Industrialization and the Small Firm

Patterns and Policies

Donald R. Snodgrass
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PREFACE

The debate over the role and impact of small and medium enterprises (SMEs) in developing countries is fraught with controversy and disagreement.

- Do SMEs offer advantages in terms of employment, efficiency, and equity; or are these benefits seen only in textbook scenarios?
- What is the most effective means of encouraging SMEs, and how do the situation and challenges of SMEs change as a country develops?
- What role do SMEs play in the process of efficient industrialization?
- What effect does economic policy have on the creation of productive employment and the growth of individual businesses in developing countries?

Authors Donald R. Snodgrass and Tyler Biggs tackle these and other issues in their analysis of small and medium enterprises in developing countries, looking at the special circumstances for SMEs in low-income, middle-income, and high-income developing countries.

This book presents a synthesis and analysis of the research findings of the Employment and Enterprise Policy Analysis Project (EEPA), which was commissioned in 1984 by the Office of Rural and Institutional Development, Bureau for Science and Technology, United States Agency for International Development. Many of the project's findings have been previously released in the twenty-nine papers in the EEPA Discussion Paper series.

The project developed out of a concern about the relationships among employment creation, individual business development, and the government policies of developing countries. Its larger objective was to examine

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how SMEs might solve the problem of slow job creation in larger, formal businesses in most developing countries.

Donald Snodgrass and Tyler Biggs, the authors of *Industrialization and the Small Firm*, served as project coordinator and project manager, respectively. Professor Snodgrass is an institute fellow at the Harvard Institute for International Development (HIID), and Professor Biggs was a research associate at HIID while this book was being completed.

This book is a copublication of the International Center for Economic Growth and the Harvard Institute for International Development. We are pleased to offer this unique and useful comparative work to policy makers who seek to facilitate the economic growth of SMEs in developing countries. We hope it will help practitioners, policy makers, and other professionals to better understand the dynamics of job creation and business development in developing countries. For such a complex subject, no simple solutions can be offered. We hope, however, that the study will help create policy environments in which small and medium businesses will increase their influence in the labor market, thereby improving the quality of life for workers in developing countries.

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INTRODUCTION

This book is a product of the Employment and Enterprise Policy Analysis Project, known as EEPA. Therefore, we begin by giving the historical context of EEPA. Also included in this introduction are some definitions and conventions used in this book, an explanation of how the material is organized, and credits and disclaimers.

EEPA

EEPA was a sustained effort to improve understanding of the role that small and medium enterprises (SMEs) can play in the process of efficient industrialization and of the effects of economic policy on the creation of productive employment and the growth of individual business enterprises in the developing countries. EEPA was commissioned in 1984 by the Employment and Enterprise Development Division of the Office of Rural and Institutional Development, Bureau for Science and Technology, United States Agency for International Development. It ended officially on September 30, 1991. The Harvard Institute for International Development (HIID) was prime contractor for EEPA; Michigan State University (MSU) and Development Alternatives, Incorporated (DAI), were subcontractors.

EEPA comprised a complex set of research and technical assistance activities. Core funding provided by U.S. Agency for International Development (USAID) was used primarily for research, dissemination of findings, and project management. Core-funded research was carried out in the United States, Belize, South Korea, Niger, Nigeria, and Taiwan. Many of EEPA's research findings have previously been made available to interested readers through the twenty-nine papers in the EEPA Discussion Paper series. A list of these papers, many of which were subsequently published, appears in Appendix B.

In addition to the core funding, the project received buy-in funds to undertake long-term field activities in three countries (Bangladesh, Rwanda, and Sri Lanka) and short-term field activities in nineteen countries (Bangladesh, Belize, Botswana, Cameroon, Dominican Republic, Ecuador, Ghana, Honduras, Malawi, Morocco, Nepal, Niger, Nigeria, the Philippines, Senegal, Somalia, Sri Lanka, Tunisia, and Zaire). It also did buy-in work on behalf of AID's Bureau of Policy and Program Coordination, Africa Bureau, and Asia/Near East Bureau. The buy-in activities provided an important complement to the core-funded research, serving as opportunities to learn about job creation and enterprise development in varying settings and to apply and test the research results by advising host governments and AID missions on employment and enterprise policy.

EEPA, as its name suggests, was concerned with the relationships among employment creation, the development of individual business enterprises, and the policies enacted by developing country governments. The project grew out of concern about the slow pace of job creation in larger, more formal business enterprises in most developing countries and was shaped by a conviction that SMEs could be an important part of the solution. A short account of the project's antecedents appears in Chapter 1.

We have generally employed the following definitions:

1. *SMEs.* Like most previous analysts, we use workers per establishment as our normal yardstick of enterprise size. This is standard practice, not because employment is an ideal measure but because employment data are much easier to obtain than information on invested capital and other indicators of enterprise scale.

   As for terminology, other studies have referred to small-scale enterprise (SSE) or small-scale industry (SSI), employing various definitions. We generally prefer small and medium enterprises (SMEs), by which we mean plants or firms[1] employing fewer than 100 workers unless otherwise stated. This definition includes

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a fairly wide range of enterprises, from "microenterprises" with 1–10 workers (AID's current definition) or "cottage shops" with 1–19 (a category used by some writers) up to medium-sized enterprises in the 50–100 worker range, a category which includes the average manufacturing firm in some developing countries. In developed countries, SMEs are often taken to be enterprises that employ up to 500 workers, but this would include almost all establishments in most developing countries.

2. *Developing countries*. Following World Bank definitions (World Bank 1992), "developing countries" refers to countries with per capita gross national product (GNP) below $7,500 in 1990. They can be divided into low-income countries (per capita GNP of less than $600 in 1989), lower middle-income countries ($600–$2,500) and upper middle-income countries ($2,500–$7,500).

ORGANIZATION OF THIS BOOK

Our principal aim is to present the findings of EEPA and related research on industrial SMEs in a form accessible to all with an interest in the subject. A particular concern is to reach USAID personnel and other professionals actively engaged in work concerning SMEs in developing countries. Practitioners are warned, however, that this is not a cookbook. The problems discussed are complex, and there are no simple rules or formulas suitable for literal and direct application in any developing country in which the reader happens to be working. Rather, we aim to help the reader improve his or her understanding of the dynamics of employment creation and enterprise development in developing countries, leaving the application of that improved understanding to the intelligence of the reader, who must interpret and act upon the specific circumstances that he or she faces.

Chapter 1 provides an introduction to the issues with which the book deals. It also summarizes the entire argument and foreshadows some major findings.

