, quick and credible collection procedures, penalties for late payments and incentives for repayment, and frequent contact with the borrower. These are more important considerations in securing and maintaining low delinquency rates than thoroughness of analysis for SMEs requesting small amounts of working capital.
- . Use of technical assistance as an integral part of the loan application and recuperation process. When this is provided effectively, beneficiaries perceive it as helpful in improving business practices as well.
- . The organization's ability to increase the size of its portfolio by charging commercial interest rates (and above) and maintaining low delinquency rates. Most organizations' self-sufficiency is rooted in their ability to expand loan funds and earn income from credit extended.
- . The introduction of a savings program that assists capitalization of a credit fund and promotes client identification with the implementing institution

- . Computer capacity, now almost essential to a successfully managed credit portfolio and well managed organization

Technical Assistance and Training Agencies

With the exceptions of CIDE and INCAE, none of the training agencies reviewed focus their efforts on support of SMEs, either as a broad goal or as a set of client centered interests. Coverage of SMEs, with the exception of INFOP, is numerically and geographically marginal. Methodologies and operating principles are generally not relevant to direct subsector support. Mechanisms for delivery of services (where relevant) are absent. Services are provided through direct collaboration with implementing institutions, especially PVOs.

Despite some areas of actual or potential support, no technical assistance and training agency outside the implementing institutions can deliver training to SMEs in credit-linked and relevant forms. Increasing the capacity of implementing institutions appears necessary to expand SMEs. This effort will require technical assistance and training as well.

"Second Story" Organizations

Few "second story" organizations, or organizations that have the potential to develop as such (CDI), can offer a wide range of program and support services to a broadly institutional and SME clientele. For example, the Chambers of Commerce and Industry have an organizational bias toward large and medium-sized business and a specific geographic focus. FEDECAMERAS, the Federation of Chambers, is too far removed to

provide necessary services to implementing institutions, and an important Chamber, C.C.I.C., is not a member.

Two organizations currently provide assistance to PVOs, cooperatives, and trade associations in support of business development. These are the ANDI/PYME program and FOPRIDEH, although FOPRIDEH's objectives are much broader. A major concern with ANDI/PYME is the capacity of its management and staff to undertake additional workload in a program that is still struggling to focus its objectives and activities. FOPRIDEH, on the other hand, has broad objectives and lacks a specific focus on small and micro enterprise development. Its potential to coordinate effectively with private for-profit and government agencies is unproven. The organization is relatively new and has not developed internal policies, approaches, or strategies to assist the SME subsector (see Appendix B for details).

Donor Support

Multi- and Bilateral Donor Support

Generally, bi- and multilateral donors do not have a developed strategy for reaching SMEs. Their programs reflect their own operating principles and biases. Large credit programs are the basic ingredient of multilateral programs. Technical assistance and training are provided, when required, but these program components are not considered as important as sufficient amounts of credit. Bilateral donors, on the other hand, generally consider technical assistance and training more critical than credit. Limited access to credit rather than insufficient amounts, is believed to be the crucial problem. Generally, multilateral donors direct their assistance to small and medium-scale industry throughout

Honduras, while bilateral donors tend to concentrate in rural areas, working mostly through cooperatives (see Appendix C for details).

USAID/H

USAID/H does not have an overall strategy for small enterprise support. Only two USAID/H offices, PSP and RD, administer active projects that directly or indirectly support SMEs. Other offices reviewed either have no current or planned small business programs or have programs with random assistance secondary to SME support (see Appendix E for details).

A review conducted of current USAID support concluded that there is no regional bias or urban/rural focus in support of SMEs. PSP's projects concentrate on urban areas; their major objectives are employment and income generation. RD's projects, which do not emphasize SME development, focus on rural areas; their major objectives are production and income generation. Marketing activities received little, if any, attention. However, USAID/H does provide assistance to implementing institutions and (directly) to beneficiaries.

Donor cooperation for SME support is limited. However, in interviews during this strategy review, donors indicated a need for some type of donor coordination. USAID leads the donor community in terms of personnel and resources focused on the SME sector. With this USAID initiative in strategy development, it can lead donor dialogue and coordination of SME support in Honduras.

Conclusions

The major institutional problems affecting SME development in Honduras concern coverage, client focus, staffing, budget, inter-institution coordination, and support from training agencies, "second story" organizations, and donors.

Coverage

Coverage of the SME sector as a whole is extremely low. CDI estimates that only 10 percent of the small and medium-scale industries in Honduras, the subsector receiving the most assistance, receives financing from the public sector (5 percent) and formal private sector institutions (5 percent). A recent survey of public and private support institutions indicates that approximately 6,700 clients were provided services in 1986, compared to the 78,400 estimated total number of SMEs in Honduras. This survey assumed no overlap; services reviewed included credit, technical assistance, training, seminar attendance, and promotional talks. Effective coverage is estimated to be much lower than the 8.5 percent indicated by this survey.

Overall individual institutional coverage is low, ranging from approximately 150 to 2,600 clients assisted yearly. The number of clients reached with program assistance packages is lower, ranging from 9 to 2,600 annually. Four organizations reach over 100 clients; the remainder reach less than 50. Coverage is higher and more focused among organizations that specialize in SME support. While there is some incremental capacity for organizations to increase coverage (three of the programs have operated for less than two years), institutions must develop growth strategies to reach more clients.

Expansion of Client Focus

The organizational mandates of most institutions call for a specific client focus -- industry, commerce, artisans, women, cooperatives. Expanding into new geographic areas, working with new clients, and diversifying program areas would not, for the most part, after these institutions' original organizational philosophy, orientation, or mandate. These have to change to give any new client focus meaningful financial support.

Expansion Staff Size and Capacity

Expanded program size and coverage will require increased staff size and capacity. Expansion is further limited by a lack of computer-based data and computer management skills. Financial management capability is limited for the same reasons.

Budget Expansion and Self-Sufficiency

None of the organizations reviewed, with the exception of CADEHSA, operates on internally generated funds from program or services income. No organization generates funds by providing training to clients. Some have been successful in generating funds from credit programs; all of these credit funds were grants from donors or soft loans from the Inter-American Development Bank. Some credit programs have attained a high level of self-sufficiency. For example, the ASEPARE CREDISOL program currently covers approximately 75 percent of all costs associated with the program. In most cases, income earned is used to increase the size of the fund, rather than to covering operating costs. This measure for attaining

increased self-sufficiency is appropriate, since most programs will never reach acceptable levels of self-sufficiency unless they increase the scale of their credit operations dramatically.

Inter-Institutional Coordination

The level of coordination among institutions is low. Although many institutions have developed credit delivery and training methodologies with some measure of success, information collection and dissemination, collaborative programming, and inter-agency learning efforts are still in an embryonic state.

Training Agency Support

Generally, two types of training organizations currently operate programs in Honduras. The first group is geared toward upgrading the skills of the labor forces; the second is geared toward strengthening upper-level and middle management skills in large-scale enterprises. There appears to be no training agencies for SME support institutions.

"Second Story" Organizational Support

"Second story" organizations share certain characteristics: they focus on specific client groups, they have recently established support services, or they do not focus on SMEs. No "second story" organization incorporates all the program components appropriate to implementing institutions supporting SMEs.

Donor Activity

Bi- and multilateral donor activity in support of SMEs is limited and fragmented.

Financial Intermediation

Acceleration of economic growth and creation of employment will require a major private sector investment effort. This can only occur in a favorable investment climate. Some factors affecting the investment climate in Honduras are largely beyond the government's control, but weak economic and financial management compound the negative external factors and have led to substantial capital flight. The investment climate is also influenced by its legal and institutional framework and the availability of essential factors of production. Medium-term financing and skilled labor are the most important of these (World Bank, 1986).

Credit from the formal banking sector is abundant, but not accessible to SMEs. Unused program funds in 1986 remained at substantial levels: CDI, approximately US\$1.7 million; FONDEI, approximately US\$5.5 million (Castillo, 1986). On the other hand, credit from non-banking lending institutions is accessible to SMEs, but not abundant. Current NGO loan portfolios for SMEs range in amounts from US\$23,500 to 600,000. Most of the portfolios are under US\$150,000 (estimate based on material from eight NGOs providing SME credit). Medium-term credit is scarce in Honduras, regardless of enterprise size. Thus, the pattern of private sector investment is largely determined by the entrepreneur's ability to self-finance investments. SMEs are particularly disadvantaged because they often have greater difficulty than larger enter-

prises in raising funds and are perceived by the banks as a bad risk.

This condition still exists after considerable activity by USAID, the World Bank, and others since the early 1960s. Many of the development questions vis-a-vis the Honduran financial system, especially in the private sector, hinge on the virtual absence of capital market institutions capable of marshalling savings for longer-term debt and equity financing (Vanderveen, 1985).

