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A.I.D.'S SMALL-ENTERPRISE AND MICROENTERPRISE PROJECTS:
BACKGROUND AND CURRENT ISSUES

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by

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The views and interpretations expressed in this report are those of the author and should not be attributed to the Agency for International Development.

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FOREWORD

Small-enterprise and microenterprise development projects have become an increasingly important part of Agency for International Development (A.I.D.) assistance programs. At this point, the ample evaluation literature makes it possible to identify recurring patterns common to better performing small-enterprise development projects. However, not all small-enterprise and microenterprise projects have been successful. Recent studies indicate that a policy environment that does not promote efficient users of economic resources may be a serious constraint to effective small-enterprise development. As a result, there is a growing debate on how to interpret and respond programmatically to the constraints and opportunities facing these small firms.

This report presents an overview of the recent debate on the constraints facing small-scale firms and discusses A.I.D. project and policy-based approaches to small-scale enterprise development, specifically the characteristics influencing project performance. It should be emphasized that this report is not intended to be a comprehensive study of A.I.D.'s experience with small-enterprise and microenterprise development projects, based upon an in-depth review of individual project evaluations. Rather, the objective is to highlight key findings from selected evaluations, reviews, and recent policy studies, and to raise issues concerning an important area of A.I.D.'s assistance program.

Cressida McKean, the principal author, based this report on a draft overview of the topic prepared by Annette Binnendijk in 1985. The current expanded version draws on more recent studies and evaluations. This report was prepared independently of the Microenterprise Stock-taking Study, also undertaken by the Center for Development Information and Evaluation (CDIE).

CDIE welcomes comments from its readers to help expand our understanding of ways to better address the opportunities and constraints facing small-scale enterprises.

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SUMMARY

A review of Agency for International Development (A.I.D.) evaluation experience with small-enterprise and microenterprise projects indicates that these activities are valuable, though imperfect, vehicles for generating income and employment in developing countries.

An important issue in the growing debate on how to interpret and respond programmatically to the constraints and opportunities facing these firms is whether small labor-intensive enterprises are efficient users of economic resources. Several studies have concluded that very small firms (one-person firms) are not economically viable. But opinion is divided on whether firms with fewer than 10 workers make efficient use of their factors of production and whether firms in the medium-size range (10 to 50 workers) are relatively more efficient. Several questions arise: Should attention be directed to "efficient" microenterprises, that is, those with 10 or fewer workers? Should attention be directed to "dynamic" mid-sized firms? Or should the employment size of firms not be used as a criterion for promoting the efficient use of economic resources and generating employment?

Small-scale enterprises can contribute significantly to the creation of new employment opportunities at low cost per job. Recent studies indicate that concentrating on larger small-scale enterprises may lead to greater job creation, while providing assistance to the smallest microenterprises may either reduce underemployment or displace other small-scale firms. However, the employment impact of projects providing direct assistance to small-scale enterprises still appears limited in many cases, given the overriding policy constraints.

Some of the small-scale enterprise projects that have been reviewed are relatively successful in economic terms, generating high economic rates of return; however, financial profitability at the firm level is frequently low. Increases in income were often short-lived because of price distortions and other policies adversely affecting efficient industrial production, especially by small-scale enterprises. Moreover, project performance in attaining financial viability and self-sufficiency is often problematic.

Although small-scale enterprise projects have benefited the intended target group, difficulties remain in cost-effectively reaching very small firms, especially in projects with a large volume of technical assistance. Moreover, given limited project

resources and the intractable problems facing these producers, the vast majority of small-scale enterprises in developing countries are not directly affected by these project efforts.

Drawing on existing evaluation reviews, it is possible to identify recurring patterns common to better performing small-scale enterprise projects that extend credit, training, or technical assistance. However, some of the most serious obstacles that both limit small-scale enterprise development opportunities and hinder small-scale enterprise project success are factors external to the project, particularly a policy environment that does not promote efficient users of economic resources. Although A.I.D. has had limited experience with policy-based programs addressing the constraints facing small firms, recent research on policy impediments may contribute to the development of approaches to channel assistance more selectively, for example, to specific subsectors, or to address key policy biases.

1. INTRODUCTION

This paper highlights some of the findings of recent evaluation reviews of Agency for International Development (A.I.D.)-funded small-scale enterprise projects, including projects supporting microenterprises. It summarizes the experience of these projects in meeting development objectives and discusses the features that are commonly associated with successful performance. The paper also pays attention to factors external to specific projects and approaches that address policy and other external constraints.

A.I.D.'s involvement in private sector development goes back several decades. Historically, A.I.D.'s private sector efforts have dealt primarily with the development of infrastructure, industrial estates, power, transportation, communication facilities, and development finance corporations in support of private business. Nevertheless, between 1952 and 1980, A.I.D. financed over 775 projects that provided financial and technical assistance to small enterprises, mostly in Asia and Latin America (Bremer et al. 1985, 22).

With the New Directions mandate in 1973, A.I.D. increased its emphasis on assistance to small-scale enterprises. The Foreign Assistance Act, as amended in 1975, explicitly provided for "programs of urban development, with particular emphasis on small labor intensive enterprises, marketing systems for small producers and financial institutions." Small-scale enterprise development was viewed as a primary opportunity for improving the productivity, income, and employment opportunities of the poor of developing countries. In 1981, the Private Sector Development Initiative emphasized project activities supporting enterprise development, including small enterprises, while increasing the attention focused on policy and other external constraints to enterprise development.

