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ENTERPRISE SCALE,  
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AND DEVELOPMENT

Evidence on Policy Biases,  
Firm Size, Efficiency, and Growth

Robert C. Young

INTERNATIONAL  
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ECONOMIC GROWTH

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# **Enterprise Scale, Economic Policy, and Development**

**Evidence on Policy Biases,  
Firm Size, Efficiency, and Growth**

Robert C. Young



An International Center for Economic Growth Publication

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## ACRONYMS USED

AID	United States Agency for International Development
APRE	AID's former Bureau for Asia and Private Enterprise
DAI	Development Alternatives, Inc., Bethesda, MD, USA
DEVRES	DEVRES, Inc., Bethesda, MD, USA
EEPA	The Employment and Enterprise Policy Analysis Project (prime contractor: HIID; subcontractors: DAI & MSU)
GDP	Gross Domestic Product, a measure of national income
GEMINI	An AID-funded DAI microenterprise project
GNP	Gross National Product, another measure of national income
HIID	Harvard Institute for International Development (Cambridge, Massachusetts, USA)
IFAD	International Fund for Agricultural Development, Rome, Italy
ILO	International Labor Organization, Geneva, Switzerland
ITDG	Intermediate Technology Development Group, London, UK
MSU	Michigan State University, East Lansing, Mi, USA
NGO	Non-Governmental Organization
OECD	Organization for Economic Cooperation and Development, Paris, France
PVO	Private Voluntary Organization
R&D	Research and Development
SMIE	The Small, Micro and Informal Enterprise Office of AID
SMEs	Small and Medium Enterprises
SSEs	Small Scale Enterprises
UNDP	United Nations Development Program, New York, New York
UNIDO	United Nations Industrial Development Organization, Vienna, Austria
USA	United States of America
USAID	See: AID
USDOL	United States Department of Labor, Washington, D.C.

## PREFACE

The International Center for Economic Growth is pleased to publish *Enterprise Scale, Economic Policy, and Development* as the fifty-second in our series of Occasional Papers, which feature reflections on broad policy issues by noted scholars and policy makers.

In this paper Robert C. Young discusses evidence on the role and efficiency of the small-scale business sector. Small-scale enterprises, or SSEs, are most efficient in traditional, labor-intensive industries in less industrialized countries, where they provide essential, although often small, incomes for the poor. As nations industrialize, medium- and large-scale enterprises generally become more efficient. In some cases, however, small firms retain efficiency, despite agricultural, financial, and trade policies that are biased against them. Such biases may even offset the positive effects of direct credit or technical support to small businesses.

Young explains how government policies frequently direct resources prematurely into large-scale manufacturing, shortcutting the gradual evolution of firms from small to medium sizes (and perhaps eventually to large). This creates a "missing middle," or a shortage of modern, complex, and efficient mid-scale businesses, which would also provide a more politically stable industrial structure.

The author points out the dramatic contrast between the success stories of Taiwan and South Korea. Taiwan is distinguished by its small- and medium-scale enterprises, while conglomerates predominate in South Korea. Big companies enjoy the obvious advantages of scale and easier access to credit, technology, markets, expertise, and foreign exchange. Small-scale enterprises, however, have worked well not only

for Taiwan but for Japan and Hong Kong and are critical to the survival and development of the less-industrialized world.

The author concludes that small and medium enterprises should be encouraged as a complement to large industry by removing undue policy constraints and biases. He recommends that policy reform leading to an optimum mix of businesses of different sizes be pursued through collaboration among donor country, host country, and the public, private, and academic sectors, as well as labor groups and nongovernment organizations.

Robert Young has studied micro, small, and informal enterprise issues for more than twenty years. Young's synthesis of material on small-scale enterprises, drawn largely from the Employment and Enterprise Policy Analysis Project of the United States Agency for International Development, as well as other sources, will prove a valuable resource to those exploring the role of scale in economic development.

Nicolás Ardito-Barletta  
General Director  
International Center for Economic Growth

Panama City, Panama  
March 1994

## ABOUT THE AUTHOR

Robert C. Young has been an adviser to the U.S. Agency for International Development, on detail from the U.S. Department of Labor, since 1979. At the time he authored the present paper, Mr. Young was in USAID's Bureau for Private Enterprise and Office for Small, Micro, and Informal Enterprise. Mr. Young recently moved to USAID's Bureau for Africa, Office for Analysis, Research and Technical Support, Division for Economic Analysis. His publications have dealt with issues relating to health, manpower, economic policy, and small enterprise development. Mr. Young has also worked for the International Labor Organization, the Ohio State University, and the Ford Foundation. He received his Ph.D. in economics from Indiana University.

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Robert C. Young  
USAID/USDOL

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# **Enterprise Scale, Economic Policy, and Development**

## **Evidence on Policy Biases, Firm Size, Efficiency, and Growth**

### **Overview**

In the process of industrial transformation, medium- and large-scale enterprises are often more efficient than the small. This is particularly true in more advanced stages of development and in sectors with complex and indivisible technologies. Yet, in both less- and more-industrialized countries, there are important and complementary linkages between small and larger firms.

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, most notably in sectors where the small predominate. Moreover, small enterprises are often efficient despite policies that are biased against them, particularly agricultural, financial, and trade policies. Such biases often limit the small firms' viability, growth into larger enterprises, and contributions to national income.

There are no policy panaceas. Nevertheless, substantial evidence is examined and 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 the policies' 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. Additional policy guidelines are discussed, including those for a small- and medium-scale emphasis, a conglomerate emphasis, the soft state, and Africa.

Policy reforms conducive to more-efficient small enterprises, to a more dynamic industrial structure, and to broad-based economic growth are outlined and should be pursued through donor, host country, and public, private, labor, NGO/PVO, and academic sector collaboration.