Market Constraints

Existing programs that support SMEs put little or no emphasis on the market constraints that these enterprises face. Marketing constraints are one of the main bottlenecks in productivity and growth in both industry and agriculture in Honduras. This inefficiency arises from the lack of coordination among independent and isolated producers and merchants (often and the same enterprise), who are unable to benefit from the economies of scale associated with vertical and horizontal integration. Existing marketing firms operate with limited profit and growth objectives. They have no access to formal sources of credit, technical assistance, domestic or international market information, insurance, or training. These factors hamper the adoption of innovative approaches to enhance operating efficiency.

Micro, small, and medium-sized private marketing firms and operators in Honduras have not been able to evolve rapidly enough to keep pace with urbanization. They have adjusted to the growth of cities by simply increasing their numbers without improving their operating efficiency. These problems and inefficiencies have been addressed at various levels of

the marketing chain by innovative, integrated subsector design proposals.

The Policy Framework

There is ample evidence that the growth of small and micro enterprises in Honduras has been inhibited by a policy environment which if not overtly hostile, is at least substantially biased against the small business sector. This agrees with findings of research in other developing countries throughout the world (Haggblade, Liedholm, Mead, March 1986).

A wide range of GOH policies influences the price of capital, labor, material inputs, structure of demand for products, and profitability of various categories of producers. While there is no evidence of a deliberate GOH attempt to impede the growth of small-scale enterprise, the government's lack of understanding, its insensitivity to the impact of laws on the subsector, the lack of SME special interest representation have contributed to a complex, negative policy environment. Further complicating the policy issues is the lack of information and data on the policy environment in which Honduran SMEs operate and their response to policy initiatives. This inhibits informed analysis and decision-making.

Macro Level Policy

An inventory of policy areas that affect SMEs (developed by Haggblade, Liedholm, and Mead) is used as a reference list in Table 8. Policies with the greatest negative impact on Honduran SMEs are underlined in Table 8 and discussed below.

Table 8. Inventory of Policies, by Functional Groupings

-
1. Trade Policy
 - a. import tariffs
 - b. import quotas
 - c. export taxes or subsidies
 - d. foreign exchange rates
 - e. foreign exchange controls

 2. Monetary Policy
 - a. money supply
 - b. interest rate
 - c. banking regulations

 3. Fiscal Policy
 - a. government expenditure
 - infrastrucutre
 - direct investment in production, marketing or service enterprises
 - government provision of services
 - transfers
 - b. taxes
 - corporate income
 - personal income
 - payroll
 - property
 - sales

 4. Labor Policies
 - a. minimum wage laws
 - b. legislation with regard to working conditions, fringe benefits, etc.
 - c. social security
 - d. public sector wage policy

 5. Output Prices
 - a. consumer prices
 - b. producer prices

 6. Direct Regulatory Controls
 - a. enterprise licensing and registration
 - b. monopoly privileges
 - c. land allocation and tenure
 - d. zoning
 - e. health
-

Note: Policies with a negative impact on SME development are underlined.

Authors: Haggblade, Liedholm, Mead

Trade Policy

Overvalued exchange rates reduce the price competitiveness of consumer goods produced by SMEs and give rise to contraband. Smuggling provides the most direct competition with SME products in Honduras.

Foreign exchange controls set by the Central Bank produce a nightmare of complicated document requirements, with which an SME can rarely comply. Further, recent data supplied by the Central Bank indicate that delays in obtaining import permits and foreign exchange authorization often exceed six months for any enterprise. Small-scale enterprises lack the right connections to assure priority treatment for their foreign exchange request, and often do not receive the foreign exchange requested. Thus, SMEs lose the benefits of cheaper direct imports and a more competitive position vis-a-vis their larger counterparts.

Monetary Policy and Regulations

The Superintendency of Banks has not developed an effective bank examination system. Its review of bank portfolios for soundness consists of a review of the collateral that guarantees the loans made. Banks are often pressed to require urban real estate or similar assets as collateral under the threat of having their loans classified as substandard, doubtful, or as a loss. The reserves required for classified loans directly and negatively affect earnings. SMEs do not usually have the kind of collateral required by banks so, again, they lose access to formal sources of credit.

Labor Policies

Labor policies were most frequently cited as causing problems for SMEs and large firms alike. Most businesses try to skirt the law by hiring and firing people at short intervals in order to reduce their liability for severance pay and other benefits. The problem is so acute that the Honduran Council for Private Enterprise has suggested an emergency law suspending for one year, certain provisions of the labor code in order to stimulate the generation of employment. The most salient features of this law are suspension of the minimum wage, benefits, and the right to belong to or organize unions.

Municipal Policies and Regulations

The above outlined macro policies have less direct impact on micro enterprises. Municipal laws and regulations, dating from 1928 and in general need of reform, have more immediate impact on micro enterprises and constitute the policy framework for that group. For example:

- . Double taxation exists for small merchants in Tegucigalpa -- they must pay a municipal tax on the volume of sales, regardless of profit or loss on sales, and a national sales tax of 6 percent.
- . Businesses must be licensed by a municipality to operate there. In addition, national legal registration as a sole proprietor, partnership, or corporation is required.
- . An annual fee is imposed for posting a sign announcing the type of business in which one is engaged.
- . Obtaining stalls in the municipal markets is subject to connections and bribes. Often,

micro entrepreneurs are roused from their locations and their inventories confiscated.

Industry-Specific Policy

The extent to which a policy stance discriminates against or in favor of small firms is directly related to the role small firms have been able to play in a country's development. A number of Honduran laws that were designed to protect, support, and motivate the manufacturing sector as a whole. However, due to the biases inherent in these laws, larger enterprises are favored and the growth of small businesses inhibited. (See Appendix F for details.)

Decree Law 681, specifically designed to provide incentives for the development of artisan, small, and medium industries, provides exemptions from import duties, consular fees, consumer, and income taxes for those enterprises that qualify. An industrial classification also enables the firm one-time access to foreign exchange for equipment purchase. The procedures for classification are so complicated and costly that during 1980-85 only 336 firms were classified. Two percent of these were small industries and 1 percent artisan (micro) industries.

Decree 103, the CODEFOR law and export registration procedures, makes it almost impossible for small wood producers to export. For example, for each export shipment a small-scale enterprise must spend over four to five months and over US\$250 for permits and inspections, in addition to one month and US\$300 on a yearly basis for the export registration.

FONDEI has developed a loan portfolio benefitting mostly large industrialists, due to the use of commercial bank

intermediaries and, consequently, the bank's own collateral provisions. The total credit approved to date (US\$93,500) has been distributed in the following manner: 87 percent to large industry; 9 percent to medium industry; and 4 percent to small industry.

Agricultural Policy

Research on industrial SMEs has made clear that one of the key difficulties facing small enterprises, particularly those located in rural areas, is the limited demand for their products. A significant share of the low-cost consumer goods sold in rural markets is produced by small firms in the same area. The demand for these products and for agricultural inputs is particularly high among small farming households. Therefore, policies that promote rapid increases in agricultural income provide a powerful stimulus for small-scale enterprise. Consequently, agricultural policies such as price measures to increase the income of small farmers are important, not only in their own right, but also because they can contribute greatly to the growth of SME activities (Liedholm, Mead, 1986).

Conclusions

Research in several countries has demonstrated that, in reviewing the general policy environment of small firms, it is necessary to transcend the traditional sphere of industrial policy and include agriculture, trade, foreign exchange, and other policies (Liedholm, Mead, 1986). The policy framework presented here and the strategy team's research confirm this more global approach to the review of policies affecting SME development in Honduras. Job creation can be increased and the development of SMEs accelerated by altering GOH policy to

support those aims. While policy reform may be a necessary condition, it cannot solve all the problems of the SME sector. Well chosen policy dialogue must be combined with appropriately designed program interventions if SME development is to be achieved.

Research

There is a paucity of research institutions and capable analysts interested in and knowledgeable about the SME subsector in Honduras. Even basic and accurate data on the composition of the entire sector of the economy are lacking. For example, resources devoted to research in Costa Rica are 3 percent of GNP; in Honduras, the percentage is .2 percent of GNP. Private and public agencies supporting the SME subsector, as well as those involved in complementary activities, lack computerized data and standard methods of data collection and analysis. As with information collection and analysis, methods of dissemination for use by policymakers, practitioners, and the SMEs themselves are in an embryonic state.

Important research gaps include factors affecting firm expansion, vertical and horizontal linkages, market systems, product development and diversification, replicable modes of business development and expansion such as franchises, identification of growth industries appropriate for SMEs, and effects of policy on SMEs.