Most typically, current small-scale enterprise projects provide credit, training, and extension services for small businesses. Other small-scale enterprise projects are more complex, providing integrated technical assistance services or emphasizing institutional development. In addition, recent research projects and a few service delivery projects have begun addressing policy issues relevant to employment generation and efficient small-enterprise development. Currently, A.I.D.'s portfolio contains 60 to 80 projects, with an FY 1988 budget of approximately \$57 million, that are directed toward assisting small enterprises.¹

¹This figure is the most recent estimate of funding for microenterprise programs developed by A.I.D.'s Program and Budget Office (see O'Keefe 1988).

2. CHARACTERISTICS OF SMALL-SCALE ENTERPRISES

Small-scale enterprises are not a homogeneous group. Rather, they comprise groupings of firms differentiated by size, sector, location, profitability, growth potential, and other characteristics. Project evaluations emphasize the importance of distinguishing among these groupings when selecting a strategy for addressing particular constraints. Project activities are more effective when they are tailored to the specific needs of the intended beneficiary group. Similarly, policy interventions to support income or employment objectives may need to take into account factors relating to the size, location, and industry structure of firms.

A subset of small-scale enterprises is the smallest level of enterprises, referred to as microenterprises. These enterprises are typically family owned and operated; home based, employing no more than 10 persons; dependent on traditional technology, serving highly localized markets with relatively simple products and services; and generating a low level of earnings. Another grouping encompasses larger firms typically based outside the home, with 10 to 50 workers, dependent on less traditional technology, serving less localized markets with more sophisticated products and services, and generating a somewhat higher level of earnings.

Small-scale enterprises operate in manufacturing, services, trading, and transportation. Microenterprises tend to predominate in services and commerce, while the larger small-scale firms are more highly represented in the manufacturing sector.

An important distinguishing characteristic of small firms is the subsector (or industry) in which such firms operate, for example, furniture, garments, or food processing. Research on small manufacturing firms has found the type of industry to be one of the most critical factors for assessing capital and labor productivity or technical efficiency of small-scale firms (Little, Mazumdar, and Page 1987, 313).

3. OPPORTUNITIES AND CONSTRAINTS FACING SMALL-SCALE ENTERPRISE DEVELOPMENT

Despite their size, small-scale enterprises are important, accounting for the vast majority of industrial employment in most developing countries. Small-scale enterprises are the primary or secondary source of income for many families in poor urban and rural areas. Moreover, in some developing countries, small-scale enterprises are growing faster than large-scale

industries. Given the relative factor endowments of developing countries, the use of labor-intensive techniques by small-scale enterprises has been considered a positive attribute.

The rapid growth in the number of small-scale enterprises demonstrates their economic importance, despite the many constraints they face:

- A frequently hostile and discriminatory policy environment, with licensing and registration requirements biased in favor of larger firms
- Lack of access to institutional credit, raw materials, and supplies
- Lack of management and business skills
- Marketing or demand problems, which are dependent on local economic conditions

However, there is a growing debate in the literature on small-scale firms about how to interpret and respond programmatically to these opportunities and constraints. A particularly important issue is whether these labor-intensive small enterprises and microenterprises are efficient users of economic resources. Several studies have concluded that very small firms (one-person firms) are not economically viable. But opinion is divided on whether firms with fewer than 10 workers make efficient use of their factors of production and whether firms in the medium size range (10 to 50 workers) are relatively more efficient.

A major survey of small firms (Liedholm and Mead 1987) found that the economic profit generated per unit of capital in small-scale enterprises was positive and actually higher than that of larger firms. Moreover, for a significant range of products, small-scale industry was found to be economically efficient. The data indicate that in 7 of 12 countries surveyed, capital productivity was higher for firms in the 1-10 worker range than for firms with more than 10 workers. However, a significant finding of this study is that very small firms (one-person firms) were the least economically viable and were the slowest growing segment of the small-enterprises surveyed (Liedholm and Mead 1987, 43, 65-76).

Other studies (Little, Mazumdar, and Page 1987; Cortes, Berry, and Ishaq 1987; and Biggs, Grindle, and Snodgrass 1988) are considerably more negative about the relative efficiency of small firms. Their survey data, which are based on a different sample of countries than the Liedholm and Mead study, indicate that very small firms (1-10 workers) were not efficient users of capital. However, they found that medium-size firms (50-200

workers) were generally more efficient in their use of resources (capital and factors of production) than were either large or very small firms (Little, Mazumdar, and Page 1987, 313).

Both sets of studies agreed that because government policies have often discriminated against small firms, policy-based interventions could be a critical instrument in reducing the level of discrimination and increasing employment generation. However, an outstanding point of disagreement is whether policy and project assistance directed specifically to small firms is of value in overcoming such constraints.

Liedholm and Mead (1987) argue that policies can be made more supportive of small-enterprise producers, or at least be made neutral with respect to enterprise size. Moreover, although project-specific assistance to small firms has a number of limitations (e.g., high cost), it can successfully assist in addressing specific constraints, such as access to credit.

Biggs et al. (1988) express a different viewpoint in a recent article.