### **Industrial Transformation and Small Enterprise**

Rapid growth with considerable equity is possible with a large-enterprise emphasis, as dramatically illustrated by South Korea. Large firms humble the small in appearance, are impressive political symbols, and dramatically demonstrate apparent benefits of large enterprises as the means to growth. Bigger enterprises 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 they always use their impressive resources more efficiently in developing economies is another matter.

Although small-scale enterprises (SSEs) are not universally acclaimed, in the less-industrialized world's struggle for survival and development, SSEs are critical. As many as a billion or so very poor workers may own or work in such firms.<sup>1</sup> In the words of an International Labor Organization 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.<sup>2</sup>

Small enterprises have been widely assumed to offer significant development potential. The small-scale sector played an important role in classic development success stories—for example, Japan, Taiwan, and Hong Kong—and, incidentally, continues to be important in developed

economies.<sup>3</sup> As stated in a popular development economics text, it was hoped that SSEs would “generate more employment, permit greater decentralization, promote income equalization, and mobilize latent entrepreneurs.”<sup>4</sup>

This paper reviews important evidence on the role of the small-scale sector, its relative efficiency and interactions with the larger-scale enterprises, and policy biases inhibiting the development and efficient evolution of the small-scale sector in industrial development.

### **The Importance of Policy Analysis for Efficient Enterprise Scale and Development**

There is widespread agreement that appropriate policies are a vital, necessary, but not sufficient part of any effective development strategy. The World Bank has proposed two equally important elements in its strategy for sustainable development. The first is to “promote the productive use of the poor’s most abundant asset—labor” (the second: basic social services for the poor). “Policies that harness market incentives” are central to that first element. Similar chords may be heard in other literature: United Nations Development Program (UNDP) *Human Development Report 1990*, for example, refers to “much controversy on the appropriate policy environment,” but also refers to the “modicum of agreement” concerning the “essentials for equitable growth,” which relate well to policies with which the World Bank and USAID would feel quite comfortable, including “sensible and flexible use of prices to reflect opportunity costs,” the “opening of market systems,” and “supportive policies towards investment, technology and human resources.” Similar basic concerns with a less biased policy framework may be found in the International Fund for Agricultural Development’s 1992 report on *The State of World Rural Poverty*: “Reduce tax and expenditure biases . . . reduce distortion in product and factor markets . . . eliminate biases of financial institutions against the rural poor” . . .<sup>5</sup>

Though there is a strong empirical argument for assuring that the policy environment supports broad-based economic growth, that concern should include the impact of the policies upon the distribution of

enterprises by scale. For instance, although the World Bank, UNDP, IFAD, ILO, the PVO/NGO communities, and many governments recognize the important role that may be played by small enterprises, heavy demands upon scarce development resources preclude providing direct assistance to the vast majority of them. Nevertheless, providing an improved policy climate and removing undue policy constraints can support the majority of SSEs.

In this vein, analysts have known for some time that the policy environment for SSEs should be a healthy one, lest the efficiency of the sector be lost and the economy as a whole be crippled.<sup>6</sup> To alleviate this concern, a priority for such policy reform was recently reaffirmed by an OECD 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.<sup>7</sup>

As late as the early 1980s, however, little research had focused on the impact of policies on SSEs or the dynamics of SSEs through the long-term development process.

To improve understanding of the relationship between policies and small and medium enterprises (SMEs) in development, and building upon a program of research on SSEs,<sup>8</sup> USAID established the Employment and Enterprise Policy Analysis (EEPA) Project. This project's objectives were to

- analyze
  - policy constraints upon the small-scale sector
  - policy climates conducive to the efficient development of small and medium enterprises in a macro, long-term, and broad-based industrialization process
  - tactics for the political economy of policy reform
- participate in related technical cooperation
- disseminate the project's findings

To guide this program, the Harvard Institute for International Development (HIID), with a distinguished history of policy analysis in developing countries, was selected as the prime contractor. HIID subcontracted with Michigan State University (MSU) and Development Alternatives, Incorporated (DAI), to mobilize their extensive experience in analyzing the economics of small enterprises.

To limit the scope to resources available, the project focused on the impact of policies on manufacturing enterprises, analyzing that sector by scale, defined by number of employees. 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's growth invariably appears to accompany any successful increase in status from a low- to high-income country. Although services too are clearly important in the industrial transformation, for they also increase in relative importance, research appears to demonstrate their dependence on manufacturing, rather than vice versa.

### **Small and Medium Enterprises in the Industrial Transformation**

**Dynamic and Cross-Sectional Perspectives.** Although small enterprises typically are pervasive in both developing and developed countries, their relative importance changes over the course of economic development. The longer-term evolution of the distribution of manufacturing (also referred to in this discussion as "industry") enterprises by scale was reaffirmed early in EEPA's research.<sup>9</sup> Both cross-sectional and time series data confirmed that industrial enterprise scale increases with development and that a general pattern appeared in industrial transformations:<sup>10</sup>

- Cottage-shop manufacturing (in microenterprises, with one to four workers) predominates in the low-income countries (roughly, up to \$500 in per capita national income).
- Small- and medium-scale workshops (five to ninety-nine workers) are dominant in the emerging economies (roughly, \$501 to \$1,000 in per capita GDP).

- Large-scale firms (100 or more workers) prevail in the more advanced countries (over \$2,000), displacing the cottage-shop and most of the workshop and small factory enterprises.

This increase in average firm size along with national economic development is due to two primary phenomena. First, on the supply side, in more-developed countries, economies of scale (for example, technology, marketing, and access to influence and information) can more readily be achieved and thus 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.<sup>11</sup>

Yet, for a variety of reasons, relatively inclusive information on the smallest enterprises is often inaccurate or not available, one reason being that 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, but 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 the inadequate database and thus understand with more precision the role of SSEs as growth proceeds, a number of detailed cross-sectional surveys were carried out in developing countries. Their broad conclusions were as follows:

- Small firms (less than fifty workers) were a significant and frequently dominant (in terms of employment) component of the industrial sector (in thirteen of fourteen countries, with the SSEs generating an average of 71 percent of manufacturing employment).