Problems of Attitude

Psychologists, anthropologists, and economists disagree on the extent to which entrepreneurship is a function of drives, culture, and values or market forces and opportunities. Clearly, all these determinants play their parts in

any setting (Kilby, 1971). No single personality trait produces an entrepreneur. Some frequently cited characteristics include innovativeness, curiosity, openness to new ideas, hard work, orientation to the future and willingness to save and invest, leadership, risk acceptance, and even selfishness or greed (Grindel, et al., 1986).

In Honduras, small and micro entrepreneurs are generally not renowned for their market responsiveness and innovative natures. They are independent and hardworking. They prefer action, with an eye for short-term gain; their business decisions are based on intuition rather than empirical analysis; they suspect the advice of outsiders (trainers, financial professionals) and resist change. As a result, the entrepreneurs spend a lot of time, effort, and resources on solving unforeseen problems that may have been prevented had they better analytic tools. Their behavior can best be understood in terms of avoidance of known risks.

While these traits often can sustain a business, they constrain the development or the growth of a firm. That is, the entrepreneur's style of improvised administration becomes inadequate for viable business organization. This occurs when the enterprise requires working capital for expansion or when there is a market for a product that would require installation of new equipment. Both circumstances require change, long-term planning, forecasting, and opening books to outside agencies. "This is when our entrepreneurs react against expanding, consider the possibility of financial assistance a personal threat, and refuse to accept change. These doubts [regarding expansion] become a real obstacle for normal growth" (G. Martinez, 1986).

Although an obstacle to expansion, risk aversion is also a rational behavioral pattern for small and micro entrepreneurs, for it often means survival. Seeking ways of making an SME's investments less risky, rather than changing behavioral patterns, is a more reasonable short-term approach to this problem. Approaches can include (1) improving market information to render ventures less risky, (2) training an entrepreneur to base decisions on a combination of analysis and intuition, and (3) providing technical assistance to entrepreneurs prior to credit for working and fixed capital.

IV. A STRATEGY FOR SUPPORT OF SMEs: GROWTH WITH EQUITY

The strategy team examined a broad range of experiences in SME support in a number of developing countries. Chapter II of this report addresses the question: How best to support this growing and important sector of the economy? The evidence indicates that support of the sector is worthwhile in both economic and social terms. Chapter III explores specific factors constraining the growth of SMEs as a more productive force in the Honduran economy.

Based on our analysis of the economic and social contributions of SMEs and the constraints to their growth, Chapter IV presents a strategy for USAID support of SMEs in Honduras. In this chapter, we discuss the relevance of SME support in the context of Honduras, the 1988-89 USAID/H Action Plan, and the Central American Initiative. The next part of this chapter discusses the nature of a strategy and the methodology used to devise one. Goals and objectives of the SME strategy are then presented. We also analyze specific initiatives USAID/H can develop to address problems of SME development and some factors that can contribute to SME growth in Honduras.

While outside the scope of this strategy, because they are integral to the next steps of project design and planning, several potential program interventions are presented.

Growth and Equity in the Honduran Context

As Chapter III makes clear, small-scale enterprises contribute to the growth of the Honduran economy and productive employment generation. Support of micro enterprises, an important equity-producing counterpart to programs of economic growth, improves the income earnings and job viability of the urban poor, especially women, by making self-employment a more tenable source of family income.

The Honduran context (and USAID/H's current emphasis on export-led growth) calls for an SME strategy that gives equal weight to growth and equity within the domestic economy. Monetary and human resources concentrated on export-oriented institutions must be balanced by development of the domestic economy and attention to potentially volatile social problems. If sustained economic growth is to occur, export-led growth must be balanced by enhanced backward linkages within the domestic economy and more vertically integrated enterprise growth and support. In terms of social equity, an SME development strategy should both generate productive employment and maintain existing jobs. It should generate income and improving income distribution by providing wider access to resources. It should increase domestic production and investment by creating new small enterprises and strengthening existing small and micro enterprises.

An SME Strategy within the Context of the Country Development Strategy (CDSS), the Central American Initiative (CAI), and the 1988-89 Action Plan

The CDSS and the CAI

The USAID/H FY 1986-90 Country Development Strategy Statement (CDSS) focuses on stabilizing the Honduran economy,

decreasing social pressures from rising unemployment, and progressively increasing investment in long-term development. The period covered by the CDSS coincides with that of the Central American Initiative (CAI). According to the 1988-90 Action Plan, the Mission's strategic objectives correspond to the four goals of the CAI: (1) short-term economic stabilization, (2) basic structural reforms leading to rapid and sustained economic growth, (3) wider sharing of the benefits of growth, and (4) strengthening of democratic institutions (USAID/H 1988-89 Action Plan) (refer to Figure 3).

The Relevance of SME Support to the CAI

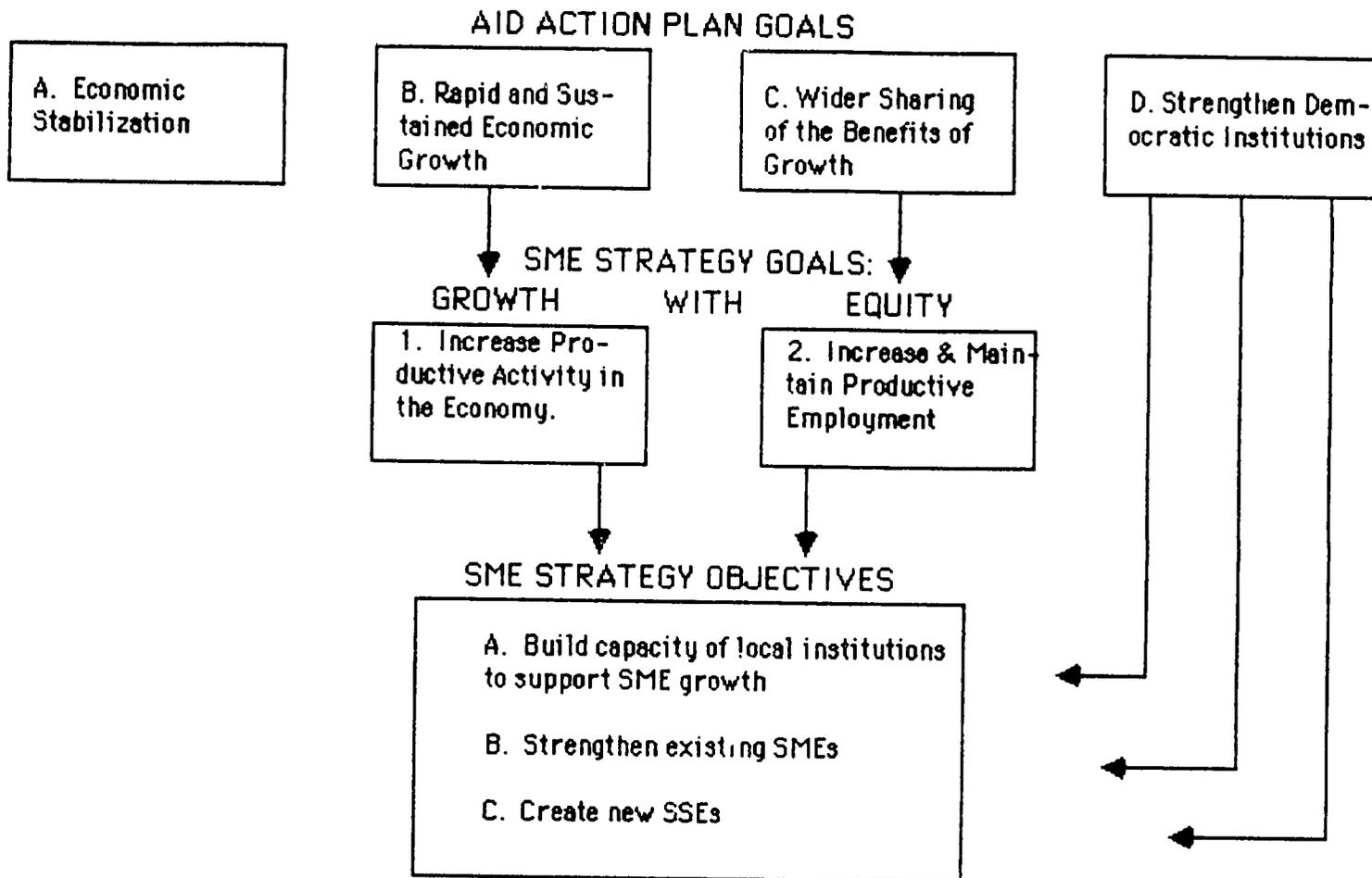
The four broad CAI goals are compatible with support of small and micro enterprise development. The CAI specifically recommends the "development of aid programs to nurture small businesses, including micro businesses." According to the CAI

Small business forms the backbone of these [Central American] economies.... Economic aid programs specifically aimed at encouraging the growth and formation of SMEs would assist in putting more people to work and also give people a larger stake in their economies.

