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ENTERPRISE SCALE, ECONOMIC POLICY AND DEVELOPMENT:
A Synthesis of USAID's Employment and Enterprise
Policy Analysis (EEPA) Project's Research

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SUMMARY

- Because of both their employment and productivity, small enterprises are vital to development. While small is not always beautiful, small firms are often more efficient in total resource use than the larger ones in sectors where the small predominate. Moreover, small enterprises are often productive in spite of policies that are biased against them, particularly agricultural, financial, and trade policies. Such biases often limit the small firm's health, viability, and growth into larger enterprises.
- Yet medium and large scale plants are often more efficient, particularly in more advanced stages of development and in sectors with complex and indivisible technologies. In both less and more industrialized countries, there are important and complementary linkages between small and larger firms.
- There are no policy panaceas. However, important patterns do appear. In countries with the lowest incomes and untapped agricultural potential, reform of agricultural policies often must receive top billing, due to their potential impacts on macroeconomic efficiency, economic growth and small enterprises. Where incomes are above \$500 per capita, other trade and industrial policies become increasingly important.
- Policy reforms conducive to more efficient small enterprises, to a more dynamic industrial structure, and to economic growth are outlined and should be pursued through donor and host country collaboration.

I. SMALL ENTERPRISES' VITAL ROLE

In the less industrialized world's struggle for survival and development, small scale enterprises (SSEs) are critical. As many as a billion or so very poor workers may own or work in such firms.³ In the words of an ILO report from the late 1970s:

for the greater part of the poverty group the small enterprise is the only activity in which they can usefully hope to be engaged, particularly in the immediate future.

Because small enterprises were believed to have played an important constructive role in classic development success stories -- e.g., Japan, Taiwan, and Hong Kong -- and, incidentally, continue to be important in developed economies,⁵ the sector has been widely assumed to offer significant development potential. As a popular development economics text put it, SSEs were hoped to "generate more employment, permit greater decentralization, promote income equalization, and mobilize latent entrepreneurs."⁶

Yet SSEs are not universally acclaimed. South Korea dramatically illustrates that rapid growth with considerable equity is possible with a large enterprise emphasis.⁷ Large firms humble the small in appearance, are impressive political symbols, and dramatically demonstrate apparent benefits of large enterprises as the means to growth. They have relatively more access to the credit, technology, markets and expertise needed for development. Moreover, large firms have the advantage of economies of scale and an impressive potential ability to earn precious foreign exchange. Whether large businesses use those resources more efficiently is another matter.

II. THE IMPORTANCE OF SSE POLICY ANALYSIS

The U.S. Congress, like development professionals and analysts throughout the world, is vitally concerned with SSEs. Illustrating this concern is the fact that Congress has required that USAID spend a minimum of \$50 million on microenterprise development in Fiscal Year 1988, and \$75 million each year since.

Yet heavy demands upon scarce development resources preclude providing direct assistance to the vast majority of SSEs. However, providing an improved policy climate, and removing undue policy constraints, does support virtually all SSEs. USAID staff and consultants have known for some time that the policy environment for SSEs should be a healthy one, lest that environment undercut the impact of those resources applied to assist SSE's directly.⁸ Moreover, policy reform's priority was recently reaffirmed by an OECD/Development Center seminar on the informal sector:

As for how to intervene, the analysis suggested that donors should prioritize their actions first to sort out policy-related problems, improve effectiveness and efficiency of institutions, and lastly to focus on direct, supply-side support.

Prior to the systematic analysis undertaken by EEPA, however, little was known about the impact of policies on SSEs or the dynamics of SSEs through the long-term development process.

III. THE PROJECT

Accordingly, to understand better the role of SSEs in development, and to enlighten the development community on issues surrounding policies as they relate to SSEs, A.I.D. decided to undertake just such an analysis. The project's objectives were to:

- analyze:
 - ** policy constraints upon the small-scale sector, and, more broadly,
 - ** policy climates conducive to the efficient development of small and medium enterprises (SMEs) in a macro, long-term, and broad-based industrialization process; and
 - ** tactics for the political economy of policy reform;
- conduct related technical collaboration; and
- disseminate the project's findings.

Building upon a substantial program of research on the microeconomics of and assistance to small enterprises,¹⁰ USAID designed and implemented the **Employment and Enterprise Policy Analysis (EEPA) Project**. The Harvard Institute for International Development (HIID) was selected as the prime contractor, bringing a long and distinguished history of in-depth experience with policy analyses in developing countries. HIID subcontracted with Michigan State University (MSU) and Development Alternatives, Incorporated (DAI) in order to mobilize their decades of experience analyzing the economics of and support to small enterprises.

So that EEPA's scope corresponded with resources available, the project focused on the impact of policies on manufacturing enterprises, analyzing that sector by scale, defined by number of employees.¹¹ The manufacturing emphasis was determined by manufacturing's unusually important role in development, such as in technology and productivity improvements and the earning of critical foreign exchange. This sector appears to invariably accompany any successful increase in status from a low- to high-income country. While services too are clearly important in this industrial transformation, for they also increase in relative importance, research appears to demonstrate their dependence on manufacturing, rather than vice versa.

IV. SMALL AND MEDIUM ENTERPRISES IN THE INDUSTRIAL TRANSFORMATION

Cross-Sectional and Dynamic Perspectives: As suggested above, small enterprises are pervasive in both developing and developed countries. Yet, for a variety of reasons, relatively inclusive information on the smallest enterprises is often inaccurate or not available. Small enterprises frequently are not included in standard industrial data reporting systems. Moreover, their prevalence is often underestimated. Many are located in relatively remote rural areas. Whether urban or rural, they are commonly so small that they are not obvious to the casual observer, often being located in the home and not visible from the street or the village path.

To overcome this problem, a number of detailed surveys were carried out. Their broad conclusions were as follows:

- small firms (less than 50 workers) were a significant and frequently dominant (in terms of employment) component of the industrial sector (in 13 of 14 countries, with the SSEs generating an average of 71% of manufacturing employment);
- most of the small firm employment was located at the smallest end of the industrial spectrum; e.g., detailed data revealed that in five of seven countries surveyed (Bangladesh, India, Sierra Leone, Zambia, Honduras, Egypt, and Jamaica), over half of SSE employment was in one-person firms and 85 percent or more of firms employed fewer than six workers;

- this importance of SSEs for employment creation is related to per capita national income, and is prominent at the lower end of the distribution of national per capita incomes;
- SSEs contributed handsomely to value-added in manufacturing (37% in seven countries for which data were available); but
- SSEs contributed a relatively small but significant share of total national income (2.9 to 8.2% in the seven countries above), because of the small share of manufacturing in GNP.¹²

In the manufacturing sector, the strong secular negative correlation between the share of small scale employment in the manufacturing sector and the level of development was reaffirmed early in EEPA's research.¹³ Both cross-sectional and time series data confirmed that industrial enterprise scale increases with development. A "general pattern" appeared in industrial transformations:¹⁴

- cottage-shop manufacturing (in microenterprises, with 1-4 workers) predominates in the low income countries (roughly, up to \$500 in per capita national income);
- small and medium scale workshops (5-99 workers) are dominant in the emerging economies (roughly, \$501 to \$1000 in per capita GDP); and
- large scale (100 or more workers) prevails in the more advanced countries (over \$2000), displacing the cottage-shop and most of the workshop and small factory enterprises.

This increase in average firm size is due to two primary phenomenon. First, on the supply side, in more developed countries, economies of scale (e.g., technology, marketing, access to influence and information, etc.) can more readily be achieved and provide an impetus to growth. These economies are supported by the integration of national markets through declining transport and communication costs, which undercut the natural protection favoring SSEs in less complex economies.

The second phenomenon raising the average firm size, this one on the demand side, is the shift in the pattern of aggregate demand over the course of development to one weighted more heavily toward industries dominated by capital-intensive and large-scale enterprises. In other words, as examples, the share of national income spent on food and clothing declines relative to the share going to steel, transportation equipment, and petrochemicals.¹⁵

Transformation at the firm level: The birth, growth, death, and phoenix-like rebirth of SSEs:¹⁶ While, as discussed above, the pattern of what happens to SSEs at the macro level over the long-term is relatively clear, their micro-dynamics over the medium-term is much less clear, with very little pertinent data available. Birth rates per year (ratio: new firms/existing firms) in the three countries for which data are available ranged from eight percent (Colombia and the U.S.) to 12 percent (Sierra Leone). For new

firms, roughly three-quarters were microenterprises (India and Philippines data). Births appear to be positively related to the demand for their commodities, but also partially to the weak demand for labor in other sectors, so that some of the smallest enterprises represent "labor sponges" during periods of hardship (see the "hard/soft" employment discussion below).

Mortality rates appear to be highest for the smallest firms and lowest for the larger firms, as one would expect. Mortality rates are also the highest during the first three to four years of a firm's existence, after which the probability of survival is substantially enhanced. A strong negative relationship between a firm's age and mortality rate is characteristic of both developed and developing countries. Mortality data, however, must be interpreted cautiously. In one instance 20 percent of firms reported as moribund had simply moved. Moreover, the death of some firms simply is part of a phoenix-like rebirth through learning process as entrepreneurs move on to better opportunities, taking with them lessons of earlier ventures. In Taiwan, for example, industries with the highest productivity growth rates also had the highest entry-exit turnover rates.¹⁷

Only scant data exist on what happens to individual firms over time in developing countries. The evidence that is available suggests that the modest "graduation rate" of microenterprises into small, medium and large firms yields only a minority of medium and large businesses with origins among the very small. This rather low average graduation rate varies substantially among countries, being relatively high in India, with its heavy support for small business. The low overall rate also appears related to the "missing middle" in the distribution of employment by enterprise scale discussed below. Possible prejudicial consequences of this gap for economic growth are discussed in the policy section below along with possible policy-related determinants. In any case, a moderately low graduation rate may not be as alarming as it may appear. Given the large number of microenterprises, the graduation of a majority to "large" status would not be necessary to generate a dynamic economy.

"Hard" Versus "Soft" Employment: In examining employment in small firms at different levels of development, EPA's distinction between "hard" and "soft" employment is useful.¹⁸ Basically, "soft" employment refers to "supply driven" job creation, people driven to look for or create new jobs, even with low incomes, as a result of unemployment or underemployment (very marginal incomes) in their former jobs. These jobs may be considered "dead-end traps characterized by low levels of economic efficiency."¹⁹ "Hard" employment refers to "demand driven" job creation, jobs created as a result of people being drawn into high productivity and high income sectors as a result of higher level technologies, new markets, or other innovations.