Chapter 2 deals with positive (as opposed to normative) analysis. It places enterprise development within the well-defined framework of economic growth and structural change pioneered by Simon Kuznets and further developed by Hollis Chenery and other researchers. Following the seminal work of Ranadev Banerji, we have tried to extend this analysis of structural change to questions of enterprise size. Our research confirms and extends the earlier conclusion that strongly marked patterns characterize various levels of development. For reasons discussed in Chapter 2,

average firm size in manufacturing rises with per capita income. SMEs are an important part of the manufacturing sector at low levels of income but play a declining and continually changing role as income rises. While the typical high-income country still has many SMEs, they differ greatly from those in low-income countries, particularly in their being less numerous and far more productive relative to larger firms. Economic development is accompanied by a reduction in productivity and wage disparities among sectors, industries, and firms of different sizes. We associate this phenomenon with improved integration and functioning of markets and increasing competition, which forces less productive industries and firms out of businesses and requires those that survive to reach similar and ever higher levels of productivity.

Chapter 3 is concerned with the impact of economic policies on employment creation and the development of productive enterprises. This is a complex matter, for several reasons. Many different kinds of policies affect job creation and enterprise growth through a complicated web of direct and indirect effects. Policy making is strongly influenced by political considerations. There are large differences in the economic, social, geographical, and political settings for policy making among third world countries. The chapter discusses, but only partially resolves, these sources of complexity.

Chapter 4 links the development of SMEs and the effects of policy on them with the preoccupation of most past writing and action with respect to the role of SMEs in developing countries' industrialization, namely credit and other programs intended to promote the growth of SMEs. The chapter outlines the scope of the SME promotion effort, reviews a number of studies that have tried to assess its effectiveness, and summarizes what is known about the effects of policies on the success of these programs.

Although Chapter 3 offers many generalizations about the political economy of policy making, these matters are, in fact, highly location specific. Much of what works in a middle-income Asian country may not have much impact, or may even be counterproductive, in Africa. Indeed, what works in East Asia may fail in South Asia. Latin America is a world in itself. Because relevant circumstances vary greatly among developing countries, Chapters 4–6 extend the policy discussion by focusing on several cases, drawn from Asia, Africa, and Latin America. In keeping with our view that the role of SMEs changes as one goes through low, middle, and high levels of development, case studies of countries at all those levels are included in Part II.

Chapter 5 examines the status of SMEs and the effects of government policies in the most desperate kind of circumstances, that of the low-income economy. The analysis concentrates on Bangladesh, a low-income country in South Asia, and on Sub-Saharan Africa, with special attention

given to two countries where work was done under EEPA, Rwanda and Malawi.

A number of countries achieved middle-income status years or even decades ago but have recently experienced difficulty in maintaining forward momentum, either in enterprise development or in economic growth. Chapter 6 examines two such situations, the case of the Philippines (a nation in which EEPA carried out a major consultancy) and that of Latin America generally. The Latin American section includes a closer look at Honduras and Ecuador, again countries studied under EEPA.

In Chapter 7 we come to the few countries that are finally breaking out of underdevelopment and entering the ranks of the newly industrialized. Two famous cases, South Korea and the Republic of China (Taiwan), provide the focus here. Although widely regarded as similar development success stories, these two countries contrast sharply when it comes to the size structure of industrial enterprises and the part played by SMEs. While South Korea represents the older and still dominant pattern of industrialization through mass production conducted mainly in large-scale plants, Taiwan presents an intriguing alternative, or divergent model. The discussion in Chapter 7 is based on research done under EEPA and other auspices.

Finally, in Chapter 8 we briefly recapitulate our main findings. Chapter 8 thus serves as an Executive Summary of the study as whole.

Finally, there are two appendixes. Appendix A discusses the process of analyzing the position of SMEs and the effects of government policies on them in a developing country. It is intended to serve as a kind of methodological starting point for anyone called upon to carry out such an analysis. Appendix B is a list of EEPA research papers.

CREDITS AND DISCLAIMERS

EEPA research involved the participation of many people, who do not agree—even after extended and sometimes warm debate—on all points relating to the role of SMEs in economic development and the effect of government policies on them. Responsibility for this book rests with the authors: Donald Snodgrass, who served as EEPA project coordinator, and Tyler Biggs, who was project manager. We wish simultaneously to recognize the major inputs of other contributors and to absolve them of responsibility for the particular presentation of their ideas and research results that appears in this book. Major inputs in the form of underlying research and earlier chapter drafts were made by Chapter 2, Jeremy Oppenheim; Chapter 3, Steven Haggblade, Donald Mead, Carl Liedholm, and Merilee Grindle; Chapter 5, Carl Liedholm, Donald Mead, and Gian Sahota; Chapter

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PART I

GENERAL ISSUES

This book about the roles that small and medium enterprises (SMEs) play in the industrialization and economic development of low-income countries addresses two major issues. First, what contributions do, and can, SMEs make to desirable development objectives such as more productive and efficient use of scarce resources (especially capital), employment creation, improved income distribution, regional dispersal of industry, and the development of dynamic private enterprises? Second, how are such contributions best promoted through government programs and policies? These are complex, much debated questions.

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Chapter 1

The Small Firm Question in Economic Development

Our discussion of SMEs is limited to the manufacturing sector. This limitation is not intended to deny or belittle the undoubted importance of SMEs in other parts of the economy, especially the service sector. Rather, it reflects two considerations. First, the factors that influence the development of SMEs in other sectors are rather different from those that influence their development in manufacturing;[1] we did not feel we could study them all, so we had to draw the line somewhere. Second, SMEs in manufacturing are particularly important because of the pivotal role that the manufacturing sector plays in the process of economic development.

Historically, economic development has been closely associated with industrialization, both in the popular mind and in the findings of leading scholars of economic development and structural transformation (Clark 1951; Kuznets 1966; Chenery 1979). Almost inevitably, as a country achieves a sustained rise in gross national product (GNP) per capita it derives an increasing share of its growing national output from the industrial sector, which absorbs rising shares of its labor, capital, and natural resource supplies. Every national development strategy features plans to develop manufacturing. Although many countries have learned to their dismay that there is far more to development than industrialization—that the balance between industry and agriculture, questions of efficiency, and many other issues must be addressed—it is hard to imagine development

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being contemplated or occurring anywhere without a significant degree of industrialization.

Kuznets (1966) defined economic development, which he called modern economic growth, as a sustained rise in GNP per capita brought about through the application of science and technology to economic activity. For per capita GNP to rise, output per worker (labor productivity) must increase. This in turn means that workers must obtain larger stocks of physical and human capital to work with and use these resources more productively by adopting improved technologies and forms of economic organization. Although increases in labor productivity are both possible and necessary in all sectors of the economy—in agriculture, industry, and services—the growing relative importance of industry as development proceeds suggests that opportunities for raising labor productivity are generally greatest in that sector. Rising industrial productivity draws more labor and other resources into that sector and raises real wages, inducing labor-saving innovations in other sectors and elevating the general standard of living.