- Most of the small-firm employment was located at the smallest end of the industrial spectrum; for example, detailed data revealed that in five of seven countries surveyed (Bangladesh, India, Sierra Leone, Zambia, Honduras, Egypt, and Jamaica), more than 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, with their contribution being more prominent at the lower end of the distribution of national per capita incomes.
- SSEs contributed handsomely to value-added in manufacturing (37 percent in seven countries for which data were available)
- On the other hand, SSEs contributed a relatively small but significant share of total national income (2.9 to 8.2 percent in the seven countries mentioned above) because of the small share of manufacturing in GNP.<sup>12</sup>

**Transformation at the Firm Level: The Birth, Growth, Death, and Phoenixlike Rebirth of SSEs.**<sup>13</sup> Although, as discussed above, the pattern of what happens to SSEs at the macro level over the long term is relatively clear, their microdynamics 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 8 percent (Colombia and the United States) 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 these firms' commodities, but also partially related to the weak demand for labor in other sectors, so that some of the smallest enterprises represent "labor sponges" during periods of hardship (see "'Hard' and 'Soft' Employment").

Mortality rates appear to be highest for the smallest firms and lowest for the larger firms, as one would expect, and 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 phoenixlike rebirth through the 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.<sup>14</sup>

Only scant data exist on what happens to individual firms over time in developing countries. The available evidence 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. Africa's generally low graduation rate appeared partially caused by an "entrepreneurial bottleneck," a deficiency in indigenous enterprise management performance for those firms with more than ten workers. The low overall rate also appears related to the "missing middle" in the distribution of employment by enterprise scale discussed later. Possible prejudicial consequences of this gap for economic growth are discussed in the policy section along with possible policy-related determinants. In any case, a moderately low graduation rate may not be as alarming as it might 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" and "Soft" Employment.** In examining employment in small firms at different levels of development, EEPA's distinction between "hard" and "soft" employment is useful.<sup>15</sup> Basically, "soft" employment refers to "supply driven" job creation, that is, 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."<sup>16</sup> "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 firms 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.<sup>17</sup>

More specifically, soft jobs are those jobs such as microscale 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 of 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 so are medium and large . . . sometimes. It all depends on the enterprise and sector. The smallest enterprises (particularly, those with merely one worker<sup>18</sup>), however, are rarely the most beautiful in terms of their productivity per worker. 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.”<sup>19</sup> 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 (substantially less than US\$1.00) and zero or

negative profits, but slightly larger firms (two to five workers) were doing substantially better, being on average profitable and with significant improvements, generally, more than quadrupling 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 more than doubled the earnings per hour of family labor (between two and eight U.S. dollars per hour, at the time of the surveys in the late 1970s and early 1980s). 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 ten of the twelve cases examined, firms employing fewer than fifty workers were more efficient.<sup>20</sup> Thus, in some sectors and countries with substantial small enterprise employment, standard efficiency measurement techniques show that small is efficient while providing essential (but often low) incomes for the poor.<sup>21</sup>

This finding—that whether small is synonymous with efficient often depends on which sector is being considered—appears consistent with the finding 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 fewer than 25 percent of manufacturing jobs are held by small firms.<sup>22</sup>

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

- 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.
- This evolution appears determined by the correlations between different economies of scale (for example, financial, technological, and marketing), the scale of markets, and changing patterns of demand as development progresses.<sup>23</sup>

**Large- and Small-Scale Interdependence.** As is true for agriculture in the rural areas, 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 (for comparative statistics, see “Alternative Strategies”). 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 “Hard State Alternative I”). Taiwan’s large firms yielded substantial dividends in the development of small and medium enterprises by training 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 like 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 available data on these ties suggest they are much more prevalent in Asia than in Africa.<sup>24</sup>

Although 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 suggested that in developing an SME-oriented growth strategy, the role of traders should not be ignored.<sup>25</sup> 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 might 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 South 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 twelve 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. In addition, policies expanding small-scale manufacturing 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.<sup>26</sup> 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.

Though 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 (for example, 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.

- Industry is not responsible for the bulk of either urban air pollution (motorized vehicles are) or organic water pollution (mainly household wastes).

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 (for example, 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 (for example, improved land and forest policies and taxes on fuel and chemical inputs) as well as technical approaches (for example, “cleaner” technologies) will be necessary, as will 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) that should not be considered for loans.

### **Policy Impacts on Small Enterprises**

In a nutshell, economic policy biases often constrain small-scale and informal sector enterprises and may 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.

EEPA's first "Discussion Paper"<sup>27</sup> found a complex set of policies affecting SSEs: monetary, fiscal, labor, trade, price, and regulatory policies yielded a mixed bag of weak, strong, positive, and negative impacts. Biases generally favored larger enterprises and undercut efficient growth. In contrast to the general pattern, India's policies have been strongly supportive of SSEs but with doubtful benefits for development.<sup>28</sup> In happy contrast with both the general pattern and India's pattern, Taiwan's policies since the early 1960s have been highly effective, supporting both growth and SMEs. The following table indicates some of the limited data available.

TABLE 1 Policy-Induced Factor Price Distortions in Large and Small Nonagricultural Enterprises (the percent difference in large firms' costs relative to small firms')

		Percent Difference:					
		(in Capital Cost Owing to)					
Period	Labor costs	Trade Regime	Interest Rate	Taxes	Total Capital	Wage/Capital Rental Rate	
<b>Asia:</b>							
Hong Kong	1973	0	0	0	0	0	0
Pakistan	1961-64	0	-38	-44	+22	-60	+150
South Korea	1973	0	-5	-35	+10	-30	+43
<b>Africa:</b>							
Ghana	1972	+25	-25	-42	+26	-41	+119
Sierra Leone	1976	+20	-25	-60	+20	-65	+243
Tunisia	1972	+20	-30	-33	NA	NA	NA
<b>Latin America:</b>							
Brazil	1968	+27	0	-33	NA	NA	NA

NA: data not available

Source: Haggblade, Liedholm, and Mead, p. 31

Even though these data reflect considerable variability, patterns are discernible: for these countries, capital market distortions (except for Hong Kong) are widespread and substantial, and labor market distortions were significant in Africa but still much less than those in capital markets. More specifically, the predominant pattern in these cases is a net effect of lower capital costs and higher labor costs for the large firms. This substantially inflates the wage/capital cost ratio and is a powerful incentive for large firms to pick labor-saving and capital-intensive technologies despite the typical relative abundance and low cost of labor.