The 1988-89 Action Plan

The 1988-89 Action Plan is to achieve economic stabilization through the GOH's implementation of macroeconomic policy changes to correct current economic disequilibria and create a policy base for a long-term, export-led growth strategy. Social stability is to be maintained through reducing unemployment, providing a minimum of food security, improving the participation of the poor in economic and social

FIGURE 3.



development, and strengthening public and private services to meet the basic human needs of the poor (Action Plan 1988-89).

Over the balance of the CAI period, USAID/H will establish an appropriate macroeconomic framework for economic stabilization and recuperation. Specific projects to enhance economic and human productivity will support this effort. USAID/H will strengthen economic productivity by encouraging increased private sector production of traditional and non-traditional products and crops and emphasizing export expansion (Action Plan 1988-90).

Designing A Strategy

Broadly speaking, a strategy is a comprehensive analytic endeavor that devises or employs theoretical and practical actions to solve a problem or achieve a goal. The development of any strategy relies on a logical progression of steps:

- (1) Defining the problems
- (2) Designing goals to address the problems
- (3) Formulating a rationale for an implementing vehicle -- in this case, answering the question "why support SMEs?"
- (4) Narrowing the focus and determining priorities by answering the questions of "who and where"
- (5) Identifying problems of using the implementing vehicle
- (6) Of those problems, identifying those that can be addressed, in this case by USAID

- (7) Formulating priorities and specific initiatives to address those problems by answering the question "what?"

Two further steps have been taken in this exercise that are properly part of the planning stage. These are: (1) determining potential program interventions (more specifically answering the question "what?") and (2) analyzing management approaches: "How can USAID most effectively support the subsector?"

The SME support strategy is a particular endeavor, forming only part of the Mission's overall support strategy. The goals and objectives of the SME strategy must be more specific than (although consistent with) the goals and objectives of the USAID Action Plan.

Goals, Objectives, and Focus of the SME Strategy

Within the context of the broader Mission goals, the specific goals of the SME strategy are: (1) to increase productive activity in the domestic economy, and (2) to increase and maintain productive employment (refer to Figure 3).

To effect these goals, the SME strategy will (1) build the capacity of local implementing and training institutions to support SMEs, (2) improve and strengthen the income earning potential of existing SMEs, and (3) create new small-scale enterprises and enterprise activity.

For reasons of equity and growth, the strategy focuses on strengthening existing SMEs in the geographic area where most SMEs are currently located (see Figure 2, Chapter I),

strengthening institutions that currently support SMEs, and encouraging the growth of new small-scale (not micro) enterprises and the diversification of product lines.

Initiatives to Address Limitations on SME Growth

The strategy proposed comprises integrated policy, program, and research components. Each component focuses on key limitations on SME development in Honduras. Broadly speaking, a comprehensive program for USAID/H support of SME development should include:

- . Initiatives to address policy questions and issues at the macro and local level
- . Program initiatives that make use of existing private Honduran organizations (NGOs), encourage private sector participation, and build on the experience of public institutions
- . Research, experimentation, and evaluation to complement policy and program initiatives

Developing each component individually provides a useful SME support mechanism. However, developing the components in an integrated fashion will facilitate a comprehensive USAID/H program that will contribute to the growth of Honduran small-scale private enterprise and to the economy as a whole.

This section of the chapter summarizes obstacles to achieving objectives and factors that will help in achieving strategy objectives. (For a more detailed discussion of constraints, refer to Chapter III.) Specific initiatives for addressing constraints and potential program interventions are outlined below.

Objective 1: Build Local
Institutional Capacity to
Support SMEs (Table 9)

Constraints

The strategy team reviewed 15 Honduran public and private organizations that implement programs with SMEs or provide training and technical assistance. A broad range of organizations in the country either specialize in SME support or include SME support as part of their program activities. Coverage is generally low and fragmented, although it is higher and more focused among the organizations that specialize in SME support. The level of coordination is low. Most organizations' mandates call for specific client focus (industry, artisans, service, commerce).

The capacity, level of coverage, methodology, institutional profile, and philosophy of SME support institutions vary considerably. No organization stands out as exceptional, although two or three are more efficiently organized and more effective in achieving results. Even among those that top the list, expanding programs will require changes in staff size, technical and management capability, and budget. Institutional capacity to expand is further limited by a lack of computer-based data and computer management skills. Financial management capability is limited for the same reasons (see Appendix B).

Generally, two types of training organizations currently operate programs in Honduras. The first is geared toward upgrading the skills of the labor force, and the second is geared toward strengthening upper level and middle management

Table 9. Objective 1: Build the Capacity of Local Implementing and Training Institutions to Support SMEs

Constraints	Specific initiatives to address constraints	Interventions
1. Coverage of SME support institutions is low and disparate.	1. Increase coverage of SME support institutions.	1. Support new regional and contiguous expansion of existing SME support institutions. Focus SME support on a national level, emphasizing SME support in the growth belt.
2. Coordination among SME support institutions is low.	2. Promote collaborative efforts that encourage complementary inputs and enable organizations supporting SMEs to learn from each other.	2. Create interinstitutional program linkages. Develop uniform standards in design, monitoring, and evaluation systems. Develop longitudinal studies on impact. Develop uniform measures of size and activity for economic viability of firms.
3. Most institutions that support SMEs are involved in a broad range of development activities, inhibiting focused support.	3. Focus support on institutions that specialize in SME programs.	3. Develop a system to determine institutional capacity.
4. SME support institutions are overextended in staff size, capability, and budget. Institutional capacity to expand is limited by lack of computer-based data. Institutional financial management capacity is limited.	4. Assist SME support institutions in addressing their reluctance to expand their activities.	4. Develop institutional selection criteria; conduct serious institutional assessments. Build staff development into every project (business skills & financial management). Improve financial systems. Enhance computer capability. Develop self-sufficiency projections with institutions. Develop performance standards.
5. Training agencies not geared to the specific problems of SME support institutions.	5. Promote collaborative efforts between SME implementing agencies and local, regional, and international training agencies.	5. Conduct staff development needs assessment jointly with SME support institutions & training agencies. Investigate results of several local training modules and programs for extension agents & mid-management. Develop business extension agent concept; design training module. Develop CEO skills in management & fund-raising.
6. SME multi- and bilateral donor activity is limited, fragmented and uncoordinated.	6. Take the lead in donor dialogue and coordination of SME support.	6. Follow-up on initial visits to continue dialogue through planning & analysis stage.

skills of large enterprises. There appear to be no training support agencies for SME support institutions.

"Second story" organizations, like implementing institutions, focus on specific client groups, have recently established support services, or do not have an SME focus. No organization incorporates all the program components appropriate for support of SMEs or implementing institutions.

Specific Initiatives to Address Institutional Constraints

While constraints seem numerous, a number of NGOs currently operating in Honduras have made advances in SME support. Public sector institutions lag behind. NGOs, which prevail in the field, charge commercial interest rates for credit funds, familiarize clients with the banking system (although it is currently out of the reach of most clients and likely to remain so for many others), increase their credit funds through interest earned, upgrade staff skills, and reduce costs of client training by relying on outside organizations. For these reasons, the strategy focuses on existing NGOs in Honduras (implementing institutions, training and technical assistance agencies, and "second story" organizations) to support SME development, complemented by selected public institutions that have played an active role in SME support.

Specialized SME support institutions, such as FUNADEH and ASEPADE, have developed or are developing computerized database systems to track their clients' enterprise development and manage their portfolio and finances more effectively. The databases provide the organizational and resource material to monitor financial rate of return (clients' business

development) and evaluate economic rate of return (impact of the project-supported enterprises). With the assistance of Peace Corps Volunteers and development community members, significant strides are being made in upgrading NGO monitoring and evaluation systems.

Recently, these organizations have successfully expanded program operations into other geographic regions. For example, ASEPADE has recently opened branch offices in Choluteca and San Pedro Sula. FUNADEH has a well-defined strategy for expansion outward from San Pedro Sula and has planned a collaborative effort with PADF and ANDI to develop similar program operations in Tegucigalpa.

Initiative 1: Increase coverage of SME implementing institutions by supporting a national effort, with emphasis on the growth belt.

Program intervention: support new regional and contiguous expansion of existing SME support programs.

Most SMEs are located in the growth belt, a slightly elongated "S" curve that extends from Atlantida, includes San Pedro Sula, slices through the Central Zone, and continues through Tegucigalpa to Choluteca/Valle. This is an area of high population density, increasing immigration, and growing productive activity (including SME activity). Prospects for new and strengthened SME growth are better in this area due to several market and production factors. These include more developed physical and institutional infrastructure, higher income levels, higher population density, a more highly educated labor pool, and more backward and forward linkage industries.