The rise in the relative importance of industry in the economy as a whole is accompanied by many changes within the industrial sector itself (see Chapter 2). The factory system, which concentrates large numbers of workers at a single work site to perform a series of specialized but interrelated production tasks, appeared in Great Britain in the early nineteenth century and became the form in which industrialization spread to other nations. Although some now contend that the factory system has had its day in developed countries and is being replaced by a system of "flexible specialization" that uses smaller plants, the large factory remains a potent model for developing countries seeking to industrialize.[2]

Even in the developed countries, despite much talk about the importance of small firms for employment creation (for example, Birch 1981), firms employing 100 or more workers still accounted for more than half of private sector employment in the seven Organization for Economic Cooperation and Development (OECD) countries for which data were available in the mid-1980s and over 60 percent of manufacturing employment in all these countries except Japan, where the figure was 53 percent (OECD 1985: 65).[3] Ranadev Banerji (1978b) showed that as countries industrialize average plant size in manufacturing rises. In the United States between 1973 and 1988, despite a widespread belief to the contrary, small manufacturing firms did not consistently create more jobs on a net basis (after allowing for jobs eliminated and firms that went out of business) than large firms.[4]

To most people in developing countries, industrialization implies the creation of factories that use capital equipment embodying technologies imported from the industrialized countries and that employ 100 or more workers. The idea that economic development involves the creation of

such factories predated political independence in most developing countries and is still alive and well.

Yet a very different idea about the scale of industrial production units also enjoys significant support in most of these countries: the notion that SMEs offer important development advantages and therefore ought to be promoted through government programs and policies. Like the large-plant idea, this proposition is as old as the concept of economic development itself. In some countries it was motivated by a desire to rebuild cottage industries that had been damaged by colonial economic policies. Often it was bolstered by equity considerations, such as the search for ways to raise the incomes of the poor in the relatively near term. Since the 1970s, small-industry promotion has gained further impetus from the perceived failure of large plants to create enough productive jobs to absorb a significant share of the rapidly growing labor force in many developing countries.

It is widely claimed that, relative to large firms, SMEs are

- *more labor-intensive*; that is, they employ more labor relative to capital than large enterprises producing similar products. This claim is important in societies where workers from poor households have few employment opportunities at reasonable rates of remuneration and scant alternative income sources.
- *more efficient*, at least in some cases; that is, they use fewer resources per unit of output. Efficiency, or productivity, can be measured roughly as output or value added per unit of labor or capital used, or more sophisticatedly as total factor productivity, which relates output or value added to a weighted index of inputs. Some analysts expect SMEs to be more efficient than large enterprises because they believe that SMEs often deal in "informal" markets, where factor and product prices more accurately reflect social opportunity costs than the prices faced by large enterprises. Labor-intensive methods of production could be more efficient than capital-intensive methods when labor is plentiful and capital scarce—by definition, the prevailing conditions in low-income countries.
- *more equitable in distributing the income that they generate.* This has to do with both the more labor-intensive production methods and the likelihood that owners of small firms are less wealthy than owners of large firms.
- *more widely dispersed geographically;* that is, they are more likely to operate in towns and villages, as well as in less developed

regions. This could contribute to a wider spread of the benefits of development.

- *more nurturing of entrepreneurs*, some of whom later expand their tiny firms into successful medium and large enterprises.

If all these claims were demonstrably true, SMEs would indeed be a highly appealing way of organizing production in low- and middle-income countries. But do the supposed advantages of SMEs hold up in the real world? The large literature on this question reflects much disagreement, as we will see.

Controversy, moreover, is not limited to *ends*—whether, if small industry were successfully promoted, the desired broader objectives (employment creation, enterprise growth, industrial dispersion) would be attained. It also concerns *means*. Even if the ends are valid, do reasonably cost-effective instruments for achieving them exist? Many developing country governments, international assistance agencies, and private voluntary organizations (PVOs) have initiated SME promotion programs in pursuit of perceived economic, social, and political advantages. Most of these programs provide directed credit, with or without ancillary technical assistance. Others furnish advice of various kinds, provide factory sites, or help small firms obtain raw materials and market their products. Sometimes such promotional programs are supplemented by policy measures such as tax concessions, commercial bank lending quotas, regulations to promote subcontracting by large firms, or government procurement preferences.

Evaluations of SME promotion programs show that many of them are of limited value (Chapter 4). Walter Elkan (1986) and others have suggested that more emphasis on policy reform and less on programs to promote SMEs might improve the outcome. An important variant of this view contends that the greatest need is for deregulation to reduce or eliminate existing policies that are biased against SMEs.

When USAID initiated EEPA in 1983, it defined the project's objective in the following terms:

> to promote employment generation and small and medium enterprise (SMEs) development in LDCs and thereby produce more efficient and equitable patterns of capital and labor use, regionally as well as by enterprise scale. Assistance provided under the project should result in SMEs accounting for increased shares of (i) total nonagricultural employment and (ii) the total number of enterprises. At a more macroeconomic level, it should also result in improved capital-labor and capital-output ratios and

> a decrease in the tendency of employment to be concentrated in large-scale enterprises and urban regions. (USAID 1983: 1)

This formulation presumed that SMEs in developing countries are more efficient, more labor-intensive, and geographically more widely dispersed than large enterprises. Promotion of SMEs would therefore enhance both efficiency and equity objectives, achievement of which could be measured by growth in the number and economic importance of SMEs, as well as by increased labor intensity and employment dispersion in the economy as a whole. The main means of SME promotion to be explored was policy reform, particularly the removal of policy biases that retard the development of SMEs:

> The objective of promoting efficient and broadly-based economic development importantly requires being concerned with the policy biases which commonly favor capital-intensive techniques, large-scale enterprise and concentration of activities in the capital city. The economic and political climate is broadly favorable to a swing back from interventionist employment and enterprise policies toward a freer economic environment in which market forces play the predominant role. AID's strategy accords high priority to supporting and promoting this pendulum swing in public policy. (USAID 1983: 3)

The EEPA paper was one of a long series of expressions of interest in small enterprise development by USAID and other development agencies, dating at least from the 1960s.

EMERGENCE OF THE SME IDEA

This section traces the history of SMEs in developed and in developing countries and then recounts the Indian experience with SMEs. Finally, the integrated service delivery approach developed by Staley and Morse is discussed, as well as the employment crisis of the 1970s, which heightened interest in their recommendations.

Experience in the Developed Countries

Before the British Industrial Revolution of the late eighteenth and early nineteenth centuries, and even during its initial phase, manufacturing took place either in workers' cottages or in small workshops. When Adam Smith

(1776) pointed to the potential for raising industrial productivity by increasing the division of labor and linked that process to growth in the extent of the market, he had in mind not a modern factory but only a simple shop in which work would still be done by hand but a larger volume of output would permit the production process to be broken down into smaller component parts. Not until steam power came into common use and technologies such as the power loom appeared was the modern factory born. By the mid-nineteenth century, however, it had triumphed; the large factory, the "dark Satanic mill" of Dickensian times, had become the locus of most industrial activity.