Because of widespread concern with taxes, one should note that—except for 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. Yet, 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.”

Beyond these microeconomic effects, quantitative analyses of macro impacts were scarce and fraught with substantial analytical problems. Although the estimates were uniformly substantial as a share of gross domestic product (GDP), there was considerable variation in the assessments of the magnitude. The findings suggested that misguided policies, by leading to resource misallocations, reduced GDP between 6 and 18 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 are the following:

*Agricultural Policy.* Widespread biases against agriculture have negative impacts on SSEs due to both input and output linkages between the agricultural and SSE sectors.<sup>29</sup> 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 the incomes of farmers and, thereby, of SSEs are as follows:

- the pro-industry/anti-agriculture bias in trade and pricing policies, including centralized marketing and pricing
- the urban infrastructure bias that shortchanges rural roads, education, and health
- inadequate resources for R&D in agricultural technologies<sup>30</sup>

*Foreign Trade Policy.* Foreign trade policy constitutes a second set of important biases that typically undermine SSEs, as referred to in Table 1 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
- overvalued exchange rates, which reduce (1) the incentive to export, and (2) the supply of inputs for and demand for goods and services from rural nonfarm enterprises.<sup>31</sup>

*Capital Markets Policies.* Capital markets policies also are widely believed to favor larger enterprises. Among the culprits are subsidized credit, interest rate ceilings, and tax incentives. In these cases, such policies often are not designed specifically to discriminate against the small firms.

On the demand side, small businesses typically cannot meet the traditionally high transaction costs of commercial banks, foreign exchange markets, and obtaining tax concessions. On the supply side,

formal sector banks have often been proscribed from charging interest rates that would cover the high per unit cost of lending to SSEs.

Although proven lower transaction-cost techniques for small loans do exist, virtually no formal sector banks have implemented such programs.<sup>32</sup> Similarly, when some credit programs for small borrowers show high repayment rates, the formal sector still appears reluctant to extend credit to them.<sup>33</sup> The net result is that small enterprises rely almost exclusively on traditional credit sources, namely, family and friends. While traders, suppliers of goods, and money lenders do extend credit to such firms, their role is much less significant.<sup>34</sup>

Liberalization of financial markets is typically included in policy reform packages, but an EEPA analysis of Taiwan's financial markets suggests that financial liberalization should not automatically be considered a windfall gain 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 developing world's imperfect capital markets, the curb market intermediaries may have "lower transaction costs and higher investment efficiency than formal financial intermediaries." Consequently, under such financial conditions, liberalization may unduly bias financial policies toward the modern and large-scale sector.<sup>35</sup>

*Labor Markets.* Governmental labor market policies have the potential to affect the relative costs of small and large enterprises. Such policy 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 conclude 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.<sup>36</sup> Regional assessments, reflected in Table 1, suggest that price distortions are minimal in Asia's relatively free labor markets, and rather more substantial in Africa and Latin America.

*Taxes.* The impact of taxes upon small and large firms is a double-edged sword. On the one hand, there are two realities that tend to shift the relative burden more to the large firms: first, small businesses are often formally exempted from taxes, and, second, even when they are not directly subject to taxes, smaller firms often are able to avoid payment due to their size and geographic dispersion. On the other hand, the large firms are believed to be able to avoid taxes under some conditions. 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 Table 1, 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.<sup>37</sup>

**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, which may yield 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; this shortcuts the historic dynamic and gradual evolution of firms from small to medium and eventually to large. On the other hand, different biases 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,<sup>38</sup> 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.<sup>39</sup>

Echoing a 1974 ILO report,<sup>40</sup> EEPA’s study of policy in the Philippines noted a pattern of dualism in the manufacturing sector: “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.” EEPA’s report referred to several ways that the policy structure frus-

trates the growth of small firms into those of more efficient medium and large scale. As small firms grew in the Philippines, they

- lost the advantage of government programs that support small enterprises
- encountered minimum wages (a sharp “wage cliff”)<sup>41</sup> and sales taxes that they could previously ignore
- typically were still too small to take advantage of incentives provided by the Board of Investments, incentives that were basically for larger enterprises

Thus, without offsetting incentives, this sharp rise in costs encountered by small firms attempting to grow creates the “small firm growth trap.”<sup>42</sup>

This trap may be particularly prejudicial to the transformation of low-income agriculturally based economies into those with a more modern industrial base. Such a pattern of policies may both impede the establishment of new medium-scale firms as well as frustrate the natural evolution of 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.<sup>43</sup> Other anticipated results include enhanced competitiveness, employment, income distribution, resilience to economic shocks and capricious international markets, and broad-based economic growth.<sup>44</sup>

Accordingly, HIID and MSU urge fostering this mid-scale sector by eliminating the sources of the “missing middle,” namely, these causal bipolar policy discontinuities.<sup>45</sup> Policies to do so are discussed below.

**The Costs of a Conglomerate Emphasis.** Although the growth trap’s injurious consequences are believed to be significant, Korea demonstrates dramatically that rapid growth is possible with a distinct “missing middle.”<sup>46</sup> Nevertheless, although Korea’s growth and distributional successes are clear, one must also ask, first, whether alter-

native policies might not have led to equal or more extensive economic success, and second, whether less industrial concentration might not have resulted in less political turmoil.

### **Policy Reform Priorities**

The multitude of intercountry differences in levels of development, political economy contexts, and resource, technological, and managerial endowments means there is no policy panacea because standardized policy packages cannot meet all needs, and policies must be designed specifically for host-country economic and political environments.