Studies show that indiscriminate promotion of small and medium and microenterprises is not the solution of the employment problem in developing countries.... First, programs and policies that target small-scale enterprises indiscriminately may achieve short-term employment gains at the expense of longer-run efficiency and even greater potential employment benefits. Second,...creating more jobs at low and stagnant or declining real wages may help relieve immediate distress, but it is not development.

Policies and programs aimed at promoting efficient industrial growth and an industrial structure with a progressive "middle" of small and medium firms would, in our view, substantially allay the output-employment trade-off (pp. 56-57).

These different views on the relative efficiency of small-scale enterprises and appropriate donor responses raise fundamental questions about the strategies for stimulating increased levels of employment in developing countries. However, policy-based interventions have not been the primary approach adopted by A.I.D. to increase employment generation. The following sections provide an overview of A.I.D.'s project approaches to small-scale enterprise development and preliminary findings about project performance.

4. OVERVIEW OF A.I.D.'S PROJECT APPROACHES TO SMALL-SCALE ENTERPRISE DEVELOPMENT

Projects, rather than policy-based interventions, have been the principal instrument of A.I.D.'s promotion of small enterprises. Most recent approaches to assisting small-scale enterprise development have typically included fairly simple interventions that provide such firms with access to credit and modest training and extension services. A.I.D. generally provides grant resources for small enterprises through an intermediary institution (most frequently a private voluntary organization, and less commonly, a development bank or credit union). Business training is sometimes provided through these same intermediaries or management training organizations. Success has been mixed, as detailed in the sections that follow.

Other approaches to small-scale enterprise development have included the provision of more complex, integrated services covering the multiple needs and constraints facing small-scale enterprises. It has been more difficult to evaluate the performance of these projects, and particularly to disaggregate costs in order to determine the effectiveness of their individual components. These projects tend to have high net operating costs per client and long-term sustainability problems, since the revenues generated by the credit component cannot begin to cover the multiple services.

Another type of small-scale enterprise project, more typical of early efforts, consists of setting up cooperative or community development endeavors involving the very poor, who are typically unskilled and based in rural areas. Often these efforts have involved major inputs in management organization, training, technology, and marketing. They have not proven to be self-sustaining once outside support has terminated (Kilby 1979; Ashe 1985, 26; McKean 1989).

More recent initiatives in support of small-scale enterprise development have attempted to address particularly critical constraints in industry subsectors through targeted technical assistance to encourage small- and medium-size firms that have growth potential.²

Several small-scale enterprise projects are emphasizing new ways of dealing with policy constraints that in the past were considered external to the project or beyond the direct control

²The Central Java Enterprise Development project in Indonesia and the Forestry Private Enterprise Initiative project in Ecuador are examples of this approach. For further background on the methodology refer to Boomgard et al. (1986) and McKean (1988).

of project designers and implementers. In recent years, A.I.D. projects have begun to incorporate policy-based research and policy dialogue initiatives into its small-enterprise and micro-enterprise portfolio. A.I.D. has funded research institutions to undertake major policy studies affecting these firms. In addition, A.I.D. has developed a technical assistance and research project designed to support policy dialogue to remedy biases against small- and medium-scale enterprises. Policy-based interventions are considered by some to be "far more cost-effective than direct technical assistance or credit projects" (Young 1987, 10).

5. EVALUATION FINDINGS: PROJECT PERFORMANCE

Measuring the success of small-scale enterprise projects is not a simple or straightforward task because of the diversity of project approaches, components, and even objectives. Even the definition of a "successful" or "better performing" project is subject to much interpretation. This section briefly discusses the overall performance of typical small-scale enterprise projects (i.e., those involving credit, and often training and extension components) in meeting the objectives of economic development, employment generation, beneficiary impact, and sustainability.

5.1 Economic Impact

Few evaluations of small-scale enterprise projects include a cost-benefit analysis, which is an ideal indicator of program performance. The principal reason for this deficiency is the lack of necessary data due to inadequate project information systems and insufficient time to conduct a comprehensive economic analysis. Moreover, the objective of A.I.D. evaluations of these projects is commonly to improve program operations through institutional assessments.

The most recent comprehensive attempt at cost-benefit analysis dates back to 1985 when Kilby and D'Zmura conducted a comparative analysis of six A.I.D.-funded credit assistance projects targeting small enterprises operated by private voluntary organizations. This study concluded that micro-enterprises are major contributors to overall economic growth. Based on the limited data available, Kilby and D'Zmura used a benefit-cost framework that included not only benefits to participating firms, but also the broader impacts on the economy (externalities). The study found benefit-cost ratios greater than one for all the projects and concluded that four of the

five small-scale enterprise projects evaluated had economic rates of return on investment of over 100 percent (p. xi). However, the methodology used in the study is considered questionable by some since the benefit-cost analysis is heavily based on assumptions about the broader impacts on the economy, rather than on data on these externalities.

5.2 Employment Generation

A review of evaluations of 19 small-scale enterprise projects by Blaney and Otero (1985) found that most small enterprise and microenterprise projects had a positive effect on enterprise profits, diversification, savings and employment. In seven of the nine projects that had employment data, employment had increased by more than 30 percent. Moreover, most projects contributed to job creation at a consistently lower cost per job than medium- and large-scale firms within the same subsectors. A review by Levitsky (1985) of 10 small- and medium-scale enterprise lending projects of the World Bank concluded that small-scale enterprises were generally able to generate jobs at a lower investment cost than were larger industries in the same country.