This "soft"/"hard" distinction is pertinent to our small/large discussion because much of the employment in the small-scale and particularly microenterprises of many very low income developing

economies is of the "soft" variety. Moreover, the low incomes and productivity of these "soft" jobs, like the wage gap between small and large enterprises, are to an important extent determined in segmented labor markets created by misconceived policies.²⁰

More specifically, soft jobs are those jobs such as micro-scale self- and solely-employed vegetable vendors, shoerepairpersons, or newspaper and magazine hawkers, who hold their very low income jobs only out of desperation. Expansion of employment in the "soft" sector is often not a sign of economic health but stagnation. Thus, one must look beyond raw employment statistics to the quality of the jobs involved. Where the expansion reflects hard employment, is demand driven and involves relatively well-paid and productive jobs, a healthy growth process is underway. The converse generally is true where employment growth reflects predominantly soft jobs. This brings us to the question of whether small firms are in general efficient.

Enterprise Efficiency, by Scale and Sector: Small is beautiful, sometimes! But, sometimes so are medium and large. It all depends on the enterprise and sector. However, the smallest enterprises (particularly, those with merely one worker²¹) are rarely the most beautiful in terms of their productivity per worker. Yet the evidence is difficult to interpret and may appear superficially contradictory.

EEPA's MSU subcontractor conducted in-depth field surveys using comprehensive efficiency measures that include both labor and capital costs and a social benefit-cost approach. MSU's findings were that, indeed, in those economic sectors where SSEs are most prevalent in numbers, small enterprises were the most efficient. More precisely, "there appears to be a direct relationship between efficiency and firm size for the micro and small enterprise size categories."²² In the four countries for which such data are available (Jamaica, Honduras, Egypt, and Sierra Leone), on average one worker firms were yielding very low returns per hour of labor and zero or negative profits. Slightly larger firms (two to five workers) were doing substantially better, being on average profitable and with significant improvements in returns per hour of labor.

As one moves into the next size group, but still small (six to nine workers), the firms were also profitable and with a more than doubling of the earnings per hour of family labor (between two and eight U.S. dollars per hour, at the time of the survey several years ago). Considering the evidence by sector, where small firms often predominate in employment terms (particularly, wearing apparel, furniture, shoes, and baking, and, less so, metal products), in 10 of the 12 cases examined, firms employing fewer than 50 workers were more efficient.²³ Thus, in some sectors and countries, with substantial small enterprise employment, using standard efficiency measurement techniques, small is efficient while providing essential (but often low) incomes for the poor.²⁴

This finding -- that whether small is synonymous with efficient often depends on which sector is being considered -- appears consistent with the finding (discussed above) that the structure of demand by industry is an important determinant of the predominance of small firms in that particular industry's size distribution. The finding that small is sometimes beautiful is also consistent with evidence from some countries in advanced stages of the industrial transition. In Japan and Italy, for instance, more than 50 percent of industrial employment is in firms with fewer than 100 employees. This does differ considerably, however, from the more prevalent pattern (such as in the United States, France, and the United Kingdom), where less than 25 percent of manufacturing jobs are held by small firms.²⁵

In summary, combining EPA's MSU survey data and HIID industrial transformation analyses, the efficiency by scale highlights are:

- SSEs are beautiful in terms of efficiency only in some sectors, but, in less industrialized countries, those sectors are commonly where small enterprises are most prevalent, with traditional, labor-intensive and low average labor productivity technologies;
- the pattern of evolution through development is for the small manufacturing firms to gradually yield to more efficient medium-sized and large firms; and
- this evolution appears determined by the correlations between different economies of scale (e.g., financial, technological and marketing), the scale of markets, and changing patterns of demand as development progresses.²⁶

Large- and Small-Scale Interdependence: As is true for agriculture in the rural areas (discussed below), large-scale enterprises, can play a lead role in the development and stimulation of micro and small enterprises. This phenomenon is well illustrated in the dramatic examples of Japan and Taiwan, with their relative abundance of SMEs, and their contrast with South Korea. All three of these countries, of course, are well known for their rapid economic growth.

Although large-scale industries are more predominant in South Korea than in Taiwan, even in the Taiwanese case, where SMEs play such a major role, large enterprises were important "growth inducing interventions" for Taiwan's government (see the "Hard State Alternative I" discussion below). Taiwan's large firms yielded substantial dividends in the development of small and medium enterprises. Large businesses trained craftsmen, who later became entrepreneurs or a source of skilled labor for the SMEs. The large businesses subcontracted for the output of the SMEs. And because the large typically had better access to credit than the small, the large also often were linked to the small by a flow of credit along with their subcontracts. The multinationals, particularly, also stimulated the transmission of new technology to SMEs verbally or through labor mobility.

But linkage and interdependency between large and small firms is not restricted to Taiwan and Japan. Subcontracting has been found to be widely used among small enterprises in other Asian countries such as Bangladesh, Thailand, and Indonesia, principally in a few product lines such as wearing apparel, wood products, and fabricated metal products. In Africa, small producers also relate in various ways to their medium and large brethren. A large company may sell kiln-dried lumber to many small carpenters, or a large firm may market the output of small production-focused enterprises. Although documentation of the dimensions of linkages is relatively rare, the data on these ties that are available suggest they are more prevalent in Asia and much less so in Africa.²⁷

While worldwide the relationship is poorly documented, the robust performance of SMEs in Japan and Taiwan, as well as the conceptual understanding of the contribution of this link (between large and small firms) to broad-based growth, suggest that thoughtful policy design in other countries may yield similar beneficial effects.

Traders and Small Enterprises: Based on EEPA's observations in Africa and an analysis of selected prominent export industries (footwear and computer components) in Taiwan and South Korea, the project suggests that in developing a SME-oriented growth strategy, the role of traders should not be ignored.²⁸ Like the large-scale/small-scale enterprise linkages, a vigorous community of traders can contribute to the development of both the SME sector per se as well as to its exports. Yet there may be conditions under which it may be difficult to tap the potential benefits from this trader/manufacturer linkage.

In Africa, traders have been observed to be an important source of entrepreneurs for budding manufacturing sectors. In Taiwan, traders were particularly valuable for identifying markets and then aggregating goods from dispersed producers for sale in bulk to foreign buyers. In South Korea, on the other hand, the economy was less well endowed with business-related human resources. Traders were much less numerous and thereby less able to support a dispersed SME development process.

That traders did not play as significant a role in Korea as in Taiwan appears due to both differences in the initial conditions of the two countries, as well as differences in governmental incentives. Taiwan was blessed with a per capita GNP 70 percent greater than Korea's (1955), a proportion of the population with 12 years of schooling three times Korea's (1960), a large inflow of business skills, and a minimal divergence of elite talents into politics and government. This setting enabled a mutually reinforcing relationship between traders and small manufacturers. Policies expanding small-scale manufacturing also stimulated the growth of traders, who expanded access to markets for small volume producers, which in turn induced growth in the number of such producers.

When presented with a small-scale option, where dispersed business skills are available, a Taiwanese approach, with extensive involvement by traders, may enable broader-based industrialization with

less risk of economic leakage. Accordingly, the promotion of traders should be considered as an option to enhance the breadth of the industrial base as well as exports.

Small Enterprises and the Environment: Because of worldwide concerns about environmental degradation, EEPA also undertook a literature review of the impact of SSEs on the environment. Although documentation addressing the topic directly is limited, two schools of thought are apparent. The first school is illustrated by London's Intermediate Technology Development Group. ITDG's assertion is that SSEs are less of an environmental threat than larger firms due to the former's dispersion and their incentive to maintain a clean environment because those working in them live nearby. The other school, characterized by the World Bank, argues that SSEs are more damaging to the environment due to their lower technical efficiency, integration into residential areas, dispersion (which makes them difficult to monitor), and lower likelihood to adopt abatement technologies.

While the data and evidence are very limited, EEPA was able to draw some tentative conclusions based on the principal sectors of SSE activity, their output relative to their larger brethren, and estimates of pollution per unit of output by the small compared to the large. These guarded estimates are as follows:

- Most SSEs (e.g., wholesale and retail trade) are not involved in activities with high environmental impact;
- SSEs with significant environmental impacts are usually not the major polluters in their industry, because of their limited contribution to total output;
- SSEs pollute more per unit of output than larger firms in their sector; and
- Industry is not responsible for the bulk of either urban air pollution (motorized vehicles are) or organic water pollution (mainly household wastes).²⁹

To deal with related degradation, the analysis includes these conclusions:

- Improved data will be necessary to prioritize interventions.
- Generalizations about environmental degradation by SSEs should be avoided, for they are serious problems in some sectors (e.g., leather tanning, electroplating and lead smelting) and countries and relatively benign in others.
- The "worst first" principle should be applied when addressing environmental impacts, dealing with SSEs only when they are determined to be the worst polluters.
- Policy reforms (e.g., improved land and forest policies and taxes on fuel and chemical inputs) as well as technical approaches (e.g., "cleaner" technologies) will be necessary, as is further research.
- To avoid costly loan-by-loan environmental impact assessments, SSE credit programs could make a short list of types of SSEs constituting serious risks to their immediate communities (lead smelters) and which should not be considered for loans.

V. OVERVIEW ON ECONOMIC POLICIES AND SMALL ENTERPRISES

In a nutshell, economic policy biases often constrain small-scale and informal sector enterprises and offset positive effects of direct credit or technical support to them. Biases in trade, agriculture, and finance are particularly problematic. As small firms are often excluded from or neglected by the administration of tax and labor laws, such policies often are biased de facto in favor of smaller firms, although with a less potent effect.