Some illustrative differences stand out. In those countries with the lowest incomes and untapped agricultural potential (for example, the African case, discussed later), agricultural policies often must receive top, but not exclusive, billing. For those fortunate countries that have progressed beyond approximately \$500 per capita, other trade and industrial policies 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. Even though considerably more research would be immensely helpful to guide policy reform,<sup>47</sup> comparative analysis does suggest effective starting points for policy reform.

**Level the Playing Field or Not?** Among the issues is whether reform should “level the playing field” and eliminate all policy biases, or, whether some sectors or enterprises should be targeted for support.<sup>48</sup> 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.<sup>49</sup>

In other words, as a starting posture, biases against SSEs should be eliminated, so that input and output markets for SSEs 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 suggests that there may be reasons to have some biases in the policy structure.<sup>50</sup> Both countries demonstrated dramatic and relatively broad-based growth, and both countries 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
- heavy investments in infrastructure and education
- a mix of neutral and targeted policies, among which were early large-scale investments, dualistic trade regimes, and selective protection

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

- at what point policy biases or market interventions (subsidies, infant industry protection, and so on) are appropriate for particular country conditions
- if targeting is appropriate, the precise structure and magnitude of biases appropriate for a given country context.

While policies fitting for particular country conditions require country-specific analysis, there is considerable expert opinion behind one important targeting issue: 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.”<sup>51</sup>

**Differential Policies for “Hard” and “Soft” States.** Decisions on whether, how, and how much to target may require a determination of whether the policy context is a “hard” or “soft” state.<sup>52</sup> A “hard state” exists where government is capable of substantial economic management without extensive bureaucratic inefficiency or leakages. The “soft state” is characterized by substantial economic mismanagement or manipulation of the public sector for private advantage. Under hard-state conditions, relatively strong governmental and market institutions 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 political influence that inefficiently squanders resources. Returning to the issue of intervention as opposed to establishing a level playing field, and the pertinence of the context being a soft or hard state, HIID’s Donald 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.<sup>53</sup>

### **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” strategies.

With a 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, and, indeed, this 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 unusual 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 later.

Two alternative hard-state strategies that EEPA has proposed for serious consideration are discussed next, illustrated by the dramatic contrast between Taiwan and South Korea. Both countries' growth is well known to have been comparatively rapid, equitably distributed, and highly successful in exports.<sup>54</sup> Yet Taiwan is also distinguished for the strong performance of its small and medium enterprises whereas, in South Korea, manufacturing firms tend to be larger, product markets more concentrated, and conglomerate control greater.

TABLE 2 The Dramatic Contrast: Taiwan and South Korea Compared by Scale of Enterprise

	Taiwan	South Korea
Share of five largest conglomerates in the nation's shipments of manufactures (1982)	5%	23%
Growth in number of manufacturing firms (1966-1976)	150	10
50 largest firms' share: manufacturing sales (early 1980s)	16	38

Source: Biggs and Levy, EEPA #23.

Because of the dramatic success achieved by both countries, as well as because of the important differences in their industrial concentration,

policies and, some sense, consequential potential difficulties, a brief analysis of their policy structures is appropriate.

**Hard State Alternative I—A Small- and Medium-Scale Emphasis: the Taiwanese Model.** The first hard-state policy strategy is an “unbalanced growth,”<sup>55</sup> 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 its significant human resource/institutional base, including a strong community of experienced traders.

*Policy Targeting.* Taiwan’s economic policy was not a perfectly “level playing field.” As was true for South Korea, Taiwan had a dualistic trade regime: low overall trade barriers, substantial variation across economic sectors, high subsidies for consumer durables, and higher levels for fabrication. A fundamental difference from South Korea was that in financial markets, Taiwan did not have the artificial state-created financial economies and, in fact, had financial diseconomies for large-scale enterprises.

This government-induced development strategy initiates vigorous growth with strategic industrial interventions, sometimes manifest in the establishment of large-scale enterprises. These interventions create externalities—profitable opportunities—that induce the entry of firms responding to those entry-inducing externalities. This subsequent entry includes the proliferation of small and medium enterprises, with consequent expanded competition and transactional efficiency.

*Large Firms’ Inducing Role through Large- and Small-Scale Linkages.* 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.<sup>56</sup>

This government-induced growth of large firms in Taiwan had a variety of linkages with the small- and medium-scale sector. One important manifestation of these large- and small-scale linkages was the stimulus of the newly attracted multinationals that had strategic technological lines.<sup>57</sup> The presence of these new technologies enabled their imitation by smaller local producers; this local replication took place by word of mouth, labor migration, and supplier operations. Another large-to-small linkage in Taiwan was the substantial proliferation of subcontracting, closely linking the large firms to the small in a way also true in Japan.<sup>58</sup> In contrast, South Korea's vertically integrated processes limited subcontracting's development there. Further, large Taiwanese firms also supported the major role of SMEs by being a source of trained craftworkers who later became entrepreneurs (a practice facilitated by Taiwan's vigorous informal credit market).<sup>59</sup> Credit was still another important large-to-small-firm linkage in Taiwan: whereas 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.<sup>60</sup>

*Other SME-Supportive Interventions.* Complementing the Taiwanese government's initial large-scale industrial interventions were a variety of other economic and social policies and investments that also 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.<sup>61</sup>

Notably, what the Taiwanese 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 technological development policies including 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. Overall, these policies complemented the large-scale enterprise interventions and avoided creating a growth trap or “missing middle” in the array of firms by scale.

**Hard State Alternative II—A Conglomerate Emphasis: The South Korean Model.** EEPA’s other hard-state strategy, the South Korean model, emphasizes large-scale enterprises and is referred to as a “government-directed learning” strategy. This model has two principal tasks: “picking winners” and developing policy instruments that induce entry, growth, and productivity increases among firms with substantial potential for dynamic internal economies. An 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 coordination among a small number of large enterprises, coordination that would be exceedingly difficult to achieve in a more diffuse industrial structure.<sup>62</sup>

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. Moreover, in South Korea, the capture of these externalities through vertical integration eliminated the subcontracting from large to small that stimulated Taiwan’s SME sector.