The countries that followed Great Britain into economic development—France, Germany, the United States, Russia, and later others—all used large factories to industrialize. By copying the technologies introduced in Great Britain and other more advanced countries, these "late developers" were able to grow faster than Britain ever had. In most of these second-tier countries, economic development was state led and strongly motivated by national power and security considerations (Gerschenkron 1962). A partial exception to the large-factory approach was Japan, which began to modernize after the Meiji Restoration of 1868 but continued for several decades to rely heavily on small-scale industries with traditional bases.

Early Industrialization in the Developing Countries

Before World War II, there was little manufacturing in Latin America, in Asia outside Japan, or in Africa. Countries in these regions were still either colonies of European powers or under strong European influence. International trade mainly involved shipping manufactures from the mother country to its colonies in exchange for foodstuffs and other primary commodities. Sometimes existing colonial industries were intentionally destroyed to promote home industries that depended heavily on sales in colonial markets.[5] Cotton textiles made up 40–50 percent of British exports each year from 1816 to 1848; more than half of textile production was exported, and by 1840 nearly three-fourths of these exports went to "underdeveloped" areas (Hobsbawm 1977: 49–58).

Some industrialization occurred in Latin America in the 1930s, and a few factories opened in other areas in response to shortages during World War II, but these plants were established behind high protective walls and few survived open competition after the war.

The postwar national independence movements launched the modern era of economic development. Because many nationalist leaders identified industrialization with economic development and past denial of local

aspirations by the colonial powers, it featured prominently among the goals they defined for their countries. The general idea was that the new nations of Asia, and later Africa, would advance in the footsteps of countries that had already industrialized following the European model. Widespread distrust of international trade often lent an autarkic flavor to their industrial policies.

The Indian Example

India, one of the first countries to achieve independence and embark on a systematic development effort, embraced both large-factory industrialization and promotion of small-scale industry as national goals. Under Jawaharlal Nehru, it set out to develop a modern, capital-intensive, and self-sufficient heavy industrial sector. Yet it retained a commitment to nurture and promote small-scale industry (SSI) from its Gandhian tradition, which emphasized village self-sufficiency. This made protection of handloom weaving and other village crafts an enduring feature of Indian policy. A long list of economic, social, and political advantages was postulated for small-scale industry, and many official measures were instituted to pursue these benefits. Much of the debate about SSI has revolved around the Indian case.

In its Industrial Policy Resolution of 1956, the Indian Parliament expressed its belief that official encouragement and protection of SSI would (1) create jobs (SSI was assumed to be more labor-intensive than large-scale industry and other potential uses of capital); (2) help decentralize industry (it was assumed that SSI is more dispersed to small towns, rural areas, and remote parts of the country than larger-scale enterprise, or that it can be more easily dispersed to such areas); (3) confer social and political advantages (small enterprises were thought to promote democracy and equality); and (4) develop latent reserves of scarce resources, especially entrepreneurship and savings (Dhar and Lydall 1961).

Over the years, many Indian scholars (for example, see Shetty 1963; Mathur 1979) have argued that these advantages are genuine and worth pursuing. "The case for the development of Small-scale industries in our country, which is a developing nation, is quite sound" (Mathur 1979: 23). But there also have been numerous critics, going back at least to Dhar and Lydall (1961), who observed that many Indian industrial enterprises employing 20–49 workers used more capital *as well as* more labor per unit of output than larger enterprises; in other words, they were not really labor-intensive so much as inefficient. Careful analysis by J. C. Sandasera (1969) revealed that small units were labor-intensive in some industries but capital-intensive in others. Sandasera (1969: 63) also found that wages, output per worker, surplus per worker, output per unit of capital, and

surplus per unit of capital all tended to be lower in small than in large enterprises. He concluded that

> for a country like India, where capital savings (i.e., in relation to output and surplus) are paramount . . . large-size units and labor-intensive techniques seem to be appropriate, while small-sized units and capital-intensive techniques seem to be inappropriate. (p. 64)

Despite such findings, India continued to promote SSI through an increasingly comprehensive set of policies and programs. It built infrastructure for the use of SSI, assisted in raw material supply and marketing, and provided fiscal incentives and extension services. Finally, it restricted large firms' output of certain products and excluded them entirely from some industries (Little, Mazumdar, and Page 1987: 22–32). In 1977 the government barred large firms from making any product that could be produced by cottage or small-scale industry. The number of industries reserved for small-scale producers rose to 500 in 1978 and 800 in 1979 (Little, Mazumdar, and Page 1987: 26). Writing in 1981, Nirmala Banerjee noted that although the output and exports of small manufacturing plants had grown rapidly during the 1970s, much of this growth had come from plants owned by large-scale capitalists, who had created small production units to obtain the rents created by official preferences.

Growing recognition that many benefits intended for small-scale entrepreneurs had been co-opted by large-scale industrialists, together with the stagnation of the SSI sector since 1980, led to rising criticism of India's SSI promotion policies. In 1987, Arun Ghosh observed

> some three quarters of the total employment in industry today is in the traditional village industries and other hand crafts (including handloom weaving). And despite the efforts of the . . . specialized agencies, these traditional industries have generally been stagnant, with only a few isolated bright spots where there has been growth of employment and output. In fact, the only sectors . . . which have grown phenomenally in the last two decades are the manufacture of gems and jewelry in Gujarat, where large capitalists have successfully made use of skilled craftsmen to build up a flourishing export business; and the powerloom sector, in regard to which there is considerable doubt as to ownership, a common surmise being that the powerlooms are very largely owned by big magnates and their associates, each owning large numbers of powerlooms but being operated in tiny units, which are nonetheless concentrated in a few areas. (pp. 319–20)

Decades of effort to industrialize India did create a substantial manufacturing sector, which in 1990 produced value added worth $49 billion, equivalent to 19 percent of gross domestic product (GDP), and shipped 73 percent of national exports (World Bank 1992: 222, 248; World Bank 1993: 248). But exports were an exceptionally low 8 percent of GDP (albeit up from 4 percent in 1965), and India remained a low-income country with GNP per capita of $350 ($1,150 in terms of international purchasing power). Restrictive and protectionist policies for large as well as small enterprises, which began to be reformed only in 1992, are commonly held responsible for these lackluster results.

Staley and Morse: The Integrated Service Delivery Approach

From India, interest in SSI promotion spread to other developing countries. Beginning in 1953, a team of American economists led by Eugene Staley and Joseph Stepanek, Sr., in cooperation with Indian colleagues, produced a series of reports that, in Peter Kilby's words, "dramatically reshaped and extended Indian small industry programs" (1988: 226).[6]

A few years later, Staley and Richard Morse distilled the lessons of their Indian experience into a standard approach to SME promotion in their popular treatise, *Modern Small Industry for Developing Countries* (1965). This book came to be regarded as the authoritative statement on small-industry development. "Based on the 'principle of combination and interactions,' the philosophical core of the Indian model is that only an integrated set of interventions—analogous to seeds, water and fertilizer—can succeed."[7] Since the 1960s, this approach has been spread to developing countries, largely by Indian staff members of the World Bank, many of whom had been officials from the Indian Small-Scale Industries Organization (Kilby 1988).