The cost of creating jobs is considerably less through support for small-scale business development than through support for large-scale business development. Thus, for the same amount of capital, more jobs can be created by channeling credit to small-scale enterprises.

However, a review of small-scale enterprise project evaluations by Hunt (1985) concluded that there might be a trade-off between the objectives of new job creation and of targeting the smallest of the small enterprises, micro-enterprises. Project evaluations indicate that more new jobs are created when credit goes to firms somewhat larger than microenterprises, especially when they are new firms and manufacturing enterprises rather than service or retail trade enterprises (p. 15). Nevertheless, there is evidence to suggest that credit provided to microenterprises may substantially reduce disguised unemployment or underemployment of the owner families. An important indirect outcome of assistance to small-scale firms can be to displace non-assisted enterprises, which may result in a decline in employment in firms not receiving assistance. The firms that receive credit or technical assistance are benefiting from a form of subsidy, which may or may not result in improvements in their productivity. However, firms that do not benefit may suffer losses as a result of displacement.

Another viewpoint was presented in a recent A.I.D. study of experience with employment-generation projects (Bowles 1988). Bowles argues that small-scale enterprise projects were not very effective in generating employment because overriding policy constraints, such as the economic growth rate, inflation, and distortions in the capital and labor markets, had undermined their viability.

5.3 Impact on Intended Beneficiaries

A major objective of small-scale enterprise projects has been to benefit the poor majority segments of developing countries. Frequently, small-scale enterprise credit projects have promoted equity by providing credit only to those with low incomes or minimal assets. However, the difficulties of monitoring such requirements have frequently proved impractical. Another approach to targeting lower income small-scale entrepreneurs has simply been to limit the total size of the loans, thus ensuring that the loans would not attract the more advantaged entrepreneurs.

Emphasizing the "poorest of the poor" enterprises has also led to other problems. These microenterprises have often been marginal, lacking capital accumulation and growth potential, again highlighting the trade-offs between the objective of equity and that of economic and financial viability. Unless the borrowers in a credit project are able to sustain loan repayments at an interest rate covering the project's operating costs, the loan fund will eventually decapitalize and thus not "revolve" funds to new beneficiaries.

Given that the resources initially allocated to small-scale enterprise credit projects were typically small compared with the large number of small enterprises comprising the potential target group, the impact of these projects on beneficiaries has been relatively limited. Surveys of small-enterprises have commonly revealed that only a small fraction of entrepreneurs were aware of the programs intended to help them, and fewer yet have actually received aid.

Financial analysis of assisted firms shows much the same picture. Kilby and D'Zmura (1985) found that in individual firms receiving project assistance, wages and profits earned did not outweigh costs. These credit assistance projects appeared economically viable only after factoring in external economic benefits (e.g., backward linkages to other firms, income multiplier effects, consumer benefits).

A review of small-scale enterprise project evaluations by Hunt (1985) concluded that providing credit to microenterprises only rarely produced self-sustaining gains. The increases in income were short-lived because the owners were frequently forced to consume profits rather than reinvest. He concluded that the impact of credit on firm profitability and income was more likely to endure if the loans were given to small-scale enterprises larger than microenterprises. Thus, he concluded, there appeared to be a conflict between the two small-scale enterprise project objectives of promoting business growth and of promoting equity by concentrating on the smallest enterprises (p. 13).

5.4 Financial Performance and Sustainability at the Project Level

Of late, reviews of small-scale enterprise projects have come to increasingly pessimistic conclusions about the financial performance of these projects. An A.I.D. workshop on small enterprises, which gathered many specialists in the field, concluded that many of A.I.D.'s small-scale enterprise projects were unsuccessful (Bigelow 1987). Further, a recent assessment of the impact of projects to promote small-scale industrialization found that "the signals are mixed, the estimates are limited in number, the data are incomplete and, we hope, the record of the past is less impressive than that which will be written in the future" (Young 1987).

A principal reason for this growing pessimism was that many of the small-scale enterprise projects were not cost-effective or financially self-sustaining. This was the case for projects with only a credit assistance component, and it was particularly characteristic of projects with large technical assistance components.

Kilby and D'Zmura's (1985) conclusion that small-scale enterprise projects were not financially self-sustaining still holds true. That is, income earned by the project through interest payments and service charges on loans did not exceed administrative expenses and losses due to inflation. The Kilby and D'Zmura (1985) study found only one project (the Rural Development Fund Program of the Industrial Bank of Peru) in which interest income fully covered the project's administrative costs. A more recent review of projects promoting small-scale industrial firms concluded that "Of the many small-enterprise credit programs now in existence, only a handful now cover all or nearly all of their costs. Very few are operating on a self-sustaining basis" (Young 1987, 6). In recent testimony to Congress, Kilby's assessment was that small-scale enterprise credit programs were able to cover only 60 to 90 percent of their operating costs (1987).