*Policy Targeting.* As in Taiwan, some of South Korea’s policies were of the neoclassic level-playing-field variety, including 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 had such a substantial impact they amounted to nearly 30 percent of the value of merchandise exports.

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 percent controlled) at submarket interest rates, and assistance in marketing through the organization of huge conglomerates.

The potential for misuse of such policy instruments was considerable. For instance, 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 the part 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 South Korea's conglomerates overwhelmed its SME sector appears due both to South Korea's more limited early entrepreneurial and human resource base<sup>6,3</sup> and the broad array of large scale policy biases that helped compensate for that early human resource and institutional weakness. In other words, given South Korea's initial conditions, its policies promoting industrial concentration appear to have been a relatively "efficient response to backwardness" in its human resources base.

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

**The "Soft State."** Where government's administrative capability is more limited, to avoid the leakage of administered resources into Swiss banks or other unproductive activities, correspondingly modest

levels of intervention may be appropriate. Because a relatively pure laissez-faire strategy is not known to have been effective except for Hong Kong (a most unusual 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
- “performance-based” support for progressive small and medium enterprises (rather than micro or large enterprises),<sup>64</sup> including through means of vigorous informal financial markets<sup>65</sup>
- export promotion, including through means of
  - guaranteeing working capital for exports
  - incentives to stimulate the proliferation of export traders
  - selective involvement of multinationals as exporters
  - selective and firm-specific incentives for national exporters of manufactures

In countries 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.<sup>66</sup>

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 as well as 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.<sup>67</sup> It must be emphasized, however, that the guidelines were developed with and should be used with caution, for while African countries do generally share some commonalities, the continent also reflects substantial diversity:

- Botswana and the Congo have per capita incomes five times those of Burkina Faso and Zaire.
- Adult literacy in Zimbabwe, Kenya, and Zambia (67, 69, and 73 percent) is more than three times that in Burkina Faso and Sierra Leone (18 and 21 percent).<sup>68</sup>
- Rural population densities in Rwanda and Malawi are more than ten times those of Côte d'Ivoire and Zimbabwe.

Accordingly, the subsequent policy suggestions must be used only with due consideration for the specifics of the local socioeconomic environment.

Yet, some useful generalizations about policies for Africa are possible because of some of the continent's distinguishing characteristics. Among the relatively common features of African economies are the following:

- Low incomes prevail, reflected in the fact that nineteen of the world's twenty-five poorest countries are African.

- Low population density is typical, particularly in rural areas. With the exceptions of Rwanda and Malawi as well as 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 twenty-nine of thirty-two countries between 1980 and 1986.
- Human capital is underdeveloped and in jeopardy, with widespread adult illiteracy (more than 50 percent in more than half the Sub-Saharan countries) and, for twelve of twenty-nine countries for which data are available, a maternal mortality rate more than eleven times China's and five times Sri Lanka's.<sup>69</sup>

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 ten employees.<sup>70</sup> Finally, economic efficiency tends to be higher for those small firms that are

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

With this setting for and pattern of African SSEs, the objective of the proposed reforms is a policy, institutional, and infrastructure environment

conducive to overall growth, and thereby to expanding employment opportunities in efficient and dynamic enterprises.<sup>71</sup>

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 in "Some Particulars on Biases").
- Liberalized 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 policy reform, in most of Africa, constitutes the single most potent means to overcome governmental decision making that is particularly biased against SSEs.
  - Trade can make a substantial contribution to overcoming small domestic markets, thereby enabling some economies of scale, induced competition and efficiency, and more labor-intensive growth. Yet—as considered in the earlier discussions of the level playing field and the hard/soft states—while it is vital 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 financial tactics for small and medium firms are worthy of consideration, such as character-based lending, easing administrative processing of loan requests, improved savings mobilization, and expanding the flow of credit to SMEs through commercial banks.<sup>72</sup>

- Although SSEs typically pay lower taxes than their larger counterparts, as mentioned earlier, in some countries firms encounter “growth trap”-like difficulties as they attempt to grow and innovate.<sup>73</sup> A promising approach to fiscal reform appears to be one tried in a number of African countries, namely 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. But, 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.
- Collaboration in the reform of legal and administrative systems also is essential. These systems have close links with, but also constitute a significant burden on, enterprise growth and development, both in the letter of the law and in its implementation. Although inefficient legal and regulatory systems constrain particularly the larger enterprises, the large-scale/small-scale market interactions discussed earlier imply a derivative burden on the small as well. In addition, even though a number of reforms have already been undertaken, implementation appears to be lagging

seriously behind the mandate. Collaboration in the reform process—including academic researchers, field-experienced PVOs and NGOs, and formal and informal sector business associations—is recommended, both to provide improved information to policy-making and policy-implementation officials, as well as to spread the base of stakeholders who feel they have a sense of ownership of the reforms.

### **Policy Reform Tactics: Brief Comments**

Policy reform supporting a more efficient industrial structure is most effectively pursued through collaborative donor, host, and successful developing country policy dialogue and analysis.<sup>74</sup> With such involvement, host-country institutions and decision makers build their own analytical capability, understanding of alternative policy impacts, and sense of ownership of the proposed reforms. Appropriate tactics for such an approach include strengthening both host-country and donor policy-analysis programs, including personnel, data, and analytical resources. The host-country involvement should include representation from a wide variety of pertinent sectors, such as the business, government, academic, labor, and PVO/NGO communities.

EEPA's staff, USAID, and others have experienced the effectiveness of the 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.