The first of the EEPA project's "Discussion Papers"³⁰ was intended to synthesize the evidence to date about the impact of economic policies on small scale enterprises. A complex set of policies -- monetary, fiscal, labor, trade, price, and regulatory -- were found to yield a very mixed bag of weak, strong, positive, negative, and interacting differential impacts. In many countries, the general effects were biases in favor of larger enterprises and undercutting efficient growth. In contrast to the general pattern, India's policies have been strongly supportive of SSEs but with doubtful benefits for development.³¹ In happy contrast with both the general and India's pattern, as is known in some quarters, Taiwan's policies since the early 1960s have been highly effective, supporting both growth and small enterprises.³²

The following table indicates some of the limited data available on the effects of various policies upon small and large firms:

POLICY-INDUCED FACTOR PRICE DISTORTIONS IN LARGE AND SMALL NON-AGRICULTURAL ENTERPRISES (the percent difference in large firms' costs relative to small firms')

Period	Percent Difference in Capital Cost Owing to:						Percent Difference: Wage/Capital Rental Rate
	in Labor Costs	:Trade :Regime:	:Interest Rate	:Taxes	:Total Capital:		
Asia:							
Hong Kong 1973	0	0	0	0	0	0	0
Pakistan '61-64	0	-38	-44	+22	-60	+150	
S.Korea 1973	0	-5	-35	+10	-30	+43	
Africa:							
Ghana 1972	+25	-25	-42	+26	-41	+119	
Sierra Leone '76	+20	-25	-60	+20	-65	+243	
Tunisia 1972	+20	-30	-33	NA	NA	NA	
Lat. America:							
Brazil 1968	+27	0	-33	NA	NA	NA	

NA: data not available

Source: Haggblade et al., p. 31

These data reflect the considerable variability among countries. For these countries, capital market distortions (apart from Hong Kong) are widespread and substantial, and labor market distortions, while not present in the Asian countries, were significant in

Africa but still much less than those in capital markets. More specifically, the predominant pattern in these cases is for there to be a net effect of lower capital costs and higher labor costs for the large firms. This general pattern substantially inflates the wage/capital cost ratio and is a powerful incentive for large firms to pick labor-saving and capital-intensive technologies in spite of the typical relative abundance and low cost of labor.

Because of widespread concern with taxes, one should note that -- apart from the special case of Hong Kong, in three of the four cases in which data were available -- the general effect of direct taxes was to raise the relative capital costs of large firms over small by 20 percent. However, the net result of "[i]nvestment concessions, special tax provisions, and tax evasion 'enjoyed' by many of the larger enterprises operate to reduce the magnitude of their apparent legal tax burden, which sometimes amounts to over 50 percent of a larger firm's profits."

Quantitative analyses of the macro impacts of policy distortions on the economy were scarce and fraught with substantial analytical problems. Yet the estimated magnitudes were uniformly substantial as a share of GDP, although there was considerable variation in the assessments of the impact. The findings suggested that misguided policies resulted in a loss of GDP, due to resource misallocations, of between six and eighteen percent.

Some Particulars on Biases: Brief comments are due at least for the most blatant biases affecting SSEs. Among the strong and relatively common biases against SSEs is that of agricultural policy.³³ That a bias against agriculture has negative impacts on SSEs is due to both input and output linkages between the agricultural and SSE sectors. When agricultural incomes decline, farmers buy less from the local SSEs for both their consumption and agricultural input needs. Moreover, when there is less agricultural output, SSE incomes from processing that output are also reduced. The kinds of agriculturally-related policies believed to have these strong negative effects on farmer and, thereby, SSE incomes and productivity are as follows:

- the pro-industry/anti-agriculture bias in trade and pricing policies, including centralized marketing and pricing (see also the trade policy discussion below);
- the urban infrastructure bias that shortchanges rural roads, education, and health; and
- inadequate resources for R&D in agricultural technologies.³⁴

Foreign trade policy is a second set of important biases which are typically contrary to the interests of SSEs, as referred to in the above table and discussion of agricultural biases. More specifically, although the evidence is somewhat limited, SSEs appear to suffer from trade biases such as the following:

- the structure of tariffs, in which large firms are more often protected than the small;

- the structure of export incentives, whereby the small producers are unable to export the minimum necessary to benefit from the incentives; and
- overvalued exchange rates, which reduce (a) the incentive to export, and (b) the supply of inputs for and demand for goods and services from rural non-farm enterprises.³⁵

Capital markets policies are also widely believed to be substantially biased in favor of larger enterprises. Among the culprits are subsidized credit, interest rate ceilings, and tax incentives. In all three cases, such policies often are not specifically designed to discriminate against the small firms. The latter typically are unable to meet the traditionally high transaction costs of commercial banks, foreign exchange markets, and obtaining tax concessions. And, formal sector banks have often been proscribed from charging interest rates that would cover the high cost of lending to SSEs. The net effect is that smaller businesses suffer credit cost disadvantages, based on the high per unit transactions costs of their small financial needs, vis-a-vis the large.

Another systemic bias against the small is that there appears to be a formal sector reluctance to extend credit to small borrowers, even when some credit programs for them show high repayment rates.³⁶ The net result of these capital market policies is that small enterprises rely almost exclusively on traditional credit sources, namely, family and friends, with traders, suppliers of goods, and money lenders also involved but much less so. Formal money market sources generally account for less than one percent of small business start-up capital.

Because of (a) the frequent reporting by small businessmen of the shortage of credit as one of their principal problems, (b) the widely recognized success of Taiwan's policies, and (c) a popular preference for a hands-off liberalization and laissez-faire approach to market reform, it should be mentioned that an EEPA analysis of Taiwan's financial markets suggests that financial liberalization should not automatically be considered a panacea for SSEs. Indeed, stagflation may result. Liberalization may generate higher interest rates, pull credit into the banking system and away from the curb market, and (with reserve requirements in the formal sector) contract the money supply and growth. In addition, in the imperfect capital markets of developing economies, the curb market intermediaries may have "lower transaction costs and higher investment efficiency than formal financial intermediaries." Accordingly, liberalization under such financial conditions may bias financial policies toward the modern and large-scale sector.³⁷ (See also the financial policy discussions under "The African Case" and the consideration of hard/soft states.)

Labor Markets: There are a variety of government interventions in labor markets that have the potential to affect the relative cost structures between small and large enterprises. These interventions include minimum wages, fringe benefit regulations, limitations on the recruitment and dismissal of workers, and government

support for or opposition to trade unions. Assessments of the impact of such labor market policies is that they either have no impact on relative costs or they actually bias costs in favor of the small firms. Generally, the biases reducing SSEs' relative labor costs result from small firms either being deliberately exempted from the effect of the law or from such firms being ignored in the regulation's implementation.³⁸ Regional assessments, reflected in the above table, indicate that price distortions are minimal in Asia's relatively free labor markets, and rather more substantial in Africa and Latin America.

Taxes: The distribution of the impact of taxes upon small and large firms is a two-edged sword. Tending to shift the relative burden more to the large firms are two realities. First, small businesses are often formally exempted from taxes. And second, even when they are not directly subject to them, smaller firms often are able to avoid payment due to their size and geographic dispersion. The large firms, however, are believed under some conditions to be able to avoid taxes. The bias in favor of the large firms comes from the fact that investment inducements often make the larger firms de facto beneficiaries of tax holidays, accelerated depreciation allowances and property tax reductions. As presented in the above table, the sparse data available suggest that the overall tax policy bias creates lower relative costs for the smaller firm, although the pattern is not ubiquitous.³⁹

The "Small Firm Growth Trap," "Missing Middle," and Aggregated Effects of Policy Discontinuities: The net effect of the above policies is that there are two sets of policy influences tending toward a bipolar distribution of employment by plant size. On the one hand, government policies are often so skewed in favor of large enterprises that there may be a "premature" shift of resources into large-scale capital-intensive enterprises, without the gradual evolution of firms from small to medium and eventually to large. On the other hand, the above biases also create disincentives to the growth of micro and small enterprises into more modern, complex, and efficient mid-scale enterprises. This mix of policy impacts, perhaps along with other factors,⁴⁰ may create what is known as the "growth trap," the net effect of which yields a "missing middle" in the distribution of employment by enterprise scale. Such a policy trap was found to exist in three of EEPA's case studies, Honduras, Ecuador, and the Philippines, as well as in earlier USAID-sponsored analyses in India and Vietnam.⁴¹ EEPA's review of policies in Africa reflects the weak data base and doubt about the presence of a strong policy growth trap there, but nevertheless, expresses concern that "careful attention must be paid to avoiding sharply negative policy discontinuities that would act as a disincentive to firm expansion" into "modern small and medium-sized firms."⁴²

Echoing a 1974 ILO report,⁴³ EEPA's study of policy in the Philippines noted that in the manufacturing sector there appeared to be a pattern of dualism: "excessive bigness in firm size and business concentration," and at the small end of the scale, an economic environment supporting "the survival of an extremely large number

of small and cottage producers." The report referred to several ways that the policy structure frustrates the growth of small firms into those of more efficient medium and large scale. As firms grow, they lose the advantage of government programs which support small enterprises. On top of this loss, they find that they now encounter minimum wages (a sharp "wage cliff"⁴⁴) and sales taxes which they could previously ignore. Moreover, as the firms began to grow from a small size, they were apparently de facto still too small to take advantage of incentives provided by the Board of Investments, incentives which were seen as basically for larger enterprises. Accordingly, the cost structure rises sharply when a firm attempts to grow beyond a small size, and this sharp increase in costs creates the "small firm growth trap."⁴⁵

This trap may be particularly injurious to the transformation of low income agriculturally-based economies into those with a more modern industrial base. This confluence of policies may both impede the establishment of new medium-scale firms as well as frustrate proven successful and dynamic entrepreneurs from effecting the otherwise natural evolution of their successful and potentially dynamic small firms into more efficient medium-sized enterprises. The primary advantages of **progressive mid-sized firms** are that they tap proven entrepreneurs, reap technological, marketing, managerial and other economies of scale, and, although not researched by EEPA, may provide an industrial structure with less political volatility.⁴⁶ Dynamic entrepreneurs and mid-sized businesses may contribute to growth through enhanced competitiveness, employment, income distribution, and resilience to economic shocks and capricious international markets.⁴⁷

Accordingly, HIID and MSU argue,⁴⁸ fostering of this middle portion of the scale range and elimination of the "missing middle" are quite likely to generate more efficient growth as well as the other benefits referred to above. Policies to do so are discussed below.

An Alternative Conglomerate Emphasis and Possible Costs: While the growth trap's injurious consequences are believed to be significant, rapid growth is obviously possible with a distinct "missing middle." Korea (discussed below) demonstrates this dramatically, with a significant dip in employment within medium-sized plants combined with well-known relatively broad-based growth.⁴⁹ However, although growth and distributional successes are clear, one must also ask, first, whether equal or more extensive economic success (for reasons given below) might not have been possible with alternative policies, and second, whether less industrial concentration might not have resulted in less political turmoil.