Initiative 2: Focus support on implementing institutions that specialize in SME programs.

Program intervention:

- . Develop a system to determine NGO and government institutional capacity to support SMEs.
- . Select SME implementing institutions to participate in the strategy on the basis of past program experience, SME specialization, and organizational advancements made in SME support.

Implementing institutions that focus on SME support can contribute more to SME development than those wherein SME development is only one component of a larger social service unit. The organizational mandates and internal operating procedures of the former institutions are consistent with SME development. Thus, their specific tasks support one another, rather than responding to competing interests that force them to juggle financial and managerial resources. In addition, their internal policies, program advancements, and methodological revisions are based on experience in the field.

Concentrating human and financial resources on institutions that specialize in SME support is an important part of this strategy, since implementing institutions must dramatically increase their credit portfolios to reach acceptable levels of self-sufficiency. These specialized institutions can unify new research, program, and policy initiatives. They have formed support networks with other national, regional, and international institutions that specialize in the field.

Initiative 3: Promote collaborative efforts that encourage complementary inputs and enable organizations supporting SMEs to learn from each other.

Program intervention:

- . Create inter-institutional programmatic linkages with organizations specializing in discrete activities, such as credit delivery and training, and organizations specializing in micro and small enterprise development for the purposes of client graduation
- . Develop uniform standards in design, monitoring, and evaluation systems
- . Develop longitudinal studies on impact
- . Develop uniform measures for economic viability of firms according to size and activity, differentiating among the varying needs of industry, commerce, and service enterprises

In a field that is more practical than academic, innovative programs and successful support efforts are developed by the implementing institutions themselves. Implementing institutions specialize in developing a specific support network or a particular program activity, such as credit delivery to small industry (FUNADEH), credit delivery to micro entrepreneurs (ASEPADE), or training in enterprise development (OEF). The business of implementing institutions is implementation, and few can devote time or resources to research and evaluation. Although many institutions have developed credit delivery and training methodologies with a measure of success, information collection and dissemination, collaborative programming, and inter-agency learning are still in an embryonic state.

Initiative 4: Assist SME support institutions in addressing their reluctance to expand activities.

Program intervention:

- . Develop institutional selection criteria
- . Conduct serious institutional assessments
- . Build staff development into every project
- . Improve monitoring and financial systems
- . Upgrade computer capability
- . Develop self-sufficiency projections with institutions
- . Develop performance standards

With few exceptions, NGOs supporting SMEs in Honduras are not wedded to a particular operating style or methodology. They look for what works well and how to improve operations. While willing, they are reluctant to experiment in the absence of a clear statement of options. They work slowly and in increments. They are prepared to take calculated risks in program policy changes and expansion, but they lack confidence and skills. In a sense, their risk-averse behavior is like that of their SME clients.

A donor's involvement in assessing institutions may be threatening. Institutions have successfully audited themselves, often with the assistance of disinterested parties. They have determined what the institution does well and how to improve operations. They have identified potential growth areas while avoiding program pitfalls. Central strategy components should develop criteria to select institutions for participation in the strategy, provide funds to upgrade skills

and systems within a specific time frame, and develop stringent performance standards for institutions participating in any future program efforts. It is important to separate the wheat from the chaff.

Initiative 5: Promote collaborative efforts between SME implementing institutions and local, regional, and international training agencies.

Program intervention:

- . Conduct staff development needs assessment jointly with SME support institutions and training agencies
- . Investigate results of several local training modules and programs for extension agents and middle management
- . Develop the entrepreneurial extension agent concept and design training modules, based on INCAE's experience
- . Develop CEO skills in management and fundraising

Implementing institutions are the primary source of training and technical assistance for SME clients. They either provide services directly or arrange for the services of outside training and technical assistance agencies. Upgrading staff training and skills of implementing institutions is central to well-managed programs, SME growth, and organizational strength. The institutional survey carried out as part of the strategy indicates a link between credit programs with high loan delinquency rates and program staff untrained in business skills. Although each organization has special staff development needs, general areas needing upgrading include: business extension, analysis, and marketing

skills; program planning and management skills; managerial, accounting, and database management and analysis skills; and financial management and fundraising skills.

A number of agencies in Honduras can train implementing institution staff directly through regional or international training resources. INCAE has developed a program of extension methods and management for the "entrepreneurial extension agent." IDEA has designed a one-year managerial accountancy and database management course with specific relevance to SME credit operations. With some adaptation, GEMAH's management-by-objectives courses for large- and medium-scale enterprises may be relevant to NGO managers. Partners has developed a fundraising training program for NGOs. All these programs are new and must be evaluated carefully.

Initiative 6: Take the lead in donor dialogue and coordination of SME support.

Program intervention: follow up on initial visits to continue dialogue through the planning, analysis, and implementation stages.

Although many donors support various activities of small-scale enterprise development, overall support is limited, fragmented, and not based on strategic planning. Donor cooperation in SME support is also limited. During interviews with the strategy team, donors indicated a need for and interest in donor coordination. USAID leads the donor community with personnel and resources concentrated on the SME sector. With the initiative of the strategy development stage, USAID/H can lead donor dialogue and coordination of SME support in Honduras.

Objective 2: Improve and Strengthen
the Income Earning Potential of
Existing SMEs (Table 10)

Constraints

Research on projects, policies, and support mechanisms fostering small-scale enterprises in Honduras revealed bottlenecks in several areas important to SME growth. Credit in the formal banking system and the government programs supporting SMEs is abundant, but not accessible to SMEs. Credit in the NGO support institutions is accessible to SMEs, but not abundant. With the exception of production technical assistance provided through IESC and INFOP, training agencies are not geared to the specific business management problems of SMEs. Existing SME programs pay little attention to market constraints or market development programs. Macro and municipal policies are substantially biased against the SME subsector.

Lack of information and data on the policy environment inhibits informed analysis and decisionmaking. SMEs have no forum for policy dialogue. Overall, projects tend to focus on the support of industry, paying little attention to services and commerce.

Specific Initiatives to
Address Constraints

As in the case of building institutional capacity, experience in the Honduran context and programs currently operating has established useful groundwork for further program development. Implementing institutions, training

Table 10. Objective 2: Improve and Strengthen the Income Earning Potential of Existing SMEs

Constraints	Specific initiatives to address constraints	Interventions
1. Credit in the formal banking system is abundant but not accessible to SMEs.	1. Encourage creative collaboration between SME support institutions and commercial lenders.	1. Design a demonstration/experimental credit project for SMEs. Research possibilities of special credit windows within existing commercial banks & FIA; Research SME bottlenecks. Provide TA to banks.
2. Credit in SME support institutions is accessible but not abundant.	2. Provide directly or leverage credit funds to selected SME support institutions.	2. Coordinate with banks and other donors. Evaluate CDI/PTR experience in providing loans to NGOs for credit funds.
3. Most SME programs concentrate on industry; little attention is given to commerce and services. Training agencies not geared to specific problems of SMEs outside of production.	3. Provide balanced assistance to industry, service, commerce, agro-industry and artisans. 4. Promote SME support institution and training agency collaboration.	3. Research assistance needs of SME industry, service, and commerce. 4. Identify SME support institutions successfully providing training to SME clients. Promote material exchange and inter-agency training service provision; scholarships.
5. Existing SME programs put little emphasis on market constraints.	5. Provide information, channels, and training to SMEs in market operations and responsiveness.	5. Investigate market systems that interact with SMEs. Evaluate marketing courses. Emphasize large/small joint ventures.
5. Macro and local policies (municipal) inhibit SME growth but little is known about SME specific response to policies and how policies may promote SME growth. No data collected or research done to enable a policy dialogue. No forum for SMEs to encourage in policy dialogue.	6. Support a government effort to develop national strategy to address SME problems. Support efforts to build representative institutions for SMEs to address socio-economic constraints and to represent SMEs before government and the broader society.	6. Encourage research and policy studies on SMEs to support policy project. Include SME policy issues in overall policy project. Coordinate with donors, trade associations and chambers on SME policy issues. Develop guidebook on SME policy issues.

agencies, "second story" organizations, and individuals in research and academic institutions have begun to evaluate their experiences and take new initiatives in sector support.

Honduran NGOs are experimenting with solidarity groups in business promotion. They seek to improve large business leaders' awareness of the importance and problems of micro and small businesses in the Honduran economy. Business associations give small entrepreneurs a unified voice with which to address the government, the business community, bankers, international donors, and academic communities.