Finally, the approach of collaborative international comparative analysis, as illustrated by the work of the International Center for Economic Growth, also has been shown to yield substantial policy reforms. ICEG has successfully used collaborative dialogues between

the representatives of the public, private, labor, and academic communities from both successful and less successful economies. This dialogue has been effectively supported by modest policy-analysis grants to host-country institutions and similarly modest levels of international expertise.

Given the vital, necessary, but not sufficient potential contribution of policy reform to broad-based development, the priority for strengthening collaborative policy analysis and reform programs should not be underestimated.

### **Concluding Comments**

Small and medium enterprises are vital complements to large-scale enterprises in successful industrial transformation. SMEs 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, 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 socioeconomic environment.

The most politically and economically effective means of developing those strategies, for an optimum mix of relatively efficient 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

This report is based primarily but not exclusively on work carried out under USAID's Employment and Enterprise Policy Analysis Project (EEPA). More than fifty research and technical assistance reports have been developed under EEPA, based on work in Asia, Africa, Latin America, and the Caribbean. Copies of any of the EEPA (or GEMINI) reports discussed here are available from AID/POL/CDIE/DISC, Room 209 SA-18, Washington, D.C. 20523, or by telephone, (703) 351-4006.

U.S. Department of Labor (USDOL), on detail to the U.S. Agency for International Development (USAID). Because this is largely a review article, the author is, of course, heavily indebted to EEPA's researchers and other cited authors. Particular appreciation is also extended to the following: Michael Farbman, director, USAID's Office of Small, Micro, and Informal Enterprise, "PRE/SMIE"; Catherine Gordon, on leave from USAID to pursue nursing training; Carl Liedholm, professor of economics, Michigan State University, and a key EEPA player; Elisabeth Rhyne, a private consultant, and, formerly, also USAID/USDOL, a key member of "PRE/SMIE", and coordinator for the "SMIE" GEMINI microenterprise project; and Donald Snodgrass, EEPA's project coordinator at the Harvard Institute for International Development. All of these provided 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 EEPA or other referenced material, are the author's and are not intended to represent those of either USAID or USDOL. A full EEPA bibliography is available from the author in care of USAID/PRE/SMIE, Washington, D.C. 20523.

1. 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 Im-*

lications, 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 (1) adding rural SSE employment to ILO's rural estimate, and (2) expanding the definition to include small firms as well 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 ten workers, and "small" to up to fifty. "Informal" will be used to refer to roughly the same grouping as "small."

2. Philip A. Neck (ed.), *Small Enterprise Development: Policies and Programs* (Geneva: International Labor Organization; 1977), 13. Presumably the author is referring here basically to nonfarm options, for the great majority of less-industrialized workers are still employed overwhelmingly in agriculture. In 1989, the World Bank reports, 72 percent of the labor forces of low-income countries were employed in agriculture. *World Development Report: 1987* (Washington) p. 264.

3. In Japan (1983), enterprises with fewer than thirty employees made up 39 percent of the economy's total employment. In the United States (1977), firms with one to nineteen employees made up 22 percent of total employment. OECD, *Employment Outlook*, September 1985.

4. Malcolm Gillis, Dwight H. Perkins, Michael Roemer, and Donald R. Snodgrass. *Economics of Development*, second edition (New York: Norton; 1987) p. 561.

5. World Bank, *World Development Report 1990*, p. 3; UNDP, *Human Development Report 1990*, p. 62; and IFAD (Idriss Jazairy, Mohiuddin Alamgir, and Theresa Panuccio), *The State of World Rural Poverty: An Inquiry into Its Cause and Consequences* (1992), pp. 16-17.

6. For example, a 1974 ILO report (the [Gustav] Ranis report): "[A] bias toward large-scale manufacturing was enhanced by the policies of incentives adopted by the Government [of the Philippines] in the 1950s and 1960s." ILO, *Sharing in Development: A Programme of Employment, Equity and Growth for the Philippines* (Geneva, ILO, 1974). See also 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).

7. State Department cable: Paris 37936, December 20, 1990.

8. 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]).

9. EEPA's Donald C. Mead ("Policy Reform and the Informal Sector in Africa," EEPA #26, April 1989, p. 7) reminds us that Dennis Anderson and others, before EEPA,

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.

10. See especially, Tyler Biggs and Jeremy Oppenheim, "What Drives the Size Distribution of Firms in Developing Countries?" EEPA Discussion Paper #6, November 1986, pp. 2+. Similar concepts and relationships are also discussed in other EEPA papers, such as Tyler Biggs, Merilee S. Grindle, and Donald R. Snodgrass, "The Informal Sector, Policy Reform and Structural Transformation," EEPA 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.

11. Biggs and Oppenheim, EEPA #6; and Snodgrass (DEVRES Workshop), p. 12.

12. Liedholm and Mead, pp. 14–17.

13. Most of this evidence comes from Carl Liedholm and Joan Parker, "Small Scale Manufacturing Growth in Africa: Initial Evidence," EEPA #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).

14. Biggs, EEPA #16 (rev.), p. 21.

15. Biggs, Grindle, and Snodgrass, pp. 15+.

16. Mead, EEPA #26, p. 8.

17. 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," EEPA #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).

18. 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 (two to five 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.

19. Liedholm and Parker, p. 10.

20. Liedholm and Mead, work cited, pp. 68+. Other EEPA discussion of the scale-efficiency question is also found in Snodgrass's DEVRES workshop paper (p. 7) and Biggs, Grindle, and Snodgrass, Discussion Paper #14, pp. 15+ and 48+.

21. 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 (Oct. 1, 1991), Snodgrass, EEPA'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."

22. Snodgrass, DEVRES Workshop, p. 13.

23. For related research, discussing the complex relationship between scale and efficiency, see Ian M.D. Little, Dipak Mazumdar, and John M. Page, Jr., *Small Manufacturing Enterprises: A Comparative Analysis of India and Other Economies* (New York: Oxford, 1987), p. 305; Mariluz Cortes, Albert Perry, and Ashfaq Ishaq, *Success in Small and Medium-Scale Enterprises: The Evidence from Colombia* (New York: World Bank, 1987), pp. 209+ and 6+. For an interesting critique of the first of these by an EEPA analyst, see Donald C. Mead, "Review Article: Small Enterprises and Development," *Economic Development and Cultural Change*, January 1991.