VI. POLICY REFORM PRIORITIES

Clearly there are a multitude of intercountry differences in levels of development, political economy contexts, and resource, technological, and managerial endowments. Moreover, there is a substantial array of biases constraining small enterprises, sometimes

constituting a "growth trap" which fosters the "missing middle." In this varied context, what are the priorities for policy reform?

Most important to remember is that there is no panacea. No fixed policy package will meet all needs. Clearly, policy design must be done in the context of the host country's economic and political environment. Some illustrative differences stand out. In those countries with the lowest incomes and untapped agricultural potential (e.g., the African case, discussed below), agricultural policies often must receive top billing. For those fortunate countries which have progressed beyond approximately \$500 per capita, other trade and industrial policies have become increasingly important.

Fortunately, comparative policy analysis does suggest guidelines for countries hoping to shape a more effective set of policies for broad-based growth. While considerably more research would be immensely helpful to guide policy reform⁵⁰, EEPA has highlighted a number of general principles and priorities.

Neutral or targeted/biased policies? Among the issues confronting policy reformers is whether their objectives should be to "level the playing field" and eliminate all policy biases, or whether there should be some sectors or enterprises toward which resources should be targeted through policy biases.⁵¹ An EEPA analysis affirmed the advantage for SSEs of relatively neutral policies:

[T]he general policy environment can be made more supportive of small producers in developing countries ... through instituting a policy environment that is at least "neutral" with respect to enterprise size.⁵²

In other words, as a starting posture, the biases against SSEs should be eliminated, so that the markets the SSEs encounter for inputs and outputs are as competitive as possible, with no particular enterprises or sectors having significant policy advantages.

Yet EEPA's (and other) research on Taiwan and South Korea, in particular, has suggested that there may be important reasons to have some biases in the policy structure.⁵³ Both of these countries demonstrated dramatic and relatively broad-based growth. Both countries also had a number of other important common characteristics that contributed to that growth: coherent macroeconomic policies; an absence of democracy during the peak of early industrial expansion; suppressed labor movements, with competitive labor markets; and heavy investments in infrastructure and education. Moreover, both countries also had a mix of neutral and targeted policies, with early large scale investments, dualistic trade regimes and selective protection among the most important common targeted policies.

From these two dramatic cases, it is clear that rapid and broad-based growth may be supported by targeted interventions. What is less clear are the precise policy biases or market interventions (subsidies, infant industry protection, etc.) appropriate for particular country conditions. There is one important targeting

issue on which there is some convergence of expert opinion. Both the HIID and MSU subcontractors, as well as a recent World Bank review of small enterprises in development, argue that when supply-side interventions are planned, they should target "enterprises and industries that show high levels of efficiency and good prospects for growth of productive employment."⁵⁴

Differential Policies for "Hard" and "Soft" States: Apart from exacting economic calculations, decisions on whether, how, and how much to target also may require a determination of whether the policy context is a "hard" or "soft" state.⁵⁵ A "hard state" exists where government is capable of substantial economic management without high risks of bureaucratic inefficiency or leakages. The "soft state" exists where there is a high risk of economic mismanagement, substantial resource leakage, "socially costly rent-seeking," or private entities manipulating the public sector for private advantage. Under hard state conditions, the government and the economy have relatively strong organizational and market institutions and are able to limit policy benefits to those firms meeting predetermined criteria. Under soft state conditions, however, attempts to direct resources to high performers will be undermined by those with political influence and able to drain off resources to their own advantage.

Referring back to the questions of intervention or establishing a level playing field, and the pertinence of whether the policy context is a soft or hard state, HIID's Snodgrass has posed the problem in these terms:

It may be that few developing countries qualify as hard states for this purpose, and one is more sympathetic with the World Bank's anti-interventionist stance when one thinks about the numerous countries in which government intervention has been counterproductive than when one thinks about the few countries in which it has made a positive contribution to development. But whether countries can industrialize while keeping the playing field level is also unclear.⁵⁶

ALTERNATIVE STRATEGIES: EEPA's analysis of development strategies writes off as relatively fruitless the strategic policy alternatives that it refers to as the "balanced growth" and "market completing interventions."

With the "balanced growth strategy," the public sector attempts to guide the economy so that all sectors grow simultaneously in a fashion such that intersectoral economic demands complement intersectoral supply. This "balanced growth" strategy, however, is believed particularly inappropriate for countries in an early stage of development. This balanced growth alternative is rejected because it requires precisely those skills typically in critical short supply in low income countries, namely, a powerful analytical and administrative capacity to identify and guide a broad set of complementary investments.

The relatively pure "market completing interventions" strategy corresponds most closely with a laissez-faire approach, with interventions "to improve transactional efficiency" in financial, product, and input markets. This strategy has only played a marginal role, at best, in developing countries with which EEPA is familiar, apart from the relatively unique Hong Kong case. Because the "market completing" strategy does suggest a role for government that is not likely to be distortionary, however, this model is blended with other interventions for use in the "soft" state strategy discussed below.

The two alternative hard state strategies discussed here are based on Taiwan and South Korea's dramatic contrast in successful development. Their growth is relatively well known to have been rapid, comparatively equitable in terms of income distribution, and highly successful in exports.⁵⁷ Yet Taiwan is also distinguished for the strong performance of its small and medium enterprises, while Korea's manufacturing firms tend to be larger, product markets more concentrated, and conglomerate control greater.⁵⁸ In Korea in 1982, for example, the five largest conglomerates accounted for roughly 23 percent of the nation's shipments of manufactures, whereas in Taiwan, the figure was approximately five percent. Between 1966 and 1976, the number of manufacturing firms increased by 150 percent in Taiwan and only 10 percent in Korea, while the average number of workers in their firms increased by 176 percent in Korea and only 29 percent in Taiwan. And the importance of large establishments has increased in Korea and declined in Taiwan. In the early 1980s, Korea's 50 largest firms had 38 percent of manufacturing sales, while that share of Taiwan's top 50 was less than half Korea's, or 16 percent.

HARD STATE ALTERNATIVE I -- A Small and Medium Scale Emphasis, The Taiwan Model: The first of the policy strategies for dealing in a hard state environment -- where government has substantial expertise and is believed to be relatively honest -- can be referred to as an "unbalanced growth,"⁵⁹ sequential externalities, and government-induced development strategy. This model is best characterized by Taiwan, with its successful emphasis on small and medium-sized enterprises and a significant human resource/institutional base, including a strong community of experienced traders.

On Policy Targeting: Taiwan did not have a perfectly "level playing field" in its economic policy. As was true for Korea, Taiwan too had a dualistic trade regime, with low overall trade barriers but substantial variation across economic sectors and high subsidies for consumer durables and higher levels of fabrication. A fundamental difference from Korea and bias in Taiwan's policy structure, was the fact that in financial markets, Taiwan did not have the artificial financial economies (state created) and, in fact, had financial diseconomies for large-scale enterprises.⁶⁰

Under this government-induced development strategy, the government initiates vigorous growth with strategic industrial interventions, sometimes manifest in the establishment of large scale enterprises. These interventions create externalities or profitable opportuni-

ties that induce the entry, and subsequent cyclical entry, of firms responding to those entry-inducing externalities. Subsequent entry -- and the proliferation of small and medium enterprises, with expanded competition and transactional efficiency -- results from the sequentially produced externalities.

Large Firms' Potential Inducing Role in SME Development: In Taiwan, large firms, and in the early stages, public enterprises, played a very important role in the growth-"inducing interventions" of Taiwan's government. During the 1950s in Taiwan,

more than half of industrial production came from public enterprises As the projects got bigger and more technologically advanced, government entered into joint ventures with foreign multinationals. In this way, the basis was laid for production of petrochemicals, plastics, artificial fiber, glass, cement, fertilizers, plywood, textiles and many other products.... Even today, Taiwan's upstream industries tend to be highly concentrated and dominated by public enterprises.⁶¹

This government-induced growth of large firms in Taiwan had a variety of linkages with the small and medium scale sector.

Large/Small-Scale Linkages: One important manifestation of the large/small scale linkages was the stimulus of the newly attracted multinationals with strategic technological lines.⁶² The presence of these new technologies enabled the imitation of their production by smaller local producers. This local replication took place via word of mouth, labor migration, and supplier operations.⁶³ Another large to small linkage in Taiwan was the substantial proliferation of subcontracting, linking the large firms closely to the small in a way true also in Japan but not in Korea.⁶⁴ Whereas subcontracting was widespread in Taiwan, it was limited in Korea by vertically integrated processes.⁶⁵ Further, large Taiwanese firms also supported the major role of SMEs by being a source of trained craftsmen who later became entrepreneurs (a practice facilitated by its vigorous informal credit market⁶⁶). Beyond subcontracting, skilled labor, and entrepreneurship, credit was another important large to small firm linkage in Taiwan. Whereas the larger firms typically had access to formal credit markets, the small did not. Accordingly, product subcontracting was often accompanied by a parallel flow of credit from the large to the small.⁶⁷

Other SME-Supportive Interventions: Complementing government's initial large-scale industrial interventions were a variety of other economic and social policies and investments that served to induce the emergence of Taiwan's dynamic small and medium scale sector. In the more traditional economic vein, the Taiwanese policy mix included:

investment incentives, tax laws, labor laws [and their weak enforcement], and a host of other policies (business licensing procedures, antitrust laws, bankruptcy laws, export quota management) presented strong incentives (though often unintended by the authorities) to limit company size.⁶⁸

Notably, what they did not use were South Korea's massive financial interventions and incentives. Among the social interventions were those to relieve bottlenecks in "education, health, public utilities and pollution."

Finally, to assure gains in productivity and international competitiveness, the Taiwanese implemented numerous policies promoting technological development. This mix included R&D centers, technical libraries for business, subsidized foreign travel to equipment shows and factories, quality education (with strong science and engineering programs), efficient skill training (closely linked to industrial demand), foreign technical licensing agreements (with possible government involvement in their negotiation) and collaboration with multinationals.⁶⁹ Overall, the effect of these policies was to complement the large-scale enterprise interventions and avoid creating a growth trap or missing middle.