Staley and Morse distinguished between "modern" small enterprises, which they thought had development potential, and "traditional" firms, which they thought did not. The distinction was based on four rather subjective factors: (1) outlook (in modern firms "there is a continual search for improved ways, ready adaptability"); (2) products and product design ("products are suited to modern needs or to the emerging needs of an economy in transition from traditional to modern"); (3) physical technology of production ("appropriate use is made of efficient machines, good plant layout, precise control of chemical processes, etc."); and (4) social technology of organization and management ("appropriate use is made of business planning and budgeting, market analysis, cost accounting, enlightened

ideas of personnel management, etc.") (Staley and Morse 1965: 4). Although they defined small-scale industry ("as a rough approximation") as firms of fewer than 100 workers, few of the smallest firms would have qualified as "modern" on their definition. Their real emphasis, therefore, was on what we would term medium-scale enterprises with 20–99 workers.

Arguing that "modern small [that is, medium] industry can contribute substantially to economic development" and that "policies toward small [medium] industry should be based on a positive, developmental attitude, seeking to aid by promoting efficiency, adaptation to new circumstances and growth, rather than by protecting obsolete types of production against more modern methods," Staley and Morse (1965: 351–85) proposed a comprehensive ten-part promotional package:

- industrial advisory services
- training of entrepreneur/managers and supervisors
- industrial research services
- developmental finance
- factory sites and buildings (industrial estates)
- common facility services
- facilitation of materials and equipment procurement
- marketing aids
- labor relations services
- interfirm contracts and assistance

Although they clearly regarded an integrated service delivery program as the primary tool for developing SMEs, the authors qualified their recommendations in two important ways: first, by the stipulation that promotion should be concentrated on "modern" small firms, and second, by urging that governments establish suitable general environments for SMEs. Recognizing that the ubiquity of SMEs and the variety of problems they face make it hard to design cost-effective promotional service programs, they suggested that small manufacturing firms should be advised in groups, rather than singly as large firms would be (Staley and Morse 1965: 3–4). They made no effort to justify their recommendations through cost-benefit analysis.

The fourth point in Staley and Morse's ten-point program, developmental finance, turned out to be critical because it was the one that was

most frequently implemented. The authors justified their recommendation that specialized lending institutions be established to provide capital and credit to SMEs with the offhand observation that SMEs have no access to stock markets and find it hard to get bank loans. This led to, or at least condoned, the establishment of scores of specialized lending institutions throughout the developing world. Most of these bodies later encountered massive loan repayment problems and many eventually failed. Hindsight indicates that the assumption that banks cannot or will not lend to SMEs ought to have been reexamined. Although commercial banks do have significant limitations as sources of credit for SMEs, they are generally more effective vehicles for industrial financing than the now largely defunct bodies created in response to the logic reflected in Staley and Morse.

The "Employment Crisis" of the 1970s

Staley and Morse's list of recommended promotional activities stood for many years as an ideal blueprint for SSI promotion. Such programs became a standard component of every national development plan, but they were seldom given a high priority before the late 1970s, when there was a surge of interest that Anderson (1987) has attributed to four causes:

- Heightened realization that despite the large capital resources allocated to large-scale industry a high and sometimes rising share of industrial employment was still in the small enterprises.
- Growing understanding that because government policies were slanted toward promotion of large-scale, capital-intensive industry a shift to more neutral policies might induce more efficient use of scarce capital and improve the distribution of income.
- Evidence that small enterprises were concentrated in small towns and rural areas and linked closely to agriculture; SSI promotion was thus seen as part of the "rural-led" or "agriculture-led" development strategy increasingly advocated for use in low-income agricultural countries as an alternative to the more traditional approach emphasizing industrialization and urbanization (International Labor Office [ILO] 1974; Johnston and Kilby 1975; Mellor 1976; Lipton 1977).
- Finally, and most important, SSI was seen as a response to growing concern about rising unemployment. Infant and child mortality rates had declined sharply almost everywhere, and after a lag of from fifteen to twenty years the labor force effects of improved child survival were beginning to be felt. Added to this in many

> countries was the impact of increased female labor force participation. Although expanding school enrollments retarded labor force growth for a while, their effect was limited and temporary. On the demand side of the labor market, labor absorption in agriculture was often very low. In any case, agricultural work did not attract the growing numbers of educated first-time job seekers. Growth in the kinds of employment that these young people really wanted (in the government or established nonagricultural enterprises) lagged far behind the numbers of people seeking such jobs.

All this was seen by many in the 1970s as an "employment crisis," which might be ameliorated by a class of enterprise that could absorb workers whom the government and large private enterprises were unable to employ. As the World Bank's 1978 sector policy paper on small enterprises put it,

> In most developing countries only a fraction of the new job seekers can be employed in agriculture. The scarcity of capital severely limits the number of new nonfarm jobs that can be created, because investment costs per job are high in modern industry. An effective development policy should seek to increase the use of labor relative to capital, to the extent that it is economically efficient. (1978b: 5)

This World Bank policy statement accepted that SMEs are generally more labor-intensive than larger enterprises and argued that they should be promoted through loan finance and measures such as preferences in government procurement, subcontracting, industrial estates, technical advice, and entrepreneurship training.

Predictions that massive unemployment would emerge in developing countries as ever-larger cohorts of job seekers entered the labor force did not, however, materialize. We now know that the forecasters underestimated both the ability of people to create remunerative employment for themselves and the adaptability of labor markets (Gregory 1986).

Another source of revived interest in SSI during the 1970s was the "small is beautiful" movement inspired by E. F. Schumacher. Schumacher (1973) regarded large-scale capitalist enterprise as dehumanizing, even when it brought higher productivity and living standards. In its place, he championed an "intermediate technology" better matched to the factor endowments of developing countries and best utilized in small, human-scale firms. His message of "economics as if people mattered" was welcomed by many intellectuals in both developed and developing countries, and it inspired several PVOs, but its impact on developing country policies was minimal.

RECENT CONTRIBUTIONS TO THE DEBATE

As the development community moved into the 1980s, interest in SMEs remained strong but the mood grew increasingly critical (Anderson 1982b; Page and Steel 1984; Elkan 1986; Little 1987; Little, Mazumdar, and Page 1987). Analysts began to question whether SSI had ever met the high expectations of its proponents and wonder what could realistically be expected of it.