6. LESSONS LEARNED: FACTORS AFFECTING THE PERFORMANCE OF SMALL-SCALE ENTERPRISE PROJECTS

A review of evaluation findings of small-scale enterprise projects also provides us with some lessons from experience from which we can learn and draw guidance for the future. However, it should be remembered that what constitutes "success" in such projects has changed over time as the emphasis placed on objectives has shifted among economic growth, employment creation, equity concerns, and financial sustainability. Thus the strategies that small-scale enterprise projects follow to achieve success also vary, depending on which of these often conflicting objectives are given priority.

This section first reviews design and implementation approaches commonly associated with better performing credit and technical assistance projects serving small enterprises and microenterprises. Second, given the importance of the policy context to small-enterprise development, the section then examines a number of external factors affecting the performance of small-scale enterprise project activities. These include both project-specific approaches to external constraints and policy-based approaches.

6.1 Credit-Related Factors

Nearly all small-scale enterprise development projects, even the simplest, have a credit component. Certain general characteristics and procedures of credit institutions that assist small enterprises have been found to enhance performance. It is important to keep in mind, however, that when applied to credit programs for small-scale firms and microenterprises, "successful" is a relative concept, largely because these programs have multiple, often contradictory, objectives (Hunt 1985, 11-19; Kilby and D'Zmura 1985, 114-118; Ashe 1985, 13-17; and Young 1987, 6-7).

-- Institution-building factors

- Institutional sustainability as an integral objective of the project.
- A motivated, professional, and committed leadership, with strong management skills, knowledge of small-scale enterprises, and charisma.

- A board of directors with strong ties to the local private and public sectors able to represent the organization effectively and to assist in the mobilization of resources.
- A flexible and autonomous organization able to respond to changes in client needs and market conditions.
- Adequate interaction between loan officers and beneficiaries, and information feedback to management on their needs and perspectives.
- Decentralized credit institutions located close to clients. Decentralized decision-making and information systems so field staff and management can respond flexibly to changing circumstances.

-- Loan policy factors

- Identification of a market and strong real demand for services provided. Excessive targeting of clients may undermine sustainability of benefit flow.
- Provision of working capital rather than long-term credit for fixed investment, given the lower transaction costs, underutilized installed capacity, and greater demand. Longer term credit may be more appropriate for the upper end of the range of small enterprises, given its greater impact on value added and employment.
- Charging a rate of interest adequate to cover the cost of both the credit and administrative expenses, both to reduce the likelihood of decapitalization and to increase savings mobilization. Some have cited the value of charging commissions to cover the additional costs in countries with interest rate ceilings.
- Simple loan processing and recovery procedures, so that a reasonable number of clients can be served without exhaustive analysis, delay, and high costs.
- Community-based guarantee mechanisms, such as grouping beneficiaries into business associations, trade-based cooperatives, or solidarity groups, and character-based loan appraisals. These mechanisms can reduce promotion and processing costs, increase the number of poor beneficiaries reached, and improve repayment rates.

Specific objectives, such as having a greater impact on employment and growth, may be addressed by the following:

- Concentrating resources on firms larger than one-person enterprises, given the data on the relative inefficiency of these firms
- Focusing on manufacturing enterprises rather than on service or retail firms, given their greater backward linkages and the potential for increased value added

Other objectives, such as increasing the efficiency of the credit program, may be addressed by the following:

- Concentrating on working capital loans, as opposed to loans for fixed capital investment
- Making loans initially for small amounts and for short periods to encourage high repayment rates and then increasing the size and the term of the loan on a phased basis
- Targeting credit to established small enterprises rather than to new entrants in the industry

Equity objectives, such as reaching women or micro-entrepreneurs, may be addressed by the following:

- Targeting those with minimum income or assets
- Targeting those in the trading or service sectors
- Limiting the amount of any given loan
- Providing short-term, working capital required by the smallest microenterprises
- Targeting credit to organized groups or associations of the poor

Obviously, credit institutions are unable to fulfill all of these varied objectives. However, the better performing credit institutions have been those that have adopted a "minimalist credit" approach. This approach has a strong cost-recovery bias and concentrates on providing small, working capital loans on a phased basis, with minimal technical assistance, to established firms, including many women and microenterprises. Still, questions remain about the ability of this approach to generate employment, and to promote the "graduation" of small firms into the formal financial sector, as opposed to reducing underemployment. Still, the minimalist credit approach performs better than others on many counts.

6.2 Factors Related to Technical Assistance and Training

Another frequently used approach for assisting small-scale firms has been the provision of technical assistance, such as management, marketing, or production support. Small-scale enterprise projects have provided extension or training services to small-scale firms either as components of credit programs or separately, as a technical assistance or training project. Two issues emerge from assessments of such projects: (1) the limited data on the effectiveness of technical assistance and training in influencing the development of small-scale firms and (2) the high costs of technical assistance relative to the benefits.

Reviews of evaluations of technical assistance projects aimed at assisting small-scale firms indicate that better performing technical assistance projects are few and far between. Several studies are pessimistic about the results of technical assistance programs for small firms, particularly the inability of these programs to demonstrate that the beneficiary firms are viable and that incomes have increased (Kilby 1979, p. 313; Kilby 1985; Tendler 1982; Tendler 1983 p. 101-102). As a result, there has been substantial debate over the extent to which technical assistance and training provided through such programs is contributing to the development of small-scale firms and to increasing the income of the owners. Nonetheless, projects that have been effective have a number of traits in common (Kilby 1979; Young 1987; Boomgard 1988; McKean 1988; McKean 1989) (see Section 6.2.2).