Significant strides have been made in Monterey, Mexico, with the formation and development of MIMEXA, a self-managed association of small entrepreneurs which has large business representation on its Board of Directors. No such organization exists in Honduras. However, groundwork has been laid by FUNADEH, whose Board includes representatives of the business community. A relationship has been established between ANMPI and ANDI, trade associations for small and large industry, respectively.

Along the lines of association development, direct linkages may be established between large- and small-scale enterprises. This seems relevant in Honduras; many larger firms have begun to export as a result of the advantages offered by the CBI. Due to the uncertain political environment, industries are seeking ways to expand their export capacity without sinking large amounts of capital into fixed investment. Through the ANDI/PYME program, several ANDI members have expressed interest in joint ventures with small-scale enterprises. In efforts to increase its total membership, the CCIC is promoting membership among small-scale

enterprises. CCIC and other Chambers may attract SMEs by investigating and developing joint ventures between large and small enterprises.

Field observation in secondary cities and small towns supports the view that there is an abundance of trade in locally produced retail goods. USAID/H is preparing a project to promote the predominantly small-scale businesses involved in wholesaling and retailing of foodstuffs. This vertically integrated and balanced subsector project design (production to retail and artisan producer to wholesaler-retailer) is an innovative approach and attentive to strengthening vertical linkages within the domestic economy.

Initiative 1: Encourage creative collaboration between SME support institutions and commercial lenders.

Program intervention:

- . Consider designing a demonstration/experimental credit project for SMEs through a commercial bank with the collaboration of an NGO. In encouraging creative collaboration between SME support institutions and commercial lenders, USAID/H can elicit initial private sector support for SMEs. ANDI/PYME has initiated talks with BANHCASE to establish a special credit window for small-scale enterprises. FIA can play an important role in this experiment as well. These two efforts can be expanded to include an NGO or NGOs primarily serving "bankable" clients.
- . Given the difficulty of ANMPI clients in qualifying for FIA loans, the bankability of clients requires serious study as part of the research for an experimental project (Blayney/Clark, 1986). Creditworthy clients should not be encouraged to approach commercial

lenders before cumbersome application procedures for small-scale enterprise, special window clients are revised.

Provide technical assistance to commercial and government institutions to enable them to develop lower cost screening mechanisms for small-scale enterprises while providing temporary or declining loan guarantees. Training loan officers and bank officials on the potential and problems of small-scale enterprises should be considered.

Formal financial institutions have been a limited source of financing for small-scale enterprises in Honduras. Commercial banks have not extended credit to small firms, believing that administrative costs and risks of lending to small-scale enterprises are higher than those associated with their regular larger scale customers. Further, banks do not know how to deal with small-scale enterprise clients. The latter often cannot provide the kind of information requested by banks, cannot wait the amount of time required for loan processing, and do not possess the collateral banks require -- often 200-300 percent, generally secured by urban real estate.

Large amounts of inaccessible funds in government credit programs specifically designed for small and medium industry (CDI) are generally attributed to the high interest rate, currently 17 percent. Upon closer examination, lengthy and cumbersome loan application procedures and reluctance to lend based on high arrearage rates (29-58 percent) appear to be the real culprits.

Contrary to the experience of government and commercial lenders, experience in several NGO credit projects in Honduras reveals that administrative costs per loan are as low as 16 percent on loans of US\$250 and 7 percent on loans of US\$3,600.

Both these agencies deliver credit in two to seven weeks, have extensive follow-up and supervision services, have arrears rates (loans one day late) of 16 percent and 2.3 percent, respectively, and charge between 24 percent and 17 percent interest.

There is still quite a lot to learn about the behavior of Honduran SMEs vis-a-vis NGOs, government institutions, and commercial lenders. However, experience has demonstrated that SMEs can afford commercial interest rates for working capital. The risks of lending small amounts for working capital do not appear greater than risks of lending to larger firms. Administrative costs on small loans do not have to be exorbitant. With group or packaged loans, administrative costs can be average or below normal costs.

Initiative 2: Provide directly and/or leverage credit funds to selected SME support institutions.

Program intervention:

- . Coordinate with banks and other donors.
- . Evaluate CDI/PTR experience in providing loans to NGOs for credit funds.

While the introduction of private sector "mentality" is important, existing SME programs in Honduras are not going to become self-sufficient quickly. The aim of this initiative is to leverage some of the abundant credit and other resources of the formal sector and combine them with "soft loan" or grant funds. Important questions regarding self-sufficiency are: What level of subsidy is acceptable? What should this subsidy be used for? (e.g., a percentage of operating cost, training,

increasing a credit portfolio). Existing or new SME programs may never reach "acceptable" levels of self-sufficiency unless they increase the scale of their credit operations dramatically.

With the exception of the BID "soft loan," few NGOs have received credit program funds as loans. The CDI/PTR program experimented recently by lending funds to NGOs for on-lending to SMEs, with some initial success. Given CDI's poor track record in lending directly to SMEs, a more appropriate role may be the provision of credit lines to NGOs, especially if CDI learns from its own program experience.

Initiative 3: Provide balanced human and monetary support assistance to industry, service, commerce, agro-industry, and artisans.

Program intervention:

- . Research assistance needs of SME industry, service, and commerce.
- . Develop a balanced project portfolio.

While the number of small and micro industries reached is low relative to the number of those currently operating in Honduras, SMEs are the sector most favored by government and NGO credit and technical assistance programs. Most research has focused on these firms. Donors' preoccupation with "visible assets," not unlike the preoccupation with physical infrastructure projects of the past, skew support toward the industrial sector. Research in other countries suggests that commerce and service enterprises generally have lower rates of return and lower prospects for employment generation. These

opinions are based, for the most part, on particular instances.

In Honduras, the most common reasons for excluding services and commerce enterprises were based on (1) the difficulty of working with the sector and (2) the organizations' own promotional campaigns oriented, either by mandate or preference, toward industry. Specifically, organizations cited the following reasons: service entrepreneurs are not as aggressive, tend to be secretive, are not organized, and have not evidenced a demand for credit; credit control is difficult in commercial enterprises, since machinery and production cannot be used as a guarantee. Generally, retail and service enterprises are more easily assisted than manufacturing enterprises, since they require lower amounts of capital, technical assistance, and marketing expertise. Research in Honduras reveals that commercial enterprises are financially viable and offer good potential for investment.

Initiative 4: Promote SME support institutions and training agency collaboration.

Program intervention:

- . Identify SME support institutions successfully providing training to SME clients, either on specific topics such as production and marketing (FUNADEH and FEHCIL through IESC and FEHCIL, respectively) or more global topics such as group organization (ASEPADE) and enterprise development (OEF). Promote material exchange or inter-agency service provision for a fee.
- . Promote coordination of SME implementing institutions to discuss training needs identification, training design specifications, and

training delivery requirements that may be undertaken by outside training agencies.

- . In general, direct training to small and micro entrepreneurs outside credit delivery and implementing organizations is not advised. However, it may be possible for existing NGOs, training associations, and beneficiary networks (INCAE, Partners, and USAID scholarship programs) to identify successful and expansive small businessmen and women who would benefit from special training in entrepreneurship, business management, and in-plant work-study tours in the United States.

A number of NGOs will continue to provide both direct technical assistance and training in order to meet specific loan portfolio performance and longer term organizing objectives. However, implementing organizations rely increasingly on external resources for management training, which indicates the importance of maximizing training quality and relevance. None of the outside training agencies reviewed have the program content and relevance, coverage, and delivery capacity for direct subsector support. INFOP is a partial exception, although it too relies on implementing agencies for need identification, client selection, and training coordination. Outside institutions such as INFOP (or, less relevant, GEMAH) may themselves receive technical assistance to refine methods and content areas for SME target groups. But existing staff approaches and developed expertise may forestall any attempts to target needs and adapt training adequately.

Initiative 5: Provide information, channels, and training to SMEs in market operations and responsiveness.

Program interventions:

- . Investigate market systems that interact with SMEs in Honduras, including backward and forward production linkages among SMEs and between SMEs and large-scale enterprise.
- . Promote linkages between big business and small-scale enterprises. There is some interest in joint ventures. Whether these take the form of contracts for supplies and services, investment of risk capital, equity shares in a new activity, or a combination of these methods depends on further analysis of the issues and how it will best be developed in Honduras.
- . Evaluate and disseminate to other SME implementing institutions findings on the FEHCIL-designed ANDI/PYME marketing course, perhaps charging a fee for FEHCIL instruction.
- . Re-examine marketing innovation projects.