HARD STATE ALTERNATIVE II -- A Conglomerate Emphasis, The South Korean Model: The other hard-state strategy EEPA has referred to as a "government-directed learning" strategy, with a major emphasis on large scale enterprises. This model has two principal tasks: "picking winners" and developing policy instruments that induce the entry, growth and productivity increases among firms with substantial potential for dynamic internal economies.⁷⁰ The emphasis on conglomerates enables:

the capture of simultaneous externalities, in part by enabling large individual enterprises by virtue of their size and associated diversification to internalize externalities, in part by facilitating co-ordination among a small number of large enterprises, co-ordination that would be exceedingly difficult to achieve in a more diffuse industrial structure.

Yet, because the capture of economies is due to administrative determination of major investment decisions and a less competitive domestic environment, there are fewer pressures to enhance the long-term advantages that come from the improved "transactional efficiency of markets."

On Policy Targeting: Some of South Korea's policies were of the neoclassic level playing field variety. These included the move from a multiple to a uniform exchange rate and rebates of indirect sales taxes and import duties to all exporters meeting performance criteria. In 1968, these nondiscriminatory policies were so substantial in impact that they amounted to nearly 30 percent of the value of merchandise exports.⁷¹

Other policies, however, were heavily biased toward selected sectors (notably successful exporters) and large enterprises. These biases included infant industry protection, tax exemptions, long-term credit (100% controlled) at sub-market interest rates, and assistance in marketing through the organization of huge conglomerates. The potential for misuse of such instruments was considerable. In the allocation of long-term credit and tax breaks, the criteria for their distribution left substantial

discretion with the bureaucracy and a high degree of uncertainty on behalf of the applicant. Apparent additional rewards to successful exporters included continued government support and facility in their dealings with the bureaucracy. Even the rigor of tax collection was determined by export performance.

That Korea's conglomerates did not lead to a healthy SME sector appears due both to Korea's more limited early entrepreneurial and human resource base (discussed above, section IV "Traders...") and the broad array of large scale policy biases which helped compensate for that early human resource and institutional weakness. In other words, given Korea's initial conditions, Korean policies promoting industrial concentration may have been an "efficient response to backwardness" in its human resources base.

The costs of a Korean strategy, however, are the risks of both miscalculation in identifying profitable sectors as well as "rent-seeking ... and socially unproductive policies." However, these may be necessary risks when a human capital, entrepreneurial, and institutional base approximating Taiwan's does not exist. Without the core of a healthy trading community, a SME-based strategy may be more problematic. Yet, one should not assume away entrepreneurial talents where there is already an active trading community, as is true in some African cases.

FOR THE "SOFT STATE": Where government's capability is limited, more modest levels of intervention may be appropriate, to avoid the leakages of administered resources out of the country, into Swiss banks, or into other unproductive activities.⁷² Because a relatively pure laissez-faire strategy is not known to have been effective outside of Hong Kong, a virtually unique political and economic environment, a mixture of laissez-faire and hard state strategies is proposed for soft states. Policy formulation for these soft states, then, should "minimize discretion by government officials" and include serious consideration of the following tactics:

- efficient markets and competition, including minimizing administrative and legal barriers to establishing new businesses;⁷³
- "performance-based" support for progressive small and medium enterprises (rather than micro or large enterprises),⁷⁴ including through the means of vigorous informal financial markets;⁷⁵ and
- export promotion, including through the means of:
 - ** guaranteeing working capital for exports;
 - ** incentives to stimulate the proliferation of export traders;
 - ** selective involvement of multinationals as exporters; and
 - ** selective and firm-specific incentives for national exporters of manufactures.

In the country cases where there are also substantial price distortions, EEPA has recommended a variety of further options:

Export processing zones, tariff drawback schemes for direct and indirect exporters, bonded warehousing programs and the like are additional mechanisms for promoting exporters by affording tariff-free access to otherwise protected inputs, mechanisms that have no attraction in already undistorted price environments. But they are exceedingly attractive options in soft states riddled with distortions, where the objective is the roundabout one of working to strengthen the hand of interests favoring reform. It was evident to us in our work in the Philippines that, for all of the shortfalls in implementation, export processing zones, tariff drawback schemes, and bonded warehouses were crucial in enabling manufactures to take root; and these exporters were in late 1986 among the most vociferous advocates of continuing policy reform. Indeed, it was Korea and Taiwan that pioneered the use of zones, drawbacks and the like in the early 1960s.⁷⁶

The extent to which exports should be promoted depends on considerations such as a country's resource and institutional base and potentials for efficient import substitution and for economies of scale in domestic markets.

THE AFRICAN CASE: Because of Sub-Saharan Africa's profound developmental difficulties, EEPA developed policy guidelines for the region, based on the project's experience in a variety of African countries (e.g., in Rwanda, Malawi, and Botswana), and a mining of other policy analysis documentation.⁷⁷

Initially, Africa's diversity must be acknowledged. Illustrating the diversity, Botswana and the Congo have per capita incomes five times those of Burkina Faso and Zaire, and the rural population densities of Rwanda and Malawi are more than 10 times those of Cote d'Ivoire and Zimbabwe.

Yet the distinguishing characteristics of African economies do have implications for policy. Relatively common characteristics of their economies include the following:

- Low incomes prevail, reflected in the fact that 19 of the world's 25 poorest countries are African.
- Low population density is typical, particularly in rural areas. With the above exceptions of Rwanda and Malawi plus Burundi, rural populations are widely diffused.
- Poor infrastructure is reflected in weak transportation, communication, water, and power systems.
- Agricultural output per capita is declining, and did so in 29 of 32 countries between 1980 and 1986.
- Human capital is underdeveloped and in jeopardy, with widespread adult illiteracy (more than 50% in more than half of the Sub-Saharan countries) and, for 12 of 29 countries for which data are available, a maternal mortality rate more than 11 times China's and 5 times Sri Lanka's.⁷⁸

Within these broad characteristics of the African economies, small enterprises also have their own distinguishing features. They are

extensive and widespread, primarily rural, and overwhelmingly small (generally, a one-person household-based enterprise). Within the manufacturing sector, the sectoral composition is primarily light manufacturing, with a recent shift from traditional to more modern commodities, such as from weaving and traditional mats to tailoring and modern furniture. Moreover, contrary to some casual impressions, the majority of modern small and medium scale enterprises do not appear to have had microenterprise origins but started out with more than 10 employees.⁷⁹ Finally, economic efficiency tends to be higher for those small firms which are:

- somewhat larger, on average being positive only for firms of more than one worker (as discussed above);
- operated away from the home;
- produce more modern commodities, such as baking, tailoring, carpentry, metal-working; and
- located in the larger, more urbanized, localities.

This setting for SSEs in Africa has a number of policy reform implications. In general, the objective of the reforms is to develop a policy climate conducive to overall growth, thereby expanding employment opportunities in efficient and dynamic enterprises.⁸⁰ More specifically, this means to "strengthen the ability of productive enterprises to respond to ... growing demand."⁸¹ Accordingly, EEPA suggests the following highlights of a strategy for Africa:

- ** Agricultural policies consistent with efficient and broad-based growth are a crucial priority.** Particularly important are enhanced agricultural research and development and the elimination of urban bias in national developmental policies. As the sector is the major source of income for the rural majority, Africa's widespread rural small enterprises are heavily dependent on the health of this primary sector for their own survival and expansion, as discussed above (Section V, "Some Particulars..."). Strengthening agriculture, in other words, is a major tactic in providing enhanced demand for rural small enterprises.⁸²
- ** Liberalised foreign trade policies -- foreign exchange markets, tariffs, licenses, and export promotion policies -- are particularly important, for the following reasons:**

- Africa's growth is particularly dependent on foreign trade;
- Trade can make a substantial contribution to overcoming small domestic markets, thereby enabling some economies of scale and more labor-intensive growth;
- Basic restructuring of inefficient administered trade regimes are relatively rare; and
- Trade policy reform, in most African countries, constitutes the single most potent means to overcome costly governmental decision-making that is particularly biased against small enterprises.

Yet -- as considered in the above discussions of the level playing field and the hard/soft states -- while it is in general important to liberalize markets, there may be circumstances where infant industry protection or export incentives are appropriate.

- ** Small entrepreneurs nearly always identify credit as their primary need. To ease the extent to which credit is a constraint, a number of alternative programs for small and medium firms are worthy of consideration. These include character-based lending, easing administrative processing of loan requests, and expanding the flow of credit to SMEs through commercial banks.⁸³**

- ** Although SSEs typically pay lower taxes than their larger counterparts (as discussed above), in some countries firms encounter "growth trap"-like difficulties as they attempt to grow and innovate.⁸⁴ A promising approach to fiscal reform appears to be one tried in a number of African countries: special studies of the tax system, combined with collaboration among government, business officials, and organizations working directly with producers.**

- ** With regard to human resources priorities, EEPA's research is inconclusive. However, to enable small firms' entrepreneurs to respond better to their market signals, and to undercut the problems inherent in widespread labor force illiteracy, EEPA has supported increased spending on secondary education, a redirection of the educational system toward entrepreneurial skills, and a reorientation of vocational training to focus on basic skills in demand. In the latter case, training has often generated far more trainees than the labor market absorbed.**

- ** Collaboration in the reform of legal and administrative systems also is essential, because of their close links with and significant burden on enterprise growth and development, both in the letter of the law and in their implementation. Inefficient legal and regulatory systems constrain particularly the larger enterprises, although large scale/small scale market interactions imply a derivative burden on the small as well. While a number of reforms have already been undertaken, implementation appears to be lagging seriously behind the mandate. Collaboration in the reform process is recommended: to provide improved information to policy-making and -implementation officials from academic researchers, field-experienced PVOs and NGOs, and formal and informal sector entrepreneurs themselves.**

VII. POLICY REFORM TACTICS: Brief Comments

Donor involvement in policy reform is most effectively pursued through collaborative donor/host country policy dialogue and analysis.⁸⁵ With such involvement host country decision-makers build their own analytical capability, understanding of alternative

policy impacts, and sense of ownership relating to proposed reforms. Tactics to implement such an approach may include strengthening both host country and donor policy analysis programs, including personnel, data, analytical resources. Given the above discussion of the importance of policy reform, the priority for such programs should not be underestimated.

EEPA's staff and others have experienced the effectiveness of this collaborative approach. In one instance, after a collaborative donor/host country team's careful analysis of rural small enterprises, the host country indicated that subsequently such firms would be one of their developmental priorities. Following another collaborative advisory experience, the host country relaxed some price controls, revised its investment code to give SMEs more favorable treatment, commented that this project was unique among donors in not giving the country fish but instead in teaching it how to fish," and later promoted the host country collaborator to be Minister of Plan.