6.2.1 Technical Assistance as a Component of Small-Scale Enterprise Credit Projects

Reviews of small-scale enterprise projects with both credit and technical assistance/training components indicate that technical assistance provided did not reduce costs or permit more rapid expansion for most small-scale enterprises examined.

Kilby and D'Zmura (1985, 118-119) found that the Northeast Union of Assistance to Small Business (UNO) project in Brazil spent 30 percent of project funds for technical assistance and training with no perceptible change in the behavior or profitability of the assisted enterprises. Tendler's (1983, 5-8) evaluation of UNO found that the business training and extension had little impact on businesses. Kilby and D'Zmura concluded that technical assistance may be most useful in preventing the failure of new firms or in assisting larger enterprises involved in organizational change.

Hunt's (1985) review of small-scale enterprise project evaluations reached a similar conclusion. The amount of formal training received by small entrepreneurs did not relate to their business success. A far more important factor appears to be previous business experience.

An influential credit program with a strong technical assistance and training component is the Carvahal Program for the Development of Small Enterprises (DESAP) in Colombia, which gives a different perspective on the effectiveness of technical assistance and training efforts. DESAP offers comprehensive training and technical assistance, largely accounting courses and management support, as prerequisites for receiving credit. Although a number of firms drop out before receiving their loans, the program has had an impressive impact on those who remain, with significant increases in income and employment. Program beneficiaries are likely to be the more established firms that are able to take the time to fulfill the extensive training and technical assistance requirements (Inter-American Development Bank 1984). Still, the program has been found to be having much more difficulty covering its administrative costs with revalued from its loan fund, than have programs with far smaller technical assistance and training components, such as the Association for the Development of Microenterprise (ADEMI).

Training and technical assistance components are also incorporated into minimalist credit programs for small firms through the solidarity group mechanism. Several credit programs have used the group guarantee as a means of lending to very small firms, commonly market vendors who have been denied access to credit. A principal objective of technical support to these groups of microentrepreneurs (e.g., firm visits, training) has been to permit the credit mechanism to work efficiently. However, recent trends suggest that there is a risk of overloading the solidarity group programs with excessive technical assistance components (e.g., training in literacy, nutrition, child care). One reason for the success of the minimalist credit programs has been their bias against overburdening the credit mechanism with large amounts of training and technical assistance (McKean 1989).

Although the value of technical assistance and training components to small-scale enterprise credit projects remains unclear, several factors are cited as increasing their capacity to make a contribution (Hunt 1985, 23-26; Kilby 1979; McKean 1989).

- Training and technical assistance that are designed to increase the efficiency of the credit mechanism, as has been found to be the case with several solidarity group credit programs

- Technical assistance that is tailored to immediate business needs and constraints enabling the enterprise to lower per-unit costs
- A training/extension staff whose skills and expertise are appropriate to the different firm sizes, specific industries, and levels of business sophistication, and are otherwise tailored to the small entrepreneurs served
- A management information system that allows for feedback on beneficiary needs

Training and extension services are a potentially effective vehicle for reaching the poorest or smallest enterprises under conditions in which:

- The training is simple and builds on existing knowledge relevant to needs at the microenterprise level.
- The technical assistance staff advise or serve as brokers in dealing with government regulations and licensing procedures.
- The recipients are organized into groups or associations, thus reducing the costs of reaching beneficiaries.

Formal business training courses are more likely to be successful when the following conditions are met:

- The trainees are from relatively large firms.
- The trainees are personally motivated, as opposed to taking the course as a prerequisite for obtaining credit.

6.2.2 Small-Scale Enterprise Technical Assistance Projects

A.I.D.'s experience with projects aimed at assisting small-scale firms primarily through the provision of technical assistance is not extensive or well known. Moreover, the assessments of such projects commonly lack data about both cost-effectiveness and beneficiary impact.

Some programs with a strong training and technical assistance focus have aimed to establish new enterprises. A number of institutions executing enterprise-development projects have found that the requirements for creating a new enterprise go well beyond skill development and training for the participants

and project implementers. The number of inputs required, ranging from skills, capital, and technologies to markets, and the time commitment were beyond the capacity of those involved. In other cases, basic feasibility and marketing studies were not carried out before setting up production (Crandon 1984; Placencia 1985; Pinilla 1985; Delp et al. 1986; McKean 1989).

The trend has been for these community development-oriented programs to redirect their attention toward providing services to established small-scale firms, rather than attempting to create new enterprises. For example, the Overseas Education Fund for Women in Business project has focused on providing services to small, established home-based firms instead of creating larger group enterprises (Berenbach 1988; McKean 1989).

Another promising trend has been projects that target technical assistance interventions to address specific constraints on firms in a given industry or subsector. The object has been to analyze the forces in the industry that determine the constraints and opportunities for small firms, such as access to raw materials or buyers, and then to promote technical assistance to alleviate the most serious constraints (Boomgard et al. 1986; Tendler 1987; McKean 1988).

Effective small-enterprise technical assistance projects have a number of traits in common (Kilby 1979; Young 1987; Boomgard 1988; McKean 1989).