Two new terms were now added to the discussion: "the informal sector" and "microenterprise." Although a precise definition of informality has proven elusive (Peattie 1987), it has become widely accepted that a growing volume and range of economic activity is taking place outside the legal and regulatory systems and that this can represent a potential to be developed, rather than the menace to be suppressed that many government officials perceive. An informal sector seems to emerge when formal sector employment growth fails to provide enough acceptable jobs for the available labor force. Because the poor in developing countries usually have neither assets nor transfer payments to sustain them through long periods of unemployment, they are forced to seek at least minimal earnings through self-employment or work in unregistered, usually small, enterprises. A second cause of informal sector growth in some countries is regulatory systems that severely limit entry into formal sector economic activity as a way of protecting the interests of registered firms and their workers.

Informal sector enterprises operate outside the legal and regulatory framework and are thus technically illegal, even when their activities are morally unobjectionable. Hernando de Soto (1989) calls the informal sector "legal activities carried out in illegal ways."

Although de Soto cites contrary examples like the large unregistered bus companies that operate in Lima, most informal sector firms are very small. Many are "microenterprises," the currently fashionable term (apparently coined by Jeffrey Ashe [1985]) for 1–10 worker establishments. Contrary to Staley and Morse's emphasis on "modern" medium-scale establishments, some current advocates of small enterprise promotion limit their enthusiasm to microenterprises. The appeal of microenterprises spans the political spectrum. Liberals like them because they are small enough to be owned and operated by genuinely poor people. Conservative free-market enthusiasts see them as admirable efforts by the poor to fend for themselves, as seedbeds of capitalism and as potential sources of support for free-market economic policies.

Recent contributions to the debate about the ability of SMEs to deliver what its enthusiasts promise have yielded a mixed verdict. Mariluz Cortes, Albert Berry, and Ashfaq Ishaq (1987) carefully documented the performance of Colombian SMEs (defined as enterprises employing 5–99 workers) in

the 1970s, reaching conclusions so positive that they called their book *Success in Small- and Medium-Scale Enterprises: The Evidence from Colombia.* Inspiration has also been drawn from the experiences of East Asian SMEs, including the long-acclaimed historical contributions to economic growth of SMEs in Japan. Before World War II, Japanese SMEs specialized in products and processes that depended for their competitive success on the availability of low-cost labor, but after the war they gradually modernized, raised wages, and established complementary linkages to larger scale industry through an extensive system of subcontracting (Hoselitz 1968). More recently, both mainland China (Perkins et al. 1977) and Taiwan (Ho 1980) have made SMEs a dynamic part of their industrialization.

The availability of data on SMEs, although still weak, has improved. The World Bank's 1978 sector policy paper had tempered its advocacy of small-scale enterprise (SSE) promotion with the warning that "reliable data for making rigorous comparisons at the enterprise level and for identical products are scarce" (World Bank 1978b: 5). Concern about the information base inspired several studies that tried to document the nature and extent of small enterprise activity in manufacturing and other non-agricultural sectors, notably those conducted by Michigan State University (for example, Chuta and Liedholm 1985). These studies showed small-scale activity in many developing countries to be more widespread than previously suspected, since industrial censuses and surveys frequently either excluded the smaller units by definition or severely underenumerated them. Moreover, many of the smaller units appeared to be not only more labor-intensive than the larger ones but equally or more efficient. Although few studies of enterprise growth were carried out, there was some evidence that small firms had the capacity to expand.

Some found in these research findings an argument for intervening on behalf of small enterprise. Surely, they contended, a form of enterprise upon which so many people depend for their jobs and livelihoods, and which moreover is relatively efficient and dynamic, merits official support and promotion. But Little, Mazumdar, and Page (1987) attacked this line of reasoning. Based on intensive study of Indian experience and a review of research on several other developing countries, they argued that enterprise scale is an unreliable guide to differences in labor intensity, which according to them exhibits more variation across industries than among firm-size groups within industries. Except for a weak tendency for capital productivity and total factor productivity to be highest in enterprises with 50–200 workers, these authors found no clear general relationship between efficiency and enterprise scale.

> The very small (less than 10 workers) should not be looked to for their efficient employment of factors of production. But at the same time they

> should not be discriminated against. They are there, and they still provide the bulk of employment in the lower-income developing countries. (Little, Mazumdar, and Page 1987: 313)

> In surveys of narrowly defined industries, the idea that small, especially very small, manufacturing enterprises are relatively efficient users of resources in labor-abundant economies has been found to have no general validity. If anything, medium-size firms come out best. But size as such, especially when measured by employment, is a poor indicator of any attribute of social importance. (Little 1987: 230)

Among those who continue to argue for promotion of SMEs, a lively controversy proceeds concerning the form that such support should take. While many developing country governments and foreign aid agencies still rely on directed finance and other promotional activities, two alternative approaches have been suggested. One, mentioned earlier, is to put more emphasis on government policy, either as an alternative to promotional programs or at least as a major influence on their success. Another is a "minimalist" financial approach that emphasizes improvement in general financial services, especially through commercial banks, and eschews both high-priced technical assistance and specialized lending institutions.

THE FINDINGS OF EEPA

It was at this point that EEPA entered the debate about the role of SMEs in economic development and how it might best be promoted. The remainder of this chapter reports our main findings, which are elaborated and supported in later chapters. This section is divided into three subsections. The first reviews cross-sectional findings on SME performance and factor use, whereas the second subsection introduces a more dynamic approach to the analysis of SMEs. In the last subsection we consider the role of government in SME promotion.

SME Performance in Developing Countries: A Review

Data on the performance of establishments of different sizes in developing countries come from two main sources: manufacturing censuses and industry case studies. They can be used to calculate productivity measures of various types, benefit-cost ratios (social and private), and profit rates. Numerous studies have sought a correlation between productivity and plant size.

Factor productivities

Despite much variability, measures of factor productivity in the entire manufacturing sector do generally correlate positively with plant size. This is particularly clear for labor productivity. Data for Korea, Colombia, and India (Tables 1, 2, and 3), as well as for Taiwan, show that labor productivity rises with plant size, except for the smallest size class in Taiwan. Given the positive correlation of labor productivity with wage rates, wages also vary systematically with plant size. For example, labor productivity in Korea averages 120 percent higher in plants employing 100–199 workers than in plants with 10–19 workers (Table 1). A similar comparison for Colombia indicates a 137 percent labor productivity advantage (Table 2). For India, the difference is 73 percent, although in this case the large firms that are discussed form an inverted U-shaped relationship with plant size.

When the data are disaggregated by industry, however, regularities in the association of factor productivities with plant size begin to break down. Labor productivity continues to be positively associated with scale in most industries, but the relationship is not strictly monotonic. For example, among twenty manufacturing industries in Taiwan there is no case in which small plants (10–19 workers) have higher productivity than large ones (300+ employees). In only one case does small enterprise have higher labor productivity than medium-sized enterprise. In Colombia, when a finer breakdown of plant size is used for each industry, the relationship of size with wages is still robustly evident, but it is not monotonic and there is much variability.