VIII. CONCLUDING COMMENTS:

Small and medium enterprises are not only an important source of employment for job-scarce low income countries, but they are also an important source of efficiency, growth, and economic decentralization. Often their efficiency is in spite of hostile policy climates and inadequate growth inducing-public sector investments.

Research and experience are beginning to reveal strategies for direct and policy interventions, including those summarized above, that may yield more rapid and broad-based economic growth. Yet, while important lessons can be learned from experience to date, the complexity of development dictates that particular country strategies must be shaped using those lessons in the context of each country's socio-economic environment.

The most politically and economically effective means of developing those strategies, for an optimum mix of small, medium and large enterprises, is through carefully designed collaborative donor and host country policy analysis programs. Their thoughtful implementation may substantially enhance industrial transformation, employment, and social cohesion.

ENDNOTES

1. More than 50 research and technical assistance reports have been developed under the Employment and Enterprise Policy Analysis Project. Based on work in Asia, Africa, Latin America and the Caribbean, copies of any of the project's reports discussed here are available from AID/POL/CDIE/DISC; Room 209 SA-18; Washington, D.C. 20523, or telephone (703)351-4006. -- A.I.D. is continuing its long-term program to assist micro and small-scale enterprises, through further research, technical assistance and credit. For more information, contact the Office of Small, Micro, and Informal Enterprise; Bureau for Private Enterprise; U.S. Agency for International Development; Washington, D.C. 20523.
2. U.S. Department of Labor (USDOL), on loan to the U.S. Agency for International Development (USAID). Being a review article, the author is, of course, heavily indebted to KEPA's researchers and other cited authors. Particular appreciation is also extended to Michael Farhman and Catherine Gordon (USAID), Carl Liedholm (Michigan State University), Elizabeth Rhyne (also USAID/USDOL), and Donald Snodgrass (Harvard Institute for International Development) for highly constructive comments on various drafts. The author alone, however, is responsible for any errors of interpretation, commission, or omission. Opinions expressed in this article, other than those drawn from KEPA or other referenced material, are the author's and are not intended to represent those of either USAID or USDOL.
3. There is no commonly agreed worldwide estimate of employment in small enterprises. Yet, pursuing a partial estimate -- with a definition not exclusively based on scale but generally referring to "very small scale", largely independent and self-employed owners, with very little capital, few employees, and low levels of technology and productivity -- in early 1991 the ILO estimated that 300 million are employed in the urban informal sector. [ILO, The Dilemma of the Informal Sector, 1991, p. 11] Obviously, this does not include those employed in the numerous rural small enterprises. In the manufacturing sector, there is considerable evidence that in the poorer countries the "vast majority are located in the rural areas." [Carl Liedholm and Donald Mead, Small Scale Industries in Developing Countries: Empirical Evidence and Policy Implications, Michigan State University International Development Paper No. 9, 1987, p. 18] Accordingly, if one assumes that employment in urban small enterprises is only one-third to one-half of total small enterprise employment, then (a) adding rural SSE employment to ILO's rural estimate, and (b) expanding the definition to include small firms as well as ILO's above estimate for the "very small" category, total developing country small enterprise employment may be roughed out as somewhere in the neighborhood of one billion. It should be noted here that definitions of small, micro, informal, cottage, etc. enterprises are highly diverse in the literature. For the purpose of this report, "microenterprise" will generally refer to a firm with up to 10 workers, and "small" to up to 50. "Informal" will be used to refer to roughly the same grouping as "small".
4. Philip A. Neck (ed.), Small Enterprise Development: Policies and Programs (Geneva: International Labor Organization; 1977), p. 13. Presumably the author is referring here basically to non-farm options, for the great majority of less industrialized workers are still employed overwhelmingly in agriculture. In 1980, the World Bank reports, 72% of the labor forces of low-income countries were employed in agriculture. World Development Report: 1987 (Washington) p. 264.
5. With regard to their role in modern economies, Dun and Bradstreet ("Comments on the Economy" April/May 1991) recently estimated that the "lion's share" (57%) of employment growth in the American economy in 1991 will come from firms with fewer than 100 workers, although smaller firms were more pessimistic about the prospects for compensation increases. It should be noted, however, that this D&B definition is substantially more inclusive (i.e., up to 99 workers, rather than the 49 workers used in most of the KEPA reports).
6. Malcolm Gillis, Dwight H. Perkins, Michael Roemer, and Donald R. Snodgrass, Economics of Development, second edition (New York: Norton; 1987) p. 561.
7. For a discussion contrasting the large scale emphasis in Korea with Taiwan's less concentrated industrial structure, see Tyler Biggs and Brian Levy, "Strategic Interventions and the Political Economy of Industrial Policy in Developing Countries", KEPA Discussion Paper #23, December 1988, to be published in Dwight Perkins and Michael Roemer (eds.), Reforming Economic Systems in Developing Countries (Cambridge, MA: Harvard; 1991).
8. See the discussion of the importance of policy for project success in W. Donald Bowles, "A.I.D.'s Experience with Selected Employment Generation Projects", A.I.D. Evaluation Special Study No. 53, March 1988. While Bowles mentions the importance of policy, he also strikes a chord somewhat similar to that of Vernon W. Ruttan: "The removal of distortions in monetary, fiscal, trade, commodity, and consumer policy does not produce development. Policy reform is, in some countries, a necessary condition for development.... But the real sources of economic growth are investments in human and physical capital and in productivity-enhancing technical and institutional change." From Ruttan's, "Solving the Foreign Aid Vision Thing", Challenge (May-June 1991).
9. State Department cable: Paris 37936, December 20, 1990.
10. For background on A.I.D.'s small enterprise research, see, A.I.D., Experiments in Small- and Microenterprise Development, A.I.D. Science and Technology in Development Series (n.d.[1991]).
11. While the measurement of enterprise scale by level of output or capital investment is also potentially fruitful, limitations of the project budget, concerns of A.I.D. with employment issues, and the availability of data helped prescribe the emphasis.
12. Liedholm and Mead, pp. 14-17.

13. EIPA's Donald C. Mead ("Policy Reform and the Informal Sector in Africa", EIPA #26, April 1989, p. 1) reminds us that Dennis Anderson and others, before EIPA, hypothesized, "as economies grow richer, there is a shift out of household and artisanal activities into small workshops and factories, then into large factories." Anderson, Small Industry in Developing Countries: Some Issues, World Bank Staff Working Papers No. 518, 1982.
14. See especially, Tyler Biggs and Jeremy Oppenheim, "What Drives the Size Distribution of Firms in Developing Countries?" EIPA Discussion Paper #6, November 1986, pp. 2+. Similar concepts and relationships are also discussed in other EIPA papers, such as Tyler Biggs, Merilee S. Grindle, and Donald R. Snodgrass, "The Informal Sector, Policy Reform and Structural Transformation", EIPA Discussion Paper #14, July 1988, published in Jerry Jenkins (ed.), Beyond the Informal Sector (San Francisco: ICS Press; 1988); and Donald R. Snodgrass, "The Role of Small and Medium Manufacturing Enterprises in Industrialization and Economic Development: An Introduction to the Employment and Enterprise Policy Analysis Project", in the DEVRES, Inc. report, "Policy Reform for Broad-based Growth: A Research Workshop -- Final Report" (Bethesda, MD: DEVRES, Inc.; May 1991). The latter also provides a useful review and documentation of some of the related important literature.
15. Biggs and Oppenheim, EIPA #6; and Snodgrass (DEVRES Workshop), p. 12.
16. Most of this evidence comes from Carl Liedholm and Joan Parker, "Small Scale Manufacturing Growth in Africa: Initial Evidence", EIPA #25, March 1989, published in somewhat revised form in Frances Stewart, S. Lall, and S. Wangwe (eds.), Alternative Development Strategies in Africa (London: Macmillan; 1991).
17. Biggs, EIPA #16 (rev.), p. 21.
18. Biggs, Grindle, and Snodgrass, pp. 15+.
19. Mead, EIPA #26, p. 8.
20. Steve Haggblade, Carl Liedholm and Donald C. Mead, "The Effect of Policy and Policy Reforms on Non-Agricultural Enterprises and Employment in Developing Countries: A Review of Past Experiences", EIPA #1, March 1986, p. 7; also, published in slightly abridged form in Frances Stewart, Henk Thomas, and Ton de Wilde (eds.), The Other Policy: The Influence of Policies on Technology Choice and Small Enterprise Development (London: Intermediate Technology Publications; 1990).
21. The MSU country survey data indicate that net returns per hour of family labor and economic profit for the one worker firms were typically only a small fraction of that for the next largest group (2-5 workers), indeed, in three of the four countries, these overall economic profits "are close to zero or even negative. Many of the firms in this portion of the small industry size spectrum would appear to be at the margin of viability. Such a finding is consistent with the previously described relatively poor growth performance of this size category for Sierra Leone and India." Liedholm and Mead, p. 82.
22. Liedholm and Parker, p. 10.
23. Liedholm and Mead, work cited, pp. 68+. Other EIPA discussion of the scale-efficiency question is also found in Snodgrass' DEVRES workshop paper (p. 7) and Biggs, Grindle, and Snodgrass, Discussion Paper #14, pp. 15+ and 48+.
24. Two notes: First, total SSE resource use efficiency may be high, and average value-added per worker low, by an efficient combination of total resources. This may often reflect smaller firms minimizing relatively scarce capital and material inputs in efficient conjunction with low cost labor. Second, in a recent letter to the author (10Oct91), Snodgrass, EIPA's project coordinator at Harvard, notes, "My impression is that if one uses the simplest measure, value added per worker, it is pretty clear in most cases that productivity is higher in larger firms. The question is, how much of this is attributable to higher capital intensity and how much, if any, to more efficient use of resources? Evidence on capital productivity and TFP [total factor productivity] is more mixed."
25. Snodgrass, DEVRES Workshop, p. 13.
26. For related research, discussing the complex relationship between scale and efficiency, see Ian M.D. Little, Dipak Masumdar, and John M. Page, Jr., Small Manufacturing Enterprises: A Comparative Analysis of India and Other Economies (New York: Oxford; 1987), p. 305; Marilus Cortes, Albert Berry, and Ashfaq Ishaq, Success in Small and Medium-Scale Enterprises: The Evidence from Colombia (New York: World Bank; 1987), p. 209+. pp. 6+. For an interesting critique of the first of these by an EIPA analyst, see Donald C. Mead, "Review Article: Small Enterprises and Development," Economic Development and Cultural Change, January 1991.
27. Liedholm and Mead, pp. 56-58; and Donald C. Mead, "Policy Reform and the Informal Sector in Africa," EIPA #26, April 1989, pp. 7-8.
28. The essence of this discussion, and any quotes, comes from Brian Levy, "Export Intermediation and the Structure of Industry in Korea and Taiwan", EIPA #13, October 1987, and his "The Strategic Orientations of Firms and the Performance of Korea and Taiwan in Frontier Industries: Lessons from Comparative Case Studies of Keyboard and Personal Computer Assembly," EIPA #12, October 1987.
29. Lawrence Kent, "The Relationship Between Small Enterprises and Environmental Degradation in the Developing World (with Emphasis on Asia)," EIPA, September 1991.