24. Liedholm and Mead, pp. 56-58; and Donald C. Mead, "Policy Reform and the Informal Sector in Africa," EEPA #26, April 1988, pp. 7-8.

25. The essence of this discussion, and any omissions, comes from Brian Levy, "Export Intermediation and the Structure of Industry in Korea and Taiwan," EEPA #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," EEPA #12, October 1987.

26. Lawrence Kent, "The Relationship Between Small Enterprises and Environmental Degradation in the Developing World (with Emphasis on Asia)," EEPA, September 1991.

27. Haggblade, Liedholm and Mead.

28. See Snodgrass, DEVRES Workshop paper, and Little, Mazumdar, and Page.

29. On the importance of a sound agricultural policy for broad-based development and SSEs, 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/SMIE, May 1991).

30. 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 Hazell, "Agricultural Technology and Farm-Nonfarm

Growth Linkages," *Agricultural Economics* 3 (1989); Steven Haggblade, Peter Hazell, 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).

31. Unfortunately, overvalued exchange rates have the 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.

32. See, for example, Elisabeth Rhyne, "The Microenterprise Finance Institutions of Indonesia and Their Implications for Donors," GEMINI Working Paper No. 20, June 1991 (available through USAID/PRE/SMIE), and Richard H. Patten and Jay K. Rosengard, *Progress with Profits: The Development of Rural Banking in Indonesia* (San Francisco: ICS Press, 1991).

33. 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.

34. Formal money market sources generally account for less than one percent of small business start-up capital.

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

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

37. Snodgrass, in a letter to the author (Oct. 1, 1991), 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.

38. 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.

39. See, Susan Goldmark, Jean-Jacques Deschamps, William Glade, Maria Wilumsen, with Maria Concepcion Lopez 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. Marquez, 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 Schmitz, 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+.

EEPA's review of policies in Africa reflects a weak database and doubt about the presence of a strong policy growth trap there. EEPA, 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." Liedholm, GEMINI Working Paper #2, pp. 40, 46.

40. The Philippine's "missing middle" was examined more than a dozen years earlier 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, 158.

41. The Little, Mazumdar, 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 over 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)

42. See, Biggs, Grindle, and Snodgrass, p. 51; Biggs et al., "Small Business Policy Direction Study," pp. 33+; and Snodgrass's 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 that has not been seriously impeded by not having the smooth curve skewed to the right (lognormal) characteristic of the United States, United Kingdom, 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, EEPA #6, pp. 7+.

43. Although not researched by EEPA, 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* (Sept 23 1989; 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 South Korea's "highly concentrated industrial structure . . . is unpalatable to many Koreans." *Journal of Economic Perspectives*, Summer 1990.

44. Biggs, Snodgrass, and Grindle, pp. 52–59.

45. 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 (EEPA #26, pp. 7–9, 15).

46. See the curve in Biggs and Oppenheim, EEPA #6.

47. 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 [Nov 9 1990]—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.

48. 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).

49. Liedholm and Mead, p. 122.

50. See: Biggs, Grindle and Snodgrass; Biggs, EEPA #s 15, 16, & 17; Tyler Biggs and Chang-Ho Yoon, EEPA #27. The South 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 nonneutral policies used to support infant industries were, most important, 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 South 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).

51. Mead, "Review Article . . ." p. 413. Also, Snodgrass, DEVRES Workshop paper; and Little, Mazumdar, and Page, p. 313.

52. EEPA [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).

53. 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.

54. "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. Much of the following discussion of Taiwan and South Korea comes from this paper.

55. Biggs and Levy acknowledge an indebtedness to Albert O. Hirschman's *The Strategy of Economic Development* (Yale: 1958).

56. See note 54 above.

57. "In the early 1960s, . . . textiles and sewing machines, later on . . . secondary import-substitution industries and electronics." Biggs and Levy, pp. 33-34.

58. Biggs and Levy, EEPA #23, p. 24; and Liedholm and Mead, pp. 56-58.

59. Biggs, EEPA #16 (rev.), p. 21.

60. 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.

61. Biggs and Levy, EEPA #23, pp. 32-33. Incidentally, corporate combined with personal income taxes do not appear to have seriously damaged the economy. The maximum corporate rate was 25 percent before 1974 and 35 percent after, while the personal income tax rate, relatively high compared to current American rates, were 50 percent before 1969 and 60 percent after.

62. Biggs and Levy, EEPA #23, p. 10.

63. See Brian Levy, "Export Intermediation and the Structure of Industry in Korea and Taiwan," EEPA #13, October 1987, and his "The Strategic Orientations of Firms and the Performance of Korea and Taiwan in Frontier Industries: Lessons from the Comparative Case Studies of Keyboard and Personal Computer Assembly," EEPA #12, (October 1987.)

64. 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 materialize." In a letter to the author (91 Oct 1), 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."

65. In Taiwan little domestic credit flowed through specialized banks to SMEs, and most of that that did went as working capital for medium size 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 thirty to eighty 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.

66. Biggs and Levy, EEPA #23, p. 10.

67. 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.

68. UNDP, *Human Development Report 1992* (New York: Oxford, 1992), pp. 128–29.

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

70. Liedholm and Parker, p. 26.

71. While the problem is too complex to analyze 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.

72. 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 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 subsidized, and therefore rationed, this may represent nothing more than a desire to get in on the

bounty." [His letter to author, 91 Oct 1] Indonesia's dramatically successful savings mobilization and small enterprise loan programs are examined by Beth Rhyne, "The Microenterprise Finance Institutions of Indonesia and Their Implications for Donors," GEMINI Working Paper No. 20.

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

74. Haggblade, Liedholm, and Mead, EEPA #1; 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.

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