Factor productivity figures from industry case studies, such as the five

TABLE 1 Productivity and Factor Intensity Measures, Korea, 1968 (thousands of won)

Establishment size (no. of workers)	Y/L	K/L	Y/K	W	$\frac{Y - W}{K}$
5–9	196	296	.66	63	.45
10–19	248	275	.66	83	.44
20–49	259	388	.67	84	.45
50–99	315	387	.81	92	.57
100–199	553	380	1.45	102	1.18
200–499	607	520	1.17	125	.93
500+	598	656	.91	—	.72

NOTES: Y = value added. L = number of workers. K = market value of fixed assets including land. W = wages. Dash = not available.
SOURCE: Ho 1980, as quoted in Little, Mazumdar, and Page 1987: 109.

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TABLE 2 Distribution of Manufacturing Value Added, Colombia, 1975

Enterprise size (no. of workers)	Employment (× 1,000)	Output (billion pesos)	Output/worker (× 1,000 pesos)
Independent workers	285.0	8.8	31
2–4	265.0	6.9	26
5–9	35.4	2.1	60
10–14	37.0	2.6	70
15–19	33.0	2.5	76
20–24	25.0	1.9	76
25–49	55.0	4.8	88
50–74	37.4	4.0	108
75–99	25.6	3.5	138
100–199	71.7	12.4	173
200+	229.9	54.3	236
All	1,100.0	103.9	95
Cottage shops (1–4)	550.0	15.7	29
Small industry (5–49)	185.4	13.9	75
Medium industry (50–99)	63.0	7.6	120
Large industry (100+)	301.6	66.7	221

SOURCE: Cortes, Berry, and Ishaq 1987: 253–54.

Indian industries shown in Table 3, exhibit even more variability than census measures. Although Table 3 gives the impression that labor productivity rises with plant size, high variance within size categories reduces the statistical significance of the correlation. Systematic differences in capital productivity are less evident. Only in the machine tool industry is there a statistically significant relationship between size and productivity. The labor and capital productivities of machine tool plants with fewer than ten workers are well below those for large firms. High variability in performance, both within and between size classes, and the relatively weak relationship between productivity and plant size in these five Indian industries make two important points. First, prevailing economic policies can have an enormous effect on scale differences in economic performance. India's history of heavy protection for domestic producers and subsidies for small firms surely affected interscale productivity differences in perverse ways (Mazumdar, 1984; Little, Mazumdar, and Page, 1987). Data from East Asian countries show the expected systematic positive correlation between plant size and performance in every case. In less distorted environments, therefore, plant size appears to be a more reliable

TABLE 3 Labor and Capital Productivity in Five Indian Industries, 1977 (thousands of rupees)

Plant size (no. of workers)	Shoes		Printing		Soap		Machine tools		Metal casting	
	Y/L	Y/K	Y/L	Y/K	Y/L	Y/K	Y/L	Y/K	Y/L	Y/K
1–4	5.23	14.28	8.92	4.86	10.80	2.47	—	—	3.20	10.67
	(3.27)	(13.57)	(5.28)	(1.11)	(1.84)	—	—	—	—	—
5–9	5.61	29.87	12.15	3.51	9.33	2.20	4.16	1.11	13.91	4.97
	(4.28)	(33.72)	(6.47)	(2.47)	(2.83)	(1.22)	(1.61)	(0.17)	(10.90)	(3.98)
10–24	5.67	16.20	14.18	3.26	9.78	2.04	6.73	2.66	12.32	5.77
	(4.31)	(11.27)	(5.15)	(2.57)	(4.02)	(1.12)	(3.76)	(1.76)	(10.52)	(3.56)
25–49	6.30	13.13	14.56	3.51	11.19	1.98	7.84	3.28	14.44	7.63
	(3.29)	(10.20)	(7.53)	(3.13)	(1.19)	(0.11)	(2.43)	(1.78)	(16.66)	(7.60)
50–99	—	—	11.59	1.24	10.92	2.93	7.44	2.57	19.40	29.96
	—	—	(3.07)	(0.72)	(3.19)	(1.07)	(2.94)	(1.07)	(9.94)	(39.03)
100+	15.32	4.93	13.81	1.21	11.10	2.74	12.31	2.13	22.47	8.59
	(3.41)	(4.22)	(7.36)	(0.50)	(2.72)	(0.46)	(7.95)	(0.90)	(16.57)	(6.86)

NOTES: Y is value added. K is capital. L is labor. Standard deviations in parentheses. Dash is not available.
SOURCE: Little, Mazumdar, and Page 1987: 183.

predictor of capital intensity and productivity. Moreover, in the East Asian cases variance in economic performance within and between size classes is smaller, suggesting a lower degree of disequilibrium as a result of more efficient adjustment mechanisms.

The second issue concerns high variance in performance within size groups. Not all SMEs have low productivity; some plants are significantly more productive than the mean for their size class. In India, labor productivity is much higher in small enterprises that use power (a proxy for more modern technology) than in those that do not. This underscores the earlier point that some small firms are able to raise their productivity.

Total factor productivity (TFP)

TFP measures the productivity with which labor and capital resources are used and is thus a broader indicator of economic performance than either labor or capital productivity alone. TFP increases when the growth rate of output exceeds that of a weighted average of the amounts of labor and capital used.[8] It varies greatly within and across size classes in most country studies. Firms with fewer than 50 employees typically have the lowest TFP, but the largest enterprises often do not have the highest TFP. In most data sets, TFP peaks in the 50–100 worker size range. As Little, Mazumdar, and Page state,

> when measured by employment size, firms in the medium-size range of 50–200 workers have the highest capital productivity, and total factor productivity, in most industries in all countries examined. Also, while the variability of such economic characteristics as factor employment and productivity and profitability is very great within all size classes, it is less in the larger size groups than among the small, even ignoring the high incidence of death among the latter. (1987: 313)

Korea is a case in point (Ho 1980: 64). In 64 percent of Korea's four-digit industries in 1968, the highest TFP was recorded in the 50–100 employee size range. For 23 percent of these industries, TFP was highest in the smallest firms (fewer than 50 workers); in 13 percent of the industries, it was highest in the largest firms (over 100 workers). Similarly, in Taiwan in 1981, 50 percent of the industries registered the highest TFP in the 300–1,000 employee range, while the 20–299 employee range had the highest TFP in 25 percent of the industries (Biggs and Llorch 1989b). The largest plants (1,000+ employees) and the smallest (under 20) each had the highest TFP in 10 percent of the industries.

Industry case studies for Colombia (1967) and India (1978–1980) provide additional evidence of scale-related TFP differences. Metal working

and food processing firms in Colombia showed a positive correlation between size and TFP, which was highest in medium-sized firms (the largest ones studied). In small metal-working enterprises (below 60 employees), TFP was 70–90 percent as high as in the medium firms (60–100 employees). In food processing, TFP in the smallest firms was only 60–75 percent of TFP in medium-sized operations (Cortes, Berry, and Ishaq 1987: 91–92).