30. Haggblade, Liedholm and Mead.

31. See Snodgrass, DIVRES Workshop paper, and Little, Mazumdar, and Page.

32. Because of Taiwan's successful growth and the importance of small enterprises in that pattern, a number of EEPA's reports deal with the Taiwan and South Korea contrast, namely, Brian Levy, "Prospects and Perils for Small and Medium Enterprises in Outward-Oriented Industrial Expansions: Lessons from Korea and Taiwan", EEPA #8, November 1986; Brian Levy and Wen-jeng Kuo, "Investment Requirements and the Participation of Korean and Taiwanese Firms in Technology-Intensive Industries", EEPA #11, October 1987; Brian Levy and Wen-jeng Kuo, "The Strategic Orientations of Firms and the Performance of Korea and Taiwan in Frontier Industries: Lessons from Comparative Case Studies of Keyboard and Personal Computer Assembly", EEPA #12, October 1987, also published in World Development, April 1991; Brian Levy, "Export Intermediation and the Structure of Industry in Korea and Taiwan", EEPA #13, October 1987, published as "Transactions Costs: The Size of Firms and Industrial Policies", Journal of Development Economics v. 34, 1991; and Tyler Biggs, "Financing the Emergence of Small and Medium Enterprise in Taiwan", EEPA #15, August 1988, and "Heterogeneous Firms and Efficient Intermediation in Taiwan", EEPA #16, August 1989, to be published in Michael Roemer and Christine Jones (eds.), Markets in Developing Countries: Parallel, Fragmented and Black (San Francisco: ICS Press; 1991); Jennie Hay Woo, "Education and Industrial Growth in Taiwan: A Case of Planning", EEPA #18, August 1988, to be published as "Taiwan as a Case of Successful Educational Planning", in World Development September 1991; Brian Levy, "Export Intermediaries and Industrial Expansion: A Theoretical Perspective", EEPA #20, August 1988; Biggs and Levy's #23; and Tyler Biggs and Chang-Ho Yoon, "Market Structure and the Transition to High-End Export Products in Developing Countries", EEPA #27, January 1990, to be published in World Development.

33. On the importance of a sound agricultural policy for broad-based development and SSGs, see Hans Binswanger, "Agricultural Growth and Rural Nonfarm Activities, Finance and Development, June 1983, and the Mellor and Adelman articles in John P. Lewis and Valeriana Kallab (eds.), Development Strategies Reconsidered (New Brunswick: Transaction Books, for the Overseas Development Council; 1986); and Irma Adelman, "Beyond Export-Led Growth", World Development, Vol. 12, No. 9, 1984. For a more detailed discussion of agriculture, off-farm employment, and rural labor markets, see Joel Greer and Erik Thorbecke, Food Poverty and Consumption Patterns in Kenya (Geneva: ILO; 1986), and Steven Haggblade and Carl Liedholm, "Agriculture, Rural Labor Markets, and the Evolution of the Rural Nonfarm Economy," GEMINI Working Paper No. 19 (Bethesda, MD: Development Alternatives, Inc., for USAID/APRE/SIIR; May 1991).

34. See: Haggblade and others, EEPA #1; Peter Kilby and Carl Liedholm, "The Role of Nonfarm Activities in the Rural Economy", EEPA #7, November 1986, also published in J.G. Williamson and V.R. Panchamukhi (eds.) The Balance between Industry and Agriculture in Economic Development, proceedings of the Eighth World Congress of the International Economic Association, Delhi, India (MacMillan; 1989); Steven Haggblade and Peter Hasell, "Agricultural Technology and Farm-Nonfarm Growth Linkages," Agricultural Economics 3 (1989); Steven Haggblade, Peter Hasell, and James Brown, "Farm-Non Farm Linkages in Rural Sub-Saharan Africa", World Development, Vol. 17, No. 8, 1989; and UNDP, Government of the Netherlands, ILO, and UNIDO, Development of Rural Small Industrial Enterprise: Lessons from Experience (Vienna: 1988).

35. Unfortunately, overvalued exchange rates have a particularly insidious effect of raising the cost of input supplies in the notable case of farmers, who often have a significant potential but frustrated actual achievement in agricultural exports. See: Haggblade et al., EEPA #1; Liedholm and Mead, Ch. IV; and UNDP et al.

36. Jean-Jacques Deschamps and William Grant, with Albert Berry and Susan Goldmark, "The Impact of Financial Market Policies: A Review of the Literature and the Empirical Evidence", EEPA #21, October 1988; and Haggblade et al., EEPA #1.

37. Tyler S. Biggs, EEPA #s 15 and #16 (rev), summarized in "IID Research Review", Winter 1989.

38. Haggblade et al., EEPA #1, pp. 13-17; Liedholm and Mead, pp. 93-94; and Snodgrass, 1991, p. 14.

39. Snodgrass, in a letter to the author (10Oct91), noted that his counterpart in Indonesia is finding that "even the smallest firms are tracked down by the tax men and regulators, and moreover that compliance with the rules and regulations reduces their return on capital more than it does for the larger firms." See also, Haggblade et al., #1, pp. 29-32; Liedholm and Mead, pp. 95-96; and Snodgrass, 1991, p. 32.

40. There is uncertainty about the extent to which other factors may contribute to this gap, or dip in the distribution of employment by enterprise scale. Such factors might include resource constraints (human, capital, or technological) on the small, economies of scale (e.g., in marketing, management, or technology), access to substantial amounts of capital by elites, or the fact that importing technology through multinationals often comes in large packages.

41. See, Susan Goldmark, Jean-Jacques Deschamps, William Glade, Maria Willumsen, with Maria Concepcion Lopes and Ana Cristina Mejia, "The Effect of Policy Upon Small Industry Development in Honduras", EEPA Technical Cooperation Report, September 1987; Lehman B. Fletcher, Gustavo A. Marques, and David E. Sarfaty, "Formulating a Strategy for Employment Generation in Ecuador: Issues and Priorities", November 1988; Tom Timberg, "Report on the Survey of Small-Scale Industry Units in Bombay", World Bank Economic Development Department, 1978; and Clifton Barton, "Credit and Commercial Control: Strategies and Methods of Chinese Business in South Vietnam", Ph.D. dissertation (Cornell University, 1977), both quoted in Carl Liedholm, "The Dynamics of Small-Scale Industry in Africa and the Role of Policy", GEMINI Working Paper, No. 2 (co-funded by EEPA) January 1990, p. 40; and Tyler Biggs, Brian Levy, Jeremy Oppenheim, and Hubert Schmits, with assistance from the Philippine Center for Research and Communication (CRC), "The Small Business Policy Direction Study", for the Ministry of Trade and Industry, Republic of the Philippines (n.d. [1987]), pp. 26+. See also the discussion in Biggs, Grindle, and Snodgrass, EEPA #14, pp. 48+.

42. Liedholm, GEMINI Working Paper #2, pp. 40 & 46.
43. The 1986-87 HIID Philippine team's "missing middle" was examined by a distinguished team headed by Gustav Ranis, which noted, "the distribution of manufacturing employment in the Philippines ... is unusual in its concentration in the very small and the very large establishments." ILO, Sharing in Development: A Programme of Employment, Equity and Growth for the Philippines (Geneva; 1974), pp. 141 and 158.
44. The Little, Masumdar, and Page survey, Small Manufacturing Enterprises, reported substantial "wage cliffs" in India and Indonesia, and smaller ones in Colombia and Malaysia. The sharp rises in wages, respectively, began in the range of 100-200 workers for India and after 200 workers in Indonesia. The wage increases in developed countries associated with scale exist but "are small compared with those in any developing country." Moreover, they argue, "[i]t cannot be lightly assumed that the wage differentials which exist after allowing for skill differences must be distortions that are caused by union activity or government intervention." (P. 310)
45. See, Biggs, Grindle, and Snodgrass, pp. 51; Biggs et al., "Small Business Policy Direction Study", pp. 33+; and Snodgrass' DEVRES workshop paper, p. 14. -- It should be noted that a dualistic pattern of distribution of industrial employment by enterprise scale is not fatal, for South Korea is a dramatic illustration of a country with a substantial missing middle which has not been seriously impeded by not having the smooth curve skewed to the right (lognormal) characteristics of the U.S., UK, and Germany. The basic argument, however, is that industrialization without the scale dualism is a more efficient pattern than one without. For a selection of such graphs, see Biggs and Oppenheim, KEPA #6, pp. 7+.
46. Although not researched by KEPA, there is also a political advantage to having a healthy mid-sized set of enterprises, as opposed to a dominating set of conglomerates. London's Economist (23Sept89; p. 39): In the light of South Korea's industry being dominated by a relatively small number of big firms, "South Korea's technocrats ... are now intensely worried about [a] lack of internal competition." Moreover, the Economist reports, "business affairs are mingling dangerously with politics ... [and the] government has given the economy some problems that could prove difficult to solve." Larry E. Westphal has also referred to the fact that Korea's "highly concentrated industrial structure ... is unpalatable to many Koreans." Journal of Economic Perspectives, Summer 1990.
47. Biggs, Snodgrass, and Grindle, pp. 52-59.
48. See, for example, Snodgrass, DEVRES, p. 14; Biggs and others, "The Small Business Policy Directions Study [Philippines]"; Liedholm, GEMINI Working Paper #2, pp. 40 & 42; and Mead (KEPA #26, pp. 7-9 & 15).
49. See the curve in Biggs and Oppenheim, KEPA #6.
50. See, for example, the economic and political research priorities discussed by Gustav Ranis, Henry Bruton, Gary Fields, and Stephan Haggard, in DEVRES, Inc., "Policy Reform for Broad-Based Growth: A Research Workshop [9Nov90] -- Final Report", submitted to the Office for Small, Micro, and Informal Enterprises, Bureau for Asia and Private Enterprise, U.S.A.I.D., May 1991.
51. Snodgrass (DEVRES, 1991) refers to the "World Bank and many economists" favoring the "level playing field", and Kieth Marsden's "Creating the Right Environment for Small Firms", is a good example: "In conclusion, the best environment for small firms is a relatively free market that provides equal incentive and opportunity for all enterprises." Finance and Development (December 1981). A more recent World Bank conference illustrated the substantial set of opinions that there is not one policy route to development. "Roundtable Discussion -- Development Strategies: the Roles of the State and the Private Sector," Proceedings of the World Bank Annual Conference on Development Economics (1991).
52. Liedholm and Mead, p. 122.
53. See: Biggs, Grindle and Snodgrass; Biggs, KEPA #s 15, 16, & 17; Tyler Biggs and Chang-Ho Yoon, KEPA #27. The Korean experience suggesting the importance of policy bias in generating growth is also discussed by Larry E. Westphal in the Journal of Economic Perspectives (June 1990): "In sum, micro empirical research done over the past 15 years, some of it in Korea, suggests a strong theoretical case in favor of selective intervention to promote infant industries in less developed countries." Further, he notes that the non-neutral policies used to support infant industries were, most importantly, import protection, but also important were "preferential access to ... credit", "reductions or exemptions with respect to most or all direct and indirect taxes (including tariffs)", and the selective molding or creating of marketing agents in the form of chaebol, "extremely large conglomerate groups whose activities span all sectors but are concentrated in manufacturing and construction." The Taiwanese case is a happy contrast in that it also represents an approach to rapid growth, but without the same high degree of governmental intervention and industrial concentration found in Korea. See also, Colin I. Bradford, Jr., "East Asian Models: Myths and Lessons", in J.P. Lewis and V. Kallab (eds.), Development Strategies Reconsidered (New Brunswick: Transaction Books; 1986).
54. Mead, "Review Article...", p. 413. Also, Snodgrass, DEVRES Workshop paper; and Little, Masumdar, and Page, p. 313.
55. KEPA [Snodgrass, DEVRES, 1991, p. 15] acknowledges the early development of the "soft state" concept by Gunnar Myrdal, in his Asian Drama: An Inquiry into the Poverty of Nations (New York: Pantheon; 1968).