Existing SME programs put little emphasis on market constraints or market development programs. The few programs that have attempted direct marketing service projects, such as FEHCIL and CDI, have not met with much success. While in theory marketing projects are designed to shift out a firm's demand curve, "marketing" projects in Honduras emphasize the supply curve, mainly buying raw materials in bulk. Little attention is paid to marketing as a comprehensive concept; marketing is synonymous with selling. Thus, small firms in Honduras do not know how to price their wares competitively, focus products on consumer demand, or advertise, package, and engage in promotional efforts. They do not know who the consumer is, what he will buy, and at what price.

The overwhelming bulk (89 percent) of items produced by SMEs are light consumer goods and services demanded by both rural and urban households. Other sources of demand are backward and forward production linkages between SMEs and other non-governmental segments of the domestic economy,

government sectors (less than 1 percent in Honduras), and foreign sectors (Liedholm, 1986).

Initiative 6: Support a government effort to develop a national strategy for addressing SME problems. Support efforts to build representative institutions for SMEs, to address socioeconomic constraints and to represent SMEs before government and the broader society.

Program interventions:

- . There may be some disadvantages to including policy issues related to SMEs in the overall policy project. SME policy may get lost in the mix, or may not receive as much attention as other issues. Nevertheless, the most cost-effective approach is to include the SME policy in the Mission's overall policy project. This is also the most logical approach, since a range of policies affect SME growth and are likely to be addressed, either entirely or partially, by the overall policy project. Further, it may be the most effective approach, since leverage is critical for a subsector that has no spokesman or forum.
- . In the short term, build up the national capacity for policy analysis, research, and policy studies to feed information into the USAID policy project. Develop a guidebook on SME policy issues for use of USAID project officers and other donor personnel.
- . In the long term, strengthen private sector institutional capabilities to lobby for policy reforms. Three organizations with private sector lobbying experience are the Chambers of Commerce and Industry and ANDI. The latter also has experience in the SME subsector. Any research, policy studies, and program actions should elicit the support of these groups, which in the long run will give SMEs the leverage to lobby in their own interest.

Research in several countries has demonstrated that in reviewing the general policy environment of small firms, it is necessary to transcend the traditional sphere of industry policy and include agriculture, trade, foreign exchange, and other policies (Liedholm and Mead, 1986). In Honduras, a wide range of GOH policies influence the price of capital, labor, material inputs, structure of demand for products, and profitability of various categories of producers. While there is no evidence of a deliberate GOH attempt to impede the growth of small-scale enterprises, the government's lack of understanding, its insensitivity to the impact of laws on SMEs, and the lack of special interest representation on the part of SMEs has resulted in a complex policy environment. Informed analysis and decisionmaking is inhibited by the lack of information and data on the Honduran policy environment. Specific policy dialogue activities can only be identified after a study of the policy environment is completed.

Objective 3: Create New
Small-Scale Enterprises and
Enterprise Activity (Table 11)

Constraints

The extent to which a policy stance discriminates for or against small firms is directly related to the role small firms have been able to play in a country's development process. Unfortunately, in Honduras, little research has been done on either domestic or export-oriented growth industries that might hold a distinct comparative advantage for small-scale enterprises, including product diversification and modes of small-scale enterprise expansion, such as franchises. Limited research is available on combining export-led growth

Table 11. Objective 3: Create New Small-Scale Enterprises and Enterprise Activity

Constraints	Specific initiatives to address obstacles	Interventions
No research experimentation re: growth industries appropriate for SSEs, product diversification or modes of SME expansion, such as franchises.	1 & 2 Develop national research capability to collect analyze and disseminate information on topics relevant to new SSE growth.	1. Research growth industries, factors that affect firm expansion, product development & diversification.
No policy studies/research on combining export led growth with the development of domestic small scale "backward linkage" enterprises.		2. Research consistency of export-led growth with establishing small scale backward linkage enterprises for export industries.
Risk-adverse bankers and commercial lenders; no venture capital markets; no start-up capital for new small scale enterprises.	3. Increase access to investment capital for SSEs.	3. Encourage experimental efforts in commercial lending institutions and joint ventures between large and small enterprises.
Lack of entrepreneurial spirit; risk-adverse behavior.	4. Support educational efforts and pro-active educational research.	4. Investigate results of "entrepreneurship training". Experimental project with small number of businesses receiving concentrated attention/resources. Research investment patterns of SSEs & their responses to policies, programs and targets of opportunity.

with the development of new domestic small-scale enterprise, "backward linkage" enterprises and small-scale export industries.

Current policy on at least two levels discriminate against small-scale producers. The first level is the access to imported inputs and the foreign exchange needed to purchase them. The second level is the competitive position of small-scale enterprises in export markets.

Specific Initiatives to Address Constraints

Job creation can be increased significantly by stimulating the development of small-scale enterprises and by diversifying existing small-scale enterprises into complementary product and service lines. To achieve new small-scale enterprise growth, policy must be combined with program interventions.

Research in other countries reveals that small-scale enterprises often perform only a few functions of the many involved in transforming raw materials into finished products. Their products are sold to other firms for further processing. The system in which small producers participate includes large-scale producers and/or imports with which they compete (Liedholm and Mead, 1986). Liedholm and Mead have suggested that prospects for small producers in a particular subsector can best be explored by addressing three areas: (1) the efficiency of the whole channel in which SMEs participate, including upstream and downstream producers and the linkage mechanisms joining these different producers together; (2) the competitive position of that channel, relative to others supplying similar products in the same markets; and (3) forces

leading to change within the channel, which may increase or decrease the role of small producers.

The most relevant and important research is being done by implementing institutions that have created databases from their loan experience. Although this research will provide a biased sample, it provides the opportunity to compare industries for growth potential. It permits a detailed comparison within industries of factors that lead to growth and employment. When fully developed, the implementing institutions' database can be a strong consultancy tool. It can help identify industry cost patterns and develop sales ratios to guide business investment and administration (Heinzmen, of FUNADEH, 1986).

The research and database capacity of implementing institutions, if supported, can assist them in identifying growth industries and growth ideas within an industry. They can then analyze the efficiency of any one industry compared to others or the relative efficiency of one business within an industry.

Two programs linked to UNAH could broaden the SME research base. UNAH's Center for Entrepreneurial Development and Innovation (CIDE) was launched to support graduating students as self-employed entrepreneurs. The Centro de Estudio y Trabajo (CETAE), linked to the Business Administration Branch of the Faculty of Economic and Administrative Services, elaborates study themes for students around problems of small business development (see Appendix B for details).

Initiatives 1 and 2: Develop national research capability to collect, analyze, and disseminate information on topics

relevant to new domestic and export-oriented small-scale enterprise growth.

Program intervention:

- . Research growth industries and factors that affect firm expansion, product development, and diversification.
- . Research policy consistency of export-led growth with establishing small-scale backward linkage enterprises for export industries and promote small-scale export-oriented industries.

Initiative 3: Increase access to investment capital for small-scale enterprises.

Program intervention:

- . Encourage experimental efforts in commercial lending institutions, such as a special window for new small-scale enterprise start-up within FIA.
- . Provide technical assistance to FIA to expand its market in small industry and to initiate financial support of small agroindustry.
- . Encourage joint ventures between large and small enterprises, utilizing the Chambers of Commerce and Industry and trade associations such as ANMPI and ANDI.

Large and small firms experience similar constraints in access to start-up capital for new endeavors. Of course, as in other areas, small firms are less able to meet stringent banking requirements, which are based on collateral requirements rather than the viability of the enterprise. A few positive elements in the current Honduran context, if

encouraged, may promote new small-scale enterprise growth. FIA, for example, has made loans available to create new business ventures. The potential of large and small business joint ventures, discussed above, is another such factor.

Initiative 4: Support educational efforts and applied educational research for SME entrepreneurs.

Program intervention:

- . Investigate results of "entrepreneurship training."
- . Set up an experimental project with a few businesses receiving concentrated attention and resources.
- . Research investment patterns of small-scale enterprises and their response to policies, programs, and targets of opportunity.

Generally, small and micro entrepreneurs are not known for their market responsiveness and innovative natures. They are, however, creative and enterprising. Their survival depends on these characteristics. Their behavior is best understood in terms of risk avoidance, which has alternately been described as an obstacle to expansion and a means of survival. Rather than behavior modification, the strategy seeks to make SME clients' investments less risky. However, just as attempts to develop modern agricultural production in the rural informal sector relied on research into the role of risk aversion in peasant societies, current efforts to develop entrepreneurial behavior in the urban informal sector may require similar investigation (Bear et al., 1982).

Conclusion

In the context of USAID/H Action Plan and Central American Initiative goals, support of the SME sector aims principally at sustained economic growth and a wider sharing of the benefits of growth. Such support strengthens democratic institutions and fosters a more pluralistic society by giving the working poor a greater stake in the economy.