- Project support is concentrated on established enterprises, rather than on the complex task of creating a new enterprise.
- Attention is focused on firms larger than the smallest enterprises, given the greater potential impact of the larger firms on growth and employment.
- Technical assistance gives priority to addressing the specific needs of firms in particular industries, such as improving the firm's access to buyers and suppliers of raw materials.
- Technical support has the potential to reduce per-unit costs or to expand the marketing access of individual enterprises.
- Beneficiary firms pay for a portion of the technical assistance received.

6.3 External Factors

As with many private sector development projects, recent research studies and evaluation reports point to the critical importance of a favorable economic and policy environment to project success. Bowles's (1988) review of A.I.D.'s experience with employment generation projects stressed that such projects work best in fast-growing economies free of policy distortions.

An increasingly prevalent view among some economists is succinctly expressed by I.M.D. Little (1987) in a recent article on small manufacturing enterprises: "Trying to offset [massive price distortions resulting from misguided industrial policy] with targeted interventions that favor small firms is at best fiddling while Rome burns" (p. 234). Given the importance of the policy context, should A.I.D.'s attention be focused on project-based interventions targeting small enterprises and microenterprises as the primary means of increasing employment and income of the poor in developing countries? Should more attention be directed to addressing serious external and policy constraints on efficient, broad-based economic growth?

A.I.D. has only recently become concerned about how the policy environment influences the performance of small-scale enterprises and projects supporting these firms. Previously, project designers and managers treated external constraints as beyond their direct control. However, several factors have contributed to a shift in focus. For example, the Agency's private sector portfolio since 1980 has given greater attention to policy reform initiatives in such areas as interest rate ceilings, foreign exchange controls, and trade policy, which have particular relevance to small-enterprise projects.

6.3.1 External Constraints

Given the variety of policy perspectives on the subject, it is not possible to present more than a listing of external constraints considered important in the literature. Factors found to undermine or to adversely affect small-scale enterprise development and project performance include the following:

-- Economic conditions

- High rates of inflation can seriously affect the financial viability and sustainability of intermediaries implementing small-scale enterprise projects. Where inflation rates are over 40 percent, governments, private voluntary organizations, and other

intermediaries have been reluctant to charge interest rates on loans equal to or higher than the cost of lending. Also, inflation affects project benefits because borrowers are more inclined to use loans for nonproductive purposes.

- Weak or negative economic growth rates in a country tend to retard growth and profits in enterprises borrowing capital. The effectiveness of credit programs is highly dependent on growth rates. The consumers earn and are able to spend, the more enterprise promotion will be impeded.

-- Government policies

- Ceilings on interest rates discourage savings and lead banking institutions to ration credit to favored large-scale clients and to discriminate against riskier small-scale enterprises.
- Trade and investment incentive policies, typical of governments pursuing import substitution strategies, favor large-scale industry, are biased against agriculture, frequently discriminate against small-scale enterprises, and discourage sectoral efficiency. Particularly problematic areas include foreign exchange rationing, chronically overvalued exchange rates, tariffs, and high levels of effective protection.
- Tax laws tend to provide concessionary rates to larger firms, encouraging the use of capital. Also, small enterprises are not able and do not know how to take advantage of the tax laws.
- Restrictive regulatory and legal systems create considerable obstacles for small firms, encouraging them to remain in the informal sector and discouraging access to benefits afforded to legally constituted firms. For example, the existence of legal minimum wage regulations and payroll tax requirements discourages the growth of small firms. Small firms have little interest in "graduating" into the formal sector, given the costs associated with fulfilling these legal obligations.

-- Other external factors

- Rural to urban migration affects local demand for small-enterprise products and services, thus influencing the profitability and growth potential of small-scale enterprises.

- Lack of linkages among small enterprises and the larger business and commercial community. These include subcontracting relationships that could expand the market of small firms or provide them access to key raw materials.
- Lack of business associations or cooperatives for mobilizing small-business entrepreneurs to gain increased access to policymakers.
- Lack of support for small-enterprise projects by government officials or political elites.
- Inadequate coordination among donors over long-term project support.

This brief listing of external constraints on small-enterprise development highlights the importance of policy and other external factors to the effectiveness of small-scale enterprise projects. However, the very diversity of the list makes evident the difficulty of generalizing about the external environment in terms of its effect on small-scale enterprise projects.

6.3.2 Project-Specific Approaches Addressing External Constraints

The types of approaches to addressing external constraints on small-scale enterprise development vary considerably. Project-specific approaches have tended to be small in scope and limited to resolving particular problems facing an institution or group of entrepreneurs. Several of these project-specific approaches were identified in a recent review (Hunt 1985, 29-33).

- Setting up small enterprise project "boards of directors" with government and private business sector representatives to promote understanding and support for project objectives among these circles and to provide a forum for policy dialogue.
- Working to establish associations or cooperative groups of small entrepreneurs and microentrepreneurs to mobilize greater project or government support for members in this sector.
- Providing credit and technical services supportive of economic linkages, such as promoting subcontracting relationships and assisting complementary sectors (e.g., raw material suppliers, traders, etc.), to increase the market potential of small-scale firms.