56. Snodgrass, in DEVRES Workshop paper, p. 15. One should not equate "soft" and "hard" states with developmentally virtuous and otherwise. One thoughtful analyst: "... I would ... argue that some of the criticisms of the 'softness' of the state, and the corollary view (characteristic of early writings on development economics) that the 'harder' the state the more effective it must be, are dead wrong. Quite often what appears as softness is the responsiveness of the state to the public asserting itself and demanding that the state should take heed of the public's welfare. That need be no bad thing." Amartya Sen, "Roundtable Discussion -- Development Strategies: The Roles of the State and the Private Sector", Proceedings of the World Bank Annual Conference on Development Economics, 1990, p. 425.
57. "Between 1965 and 1983, GNP per capita grew at an average annual rate of 6.5 in Taiwan, and 6.7 percent in Korea, as compared with an average rate of 3.8 percent for a larger sample of upper-middle-income less developed nations. Gini coefficients for After-tax household income amounted to .285 (in 1978) and .389 (in 1980) for Korea and Taiwan respectively, placing both nations in the low-inequality group of countries. Interestingly (and consistent with our analysis of differences between the two countries), between the late 1960s and late 1970s inequality widened in Korea but narrowed in Taiwan." Tyler S. Biggs and Brian Levy, EEPA #23, pp. 10.
58. Biggs and Levy, EEPA #23, p. 23-24.
59. Biggs and Levy acknowledge an indebtedness to Albert O. Hirschman's The Strategy of Economic Development (Yale; 1958).
60. Biggs and Levy, EEPA #23, p. 32.
61. Biggs and Levy, EEPA #23, pp. 30-31.
62. "In the early 1960s, ... textiles and sewing machines, later on ... secondary import-substitution industries and electronics." Biggs and Levy, pp. 33-34.
63. Biggs and Levy, EEPA #23, p. 34.
64. Biggs and Levy, EEPA #23, p. 24; and Liedholm and Mead, pp. 56-58.
65. Biggs and Levy, EEPA #23, p. 24.
66. Biggs, EEPA #16 (rev.), p. 21.
67. Tyler S. Biggs, EEPA #16(rev), August 1989, p. 13. Bolnick's financial sector analysis in Malawi indicated that, contrary to the Taiwan case, "Supplier trade credit is 'extremely difficult' for SMEs to get, according to available evidence." Donald C. Mead, Bruce R. Bolnick, and Robert C. Young, "Strategies for Small and Medium Enterprises in Malawi", EEPA Technical Assistance Report, August 3, 1989, Annex IV, p. 61.
68. Biggs and Levy, EEPA #23, p. 32-33. Incidentally, corporate combined with personal income taxes do not appear to have seriously damaged the economy. The maximum corporate rate was 25% before 1974 and 35% after, while the personal income tax rate, relatively high compared to current American rates, were 50% before 1969 and 60% after.
69. Biggs and Levy, EEPA #23, pp. 33-5+.
70. Biggs and Levy, EEPA #23, pp. 5-8.
71. Biggs and Levy, EEPA #23, pp. 12-17.
72. Biggs and Levy, EEPA #23, pp. 41+.
73. Biggs and Levy, EEPA #23, pp. 44-48.
74. Snodgrass, in DEVRES' Workshop: "We asked ourselves why government intervention apparently helped in [Taiwan and South Korea] while it has been demonstrably harmful in India and many other countries. A big part of the answer is that intervention in Korea and Taiwan was generally performance-based. Assistance was not given automatically to firms just because they were small. Instead, it was made strictly conditional on performance, particularly in the export market, and withdrawn when the desired level of performance did not materialise." In a letter to the author (10Oct91), Snodgrass elaborated on performance-based interventions: "Sure, one should concentrate on firms and industries with good growth prospects, but can these be identified accurately in advance? The EEPA view is that while it is impossible to 'pick winners' in advance one should offer performance-based incentives to promising producers, then withdraw them from non-performers. However, Wade says countries must 'make winners,' not 'pick' them. That is, they must decide what industries they wish to establish, then do whatever is necessary to make them succeed."
75. In Taiwan little domestic credit flowed through specialized banks to SMEs, and most of that which did went as working capital for medium-sized exporters. There were no SSE credit programs designed to boost the sector, apart from a small number of government credit guarantees. Biggs, EEPA #16 (rev.), p. 1. -- The most important informal or curb market instrument was the post-dated check, which was usually used to facilitate trade credit between firms. Because this credit was so important (roughly 30-80 percent of private business credit, depending on the size of the firm), in the 1950s, to support this market government criminalized failure

to honor such checks, and in 1985 granted prominent enterprises a "six month grace period for redeeming bad checks (read post-dated checks)..." Small and Medium Business Assistance Center, "Financial and Management Services to Small/Medium Business in Taiwan, the R.O.C.," Annual Report, 1985, quoted in Biggs, p. 14. In 1987, following a financial scandal involving the curb market, to reduce the prevalence of post-dated checks, "the criminal penalty for issuing bad checks was abolished." Biggs, p. 17.

76. Biggs and Levy, EEPA #23, pp. 50-51.

77. Much of the following discussion of African policy priorities is from Donald C. Mead, EEPA #26, and Liedholm and Parker, EEPA #25. More detailed reports on Africa and other cases in Latin America are also available.

78. For the 12 African countries, the maternal mortality rate is higher than 500 for every 100,000 live births, versus 44 in China and 90 in Sri Lanka. World Bank, Sub-Saharan Africa: From Crisis to Sustainable Growth (Washington: 1989) p. 65.

79. Liedholm and Parker, p. 26.

80. While the problem is too complex to analyse and confirm definitively under all circumstances, there is general consensus within EEPA that a sound set of efficient growth policies can be consistent with the efficient development and growth of the small and medium enterprise sectors: "...the policy environment which supports the growth of progressive small and medium enterprises is desirable on other grounds, since it happens to be one which is also conducive to efficient industrial growth and structural transformation." Biggs, Snodgrass, and Grindle (EEPA #14), p. 84.

81. Mead (EEPA #26), pp. 9+.

82. See the above discussion of agricultural policy.

83. Mead suggests that credit does not appear to be the binding constraint on African small enterprises. More important, he argues, are the small markets in which they sell and limited information about potential new products, technologies, skills and markets. See, Donald C. Mead, EEPA #26, pp. 13-14; Augustin Ngirabatware, Leonidas Murembya and Donald Mead, "Medium and Large Manufacturing Firms in Rwanda: Diagnostic Study of Current Situation and Policy Impact", EEPA #22, August 1988; and Mead, Bolnick, and Young. Similarly, Snodgrass also expresses skepticism: "We know that small firms rely mainly on their own savings to finance their investment and borrow very little, especially from banks. What is less clear is how much this impedes their growth. I am not impressed by the fact that many small businessmen cite difficulty in obtaining capital as one of their main problems. When credit is subsidised, and therefore rationed, this may represent nothing more than a desire to get in on the bounty." [His letter to author, 10Oct91]

84. Liedholm, GEMINI #2, p. 40.

85. Haggblade, Liedholm, and Mead, EEPA #1; but see also: Patricia Vondal, "Operational Issues in Developing A.I.D. Policy Reform Programs" A.I.D. Program Evaluation Discussion Paper No. 28 (USAID/CDIE: October 1989), pp. 24-28; Sidney Weintraub, "Policy-Based Assistance: A Historical Perspective", paper prepared for discussion with A.I.D./Washington, July 20, 1989; and Donald R. Snodgrass and others, "The Use of Program Loans to Influence Policy", A.I.D. Evaluation Paper 1A, Part 1, March 1970, p. 41.

86. U.S.A.I.D., Office of the Inspector General, Regional Inspector General for Audit, Nairobi, "Audit of USAID/Rwanda's policy reform initiatives in manufacturing and employment program", no. 696-0127, 31Oct88; and State Department cable, Kigali, 17Dec87, #5945).