Honduras' high unemployment and low income calls for a SME strategy based on growth with equity. The goals of the SME strategy are (1) to increase productive activity in the economy and (2) to increase and maintain productive employment. The strategy will pursue these goals through:

- (1) Building the capacity of existing local institutions that specialize in the support of SMEs rather than creating new institutions or encouraging non-specialized institutions to initiate new programs
- (2) Strengthening existing SMEs in the "growth belt" within all subsectors, rather than concentrating investment in the industrial subsector or geographic areas with low population density and poor infrastructure
- (3) Creating new small-scale enterprise and new product lines, excluding new micro enterprise development

The Honduras SME strategy comprises policy, program, and research components. Each component addresses key constraints on SME development in Honduras. These components include:

- (1) Initiatives to address policy constraints at the macro and local levels, incorporated into the upcoming policy project, rather than a separate policy project for SMEs

- (2) Program initiatives that concentrate on integrated credit, technical assistance, and marketing packages utilizing existing human, financial, and institutional resources rather than promoting individual project support assistance and creating new training facilities and/or new credit lines
- (3) Applied research, experimentation, evaluation, and information dissemination that complement policy and program initiatives

V. ALTERNATIVE MANAGEMENT APPROACHES: NEXT STEPS

Many strategies are designed without assessing the obstacles to implementation. In Honduras, these limits to implementation -- mainly the weaknesses of major public and private sector institutions -- are important considerations in developing any strategy. The team, therefore, felt it advisable to take advantage of the knowledge of USAID/H staff and observers of the sector to discuss how a strategy could be implemented through both public and private, national and international human and institutional resources.

This chapter presents general characteristics of successful management approaches employed by USAID in other countries to support the development of small and micro enterprise. We then analyze several management approaches developed in the workshop sessions and others developed in further discussions with Mission staff. The chapter concludes with a summary of the advantages and disadvantages of each option and offers an overall recommendation for USAID/H support.

The authors recognize that the decision to implement a particular approach will require more detailed assessment of institutions and planning at the next stage of project design. An assessment of the Mission's own internal management directions will also be needed. Choice of a management approach

also depends on whether the Mission adopts the comprehensive SME development strategy recommended here or a more discrete program component approach.

General Characteristics of Successful Management Approaches

The literature, evaluations, and knowledge of current management approaches employed by USAID in other countries, indicate that successful management approaches share a number of characteristics. The approach must be politically feasible and acceptable to the community. In the design stage, care must be taken to (1) assess the image and reputation of the lead management organizations, (2) include organizations with active SME support programs, and (3) coordinate with the host country government and private agencies supporting small and micro enterprise.

Lead management organizations have experience in supporting the sector. Organizations with extensive experience in SME support avoid costly experimentation. They waste no resources on inappropriate methodologies. Their institutional support mechanisms are specifically designed for SME support. They can rely on proven methodologies and experience gained in other countries or regions. They modify and refine existing approaches to fit the local context.

Lead management organizations have established clear internal policies to develop programs to reach different clients (industry, agro-industry, service, commerce), cover specific geographic areas, encourage the participation of different organizations, and design particular project components. They have established clear lines of internal authority and responsibility. These are also delineated among other

participating agencies and between USAID and the participating agencies. Formal agreements regarding functions and organizational relationships are reached among all parties. Strong management capacity exists at all levels, but especially within the lead management organization.

In a successful management approach to SME support, entrepreneurial spirit guides management decisions. The strategy provides incentives for innovation, experimentation, and flexibility in program design and implementation. A system of accountability is based on meeting performance standards. Steps are taken toward program self-sufficiency, such as the development of project activity, revenue centers, and generating funds internally. Relying solely on traditional grant financing encourages donor dependence and discourages program efficiency. Particularly in SME support programs, it can distort sound business practices.

Successful program components respond to the particular and varied needs of the organizations working in the subsector and their clients. Such components address the needs of senior management, middle management, and extension staff; micro and small enterprise; industry, commerce, and service; and clients' varied needs vis-a-vis access to capital, marketing, management and technical training, and group formation.

Alternative Management Approaches

During the workshop sessions, the strategy team developed three management approaches. In the first approach, an existing "second story" organization manages the SME program. The second approach creates a new organization; during the first stage of development, an international "second story"

organization manages the SME program. In the third approach, an executive organization leads a consortium of local and/or international private institutions to manage the SME program. A fourth approach, contracting an organization as an extension of USAID/H, was developed based on further analysis and conversations with Mission staff. This management approach is recommended to undertake a comprehensive SME program.

Approach 1: Existing Second Story Organization

Advantages

- . Takes USAID/H out of a direct managerial role
- . Consolidates the Mission's SME portfolio
- . High degree of utilization of local human and institutional resources
- . Focuses on building local institutional capacity over the long term
- . Straightforward and clear-cut administrative and management functions and responsibilities

Disadvantages

- . No existing local "second story" organization can undertake the management function required by a comprehensive SME strategy without substantially increasing its budget and management capacity, broadening its program components, or modifying its internal policies and practices.
- . While the "second story" organization could use other donor funding to support SME programs, the model does not promote donor coordination.
- . Duplication of effort is possible, since several "second story" organizations are active in the field.

- . SME program effectiveness is heavily dependent on the capability of the organization selected.
- . This approach commits USAID/H to long-term involvement.
- . The collaboration of unlike organizations -- for example, government agencies or private for-profit groups -- may be overlooked if the "second story" organization has an established PVO or NGO clientele.

Approach 2: Creating a New Organization

Advantages

- . Consolidates the Mission's SME portfolio
- . Because the organization is new, there are no institutional biases to be undone, for example, subsector specificity or grant-making mentality. The mandate of the new organization can focus on SME support.
- . Allows for comprehensive SME support
- . Focuses on building local institutional capacity over the long term
- . Focuses on central coordination and establishing linkages among donors, banks, government, and the NGO community
- . Relies on specialized international technical expertise complemented by local human resources

Disadvantages

- . Staff may be drawn from other local institutions, weakening them in the process.
- . Could replace and/or displace existing local organizations

- . "One more" USAID organization
- . Comparatively high cost initially and a long-term funding commitment by USAID/H

Approach 3: An Executive Organization
Leading a Consortium of Local and/or
International Institutions

Advantages

- . Consolidates the Mission's SME portfolio
- . Not dependent upon the level and/or capacity of a single local organization
- . The level of reliance on local staff may vary. Ideally, much responsibility in local hands
- . Potential to develop other donor support
- . Can support a comprehensive program by emphasizing proven management capacity, financial control, and an institutional mix in support of the different SME subsectors

Disadvantages

- . Management heavy
- . Requires high level of coordination among organizations with different specializations
- . High costs for implementation and local institutional assessment and capacity building
- . Creates a new structure over existing "second story" organizations
- . Continuity of structure dependent on continued presence of executive organization
- . Time necessary to obtain legal status to operate in Honduras is high

Approach 4: USAID/H Contracts a
Private Organization to Manage the
SME Program As An Extension of the
Local Mission

Advantages

- . Staff of the managing organization can be drawn from experts within USAID/H and the private sector (local and international) to promote inter-institutional coordination.
- . Specialized staff heading specific program components, such as credit, technical assistance, marketing services, research, and information dissemination
- . Consolidates the Mission's SME portfolio
- . Moves direct management responsibility for the SME program outside the Mission, providing a "board of directors' role" for the Mission
- . Sensitive to the roles of existing local institutions
- . Draws upon existing local institutions (public and private) to implement specific activities within their realm of expertise
- . Start-up time (between contracting and implementation) is shortened since extension organization operates under USAID/H's legal umbrella
- . Can support a comprehensive program
- . Straightforward and clear-cut administrative and management functions and responsibilities

Disadvantages

- . Likely to increase USAID/H's budgetary and contractual supervisory role

- . USAID/H- dependent, no potential for other donor support
- . Could sacrifice local institutional capacity building
- . Continuity of structure depends on continued presence of contractor
- . USAID standard provisions may be inconsistent with risk-taking, innovative, flexible approaches required for SME leadership.

Each approach has certain advantages and disadvantages. They all are instructive and provide a basis for further analysis of what an effective management approach should contain. The management approaches outlined above could take a number of alternative program configurations. These do not depend on the choice of a particular management approach. For example, one alternative divides program activities into two components -- one for micro enterprise and one for small-scale enterprise. A second alternative is to divide program activities into functional areas such as credit, training and technical assistance, research, and evaluation. A third alternative would divide program activities along subsector lines; industry, agro-industry, and artisanry would form one division, commerce and services enterprises the other.

The choice of a management approach, program configurations, and interventions will depend on whether USAID/H adopts the comprehensive strategy recommended in this report, or a more discrete project approach to support SMEs. Further refinements in the choice of a management approach will be required during the next stages of institutional assessment and program design.