Better performing small-enterprise projects have had varying degrees of success with these approaches. First, individual intermediary institutions that have set up a board of directors strongly linked to the local community, including both private sector and government representatives, have been successful in mobilizing local resources and sustaining their operations over the long term. In providing technical assistance to private voluntary organizations overseas, some U.S. private voluntary organizations, such as Accion International, have promoted including representatives from banking institutions and the industrial sector on the boards of these intermediaries. Many of these organizations have a strong capacity for cost recovery and for sustaining their level of benefits. Moreover, a capacity to cope with the external environment, in the form of institutional access to policymakers, was found to be a feature of more successful microenterprise projects. In one study, Tendler (1989) found that the managers of the better performing microenterprise programs tended to be politically well connected.

Second, the formation of associations or cooperative groups has been identified in a number of evaluations and studies as critical to the development of better performing microenterprise projects. An institutional focus on a particular trade or sector of industry was characteristic of more successful microenterprise projects, particularly those focusing on the smallest firms. In a review of Ford Foundation programs, Tendler (1987) found that the better performing organizations "concentrated on a ... particular trade, sector or income earning activity (e.g., garbage collectors, food preparers, dairy producers, vegetable vendors, landless groups owning tubwells). The narrow sector focus of these organizations forces them to tailor their interventions to the needs of that particular sector or trade" (p.9). Again, Otero (1986) in a review of A.I.D. microenterprise programs found that solidarity groups, which had evolved into vendor- and trade-based associations of microenterprises, were an important source of leverage for small firms.

Third, subsector or industry-specific approaches to microenterprise development have recently emerged as an innovative alternative to coping with the external environment. Research on small enterprises and microenterprises has demonstrated that the constraints facing a small firm in one industrial subsector are very different from those in another subsector (Boomgard et al. 1986; Liedholm and Mead 1987; McKean 1988). Projects based on this subsector approach include the Central Java Enterprise Development project in Indonesia, the Forestry Private Enterprise Development project in Ecuador, and a Wool Processing Enterprise Development project in Guatemala. By providing targeted technical assistance, these projects have

stimulated linkages between small producers and buyers, expanding their market access. However, data on the project experience to date is limited, and it is too early to assess the effectiveness of these projects.

The better performing projects that adopted a project-specific approach to addressing external constraints tended to have the following features:

- A board of directors strongly linked to the local community, including both the public and private sector
- A management capacity to cope with the external environment, specifically with institutional access to policymakers
- An institutional focus on a particular trade or sector of industry
- Well-defined project objectives

6.3.3 Policy Findings and Reassessment of Small Enterprise Development Strategies

Despite efforts to overcome specific external constraints to small-scale enterprise development, individual projects alone are unlikely to make significant changes in the policy environment. Many small-scale enterprise projects involve only a small amount of resources and can provide little leverage for affecting policies on a national level.

Moreover, several recent policy studies have challenged basic assumptions about small enterprise development project strategies. For example, the Employment and Enterprise Policy Analysis (EEPA) project which has supported policy-based research, assumed from the outset that a more efficient use of capital and labor resources could be achieved in small- and medium-scale enterprises. However, a recent assessment of the studies produced under the EEPA project came to the following conclusion.

We are far from finding ourselves in a position in which we can make many generalizations about the economic efficiency of small enterprises. However, the diversity of the reported findings does suggest that any policy initiatives intended to promote a faster rate of growth of employment by encouraging the growth of the small enterprise sector need to proceed with caution and with considerable prior research into the probable viability of different forms of productive activity (Gregory 1988, 7).

For example, several studies concluded that small firms are not necessarily more efficient in their use of capital and labor. Rather, there is great variability in the efficiency of firms in different sectors or sub sectors of production. The sector of production is often a more important indicator of firm efficiency than is enterprise scale (Biggs and Oppenheim, 1986).

Preliminary findings from a study on the dynamics of small manufacturing firms (Liedholm and Parker 1989 forthcoming) also suggest that modern small and medium manufacturing firms did not start out as microenterprises. The data available to date suggests that growth does not come about from the graduation of microenterprises.

Other studies have found the lack of progressive small-medium enterprises or the "missing middle" to be a constraint to a dynamic employment-oriented strategy. Specifically, it may be an indication of reduced industrial efficiency (Biggs et al. 1988).

For A.I.D., the implication of these diverse findings is that project approaches supporting small enterprise and micro-enterprise development need to be informed by these policy studies. Such findings are relevant not only to the performance of projects explicitly targeting small and microenterprises, but they are also critical to developing complementary strategies for raising levels of income and employment in developing countries. As a recent assessment of these studies states, "the broader goals [of efficient growth in output and employment] are not likely to be served by an indiscriminate support of programs to promote SMEs [small- and medium-scale enterprises]The achievement of a truly significant expansion of industrial employment and improvement in real wages is likely to be dependent on a much broader series of reforms than simply a promotion of small enterprises" (Gregory 1988, 14).

Concluding Comments

This discussion of policy findings aims, by no means, to be comprehensive. However, these selected findings do suggest that current strategies based on targeting microenterprises or small firms may need to be reevaluated. If the objective is to raise the level of income and employment of the poor in developing countries, other approaches, which channel assistance more selectively, such as to specific subsectors, or which address specific policy biases may need to be explored.

In presenting these issues, the intent is to open up the debate about microenterprise development, and to stimulate discussion about strategies for effectively promoting balanced growth and employment generalization in developing countries.

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