Little, Mazumdar, and Page (1987) found substantial variation in TFP but little systematic relationship with firm size in their Indian industry studies. Only in the machine tool industry was TFP unambiguously correlated with firm size. However, in three of the four industries studied, large firms (100 or more employees) had higher TFP than small firms with fewer than 10 workers (Little, Mazumbar, and Page 1987: 200–201).

Carl Liedholm and Donald Mead (1987: 13) report large differences in social benefit-cost ratios, in favor of small enterprises (fewer than 50 employees), in ten of twelve industry studies in Sierra Leone, Jamaica, and Honduras.

Beyond efforts to correlate TFP with firm size, a few studies have tried to trace a causal connection between the two by controlling for other variables. Regression analysis carried out by Little, Mazumdar, and Page (1987: 201) for five Indian industries revealed a statistically significant link between TFP and size only for machine tools, once account was taken of variables such as the literacy of the entrepreneur, the age of the firm, the age of its plant, plant capacity, and employee experience. Cortes, Berry, and Ishaq (1987) analyzed the effect of firm size on TFP, holding constant variables such as management skill and technology. They found that size has no significant explanatory power when it appears in an equation with these variables. But, as Albert Berry (1992) notes, in both these studies size does appear to facilitate some of the firm characteristics associated with higher TFP, such as better technology.

Factor intensity

Those who argue for special measures to promote small enterprise often assume that these firms are more labor-intensive than larger enterprises. However, data for the entire manufacturing sector show much variation in the capital/labor ratio and no clear correlation with firm size. Two problems seem to block the expected relationship of factor intensity with firm size. First, many of the very smallest firms (fewer than ten workers) are *more* capital-intensive than the larger firms; these tiny enterprises often have capital/labor ratios as much as 60 percent higher than firms in the next higher size class (10–19 workers). Second, there is little systematic relationship between size and factor proportions between the 10–19

worker class and the 100–199 worker class. Only after firm size reaches 200 employees does capital intensity increase sharply.

The more the data are disaggregated, the less clear the relationship between firm size and capital intensity becomes. The capital/labor ratio can peak anywhere from the 10–19 worker class to the 100–199 worker class. In Korea, the highest capital intensity for many industries was found in the 5–50 employee class (Ho 1980). Within most industries and countries, *inter*industry variations in capital intensity dwarf *intra*industry variations. This led Little, Mazumdar, and Page to argue that efforts to make industrial growth more labor demanding should focus on

> altering the pattern of demands in favor of labor-intensive industries rather than on supply-side efforts to change the size structure of industries in favor of the labor-intensive segment of the firm size range, which anyway varies from industry to industry and is hard to find. (1987: 314)

Many factors intervene to complicate the relationship between enterprise size and productivity in developing countries. First, employment is often the only available measure of enterprise size. If data on capital invested were more widely available, the relationships might be clearer.[9] Second, methodological differences among studies and problems of measuring inputs may contribute to the lack of unambiguous patterns. Third, productivity measures used in the studies calculate technical input-output relationships of only a few undifferentiated products and exclude many of the pecuniary benefits enjoyed by larger firms in such areas as marketing and distribution, which are important in domestic markets and crucial in export markets. Fourth, structural disturbances and slow adjustment processes increase variability in the data and reduce the significance of the correlations between size and productivity. Fifth, differences in the policy environment cause the relationship between the efficiency measures and firm size classes to vary across countries.

Despite these complications, there is an evident relationship between size and productivity which, if not monotonic, at least involves an unambiguous jump in economic performance between the bottom of the size distribution and higher size classes. TFP most often hits its maximum in the middle size range, and less frequently in the upper size range; seldom is the highest TFP found at the bottom end. Labor productivity and wage rates peak most often in the largest size classes. Among modern factories, capital productivity is high in large firms. Small firms may also have high capital productivity (that is, they use their limited capital resources effectively), but it comes at the cost of low labor productivity and wages.

SMEs and Structural Change within the Industrial Sector

Past analysis of the question of industrial scale in developing countries has tried to identify the most efficient and labor-intensive scales of enterprise, based on cross-sectional comparisons. As the review just completed indicates, these questions are hard to answer in any general and definite way. In this subsection (and later in Chapter 2) we offer what we believe is a significant alternative perspective.

Our own attempt to understand the significance of SMEs for employment creation, industrialization, and economic development places concerns about the role of SMEs and their encouragement through government programs and policies within the broader context of economic development. It is well known that development involves systematic changes in economic structure, in particular a decline in the relative importance of agriculture as a producer of output and user of labor and other resources and a corresponding rise in the relative importance of industry and services. In this restructuring process, massive quantities of labor and other resources are transferred to more productive uses. Many of the benefits conferred by economic growth arise as a result.

Other familiar research shows that restructuring also takes place within the manufacturing sector as "early" industries are joined by "middle" and finally "late" industries.

Our effort to integrate SMEs into the structural change framework revealed two important "stylized facts." The first, noted earlier by Banerji, Anderson, and others, is that the size of the average manufacturing establishment rises with GNP per capita; SMEs gradually become a less important part of the manufacturing sector and large enterprises a more important part. The second fact is that differentials between large and small firms with respect to wages, productivity, and profit rates, which are wide at low levels of development, narrow substantially as countries develop. We believe that these findings provide keys to understanding the changing roles played by SMEs at different stages of economic development.

Rising Average Establishment Size

In low-income countries, large enterprises are very few and typically employ less than 10 percent of the manufacturing workforce whereas SMEs make up 90 percent or more of all manufacturing enterprises and account for some two-thirds of manufacturing employment. SMEs in poor countries are often owned and operated by a single family. Many are so small (one- or two-person "firms," for example) that they can barely be called enterprises at all. These omnipresent microenterprises reflect the survival strategies of poor families and individuals who have been unable

to find paid employment at satisfactory wages and have accordingly taken matters into their own hands and created jobs for themselves (and sometimes others). They produce goods and services (food, drinks, textiles, and clothing, plus a few intermediate and capital goods) for sale in local markets, usually to low-income customers. The great majority of these "livelihood enterprises" exist only as long as they are needed for survival. Eventually, their proprietors and those who work for them may be offered opportunities to work elsewhere for wages higher than their microenterprise earnings. They may then close up shop and become employees, perhaps even paid managers.[10]

In most low-income countries, while innumerable small firms coexist with a few large ones, medium-sized enterprises employing 20–100 workers (most of Staley and Morse's "modern small enterprises") are not numerous. The enterprise size structure has a "missing middle."

The rise in the average establishment size in manufacturing has two components. One component is compositional changes within manufacturing, which shift in the direction of industries with strong economies of scale. In low-income countries, the so-called early industries (food, beverages, and tobacco; textiles and clothing) produce 50 percent of manufacturing value added. But these industries grow more slowly than GDP and thus gradually decline in relative importance. They have weaker economies of scale and are thus more hospitable to SMEs than the "middle industries" (wood and wood products; chemical and rubber products; nonmetallic mineral products) that become more important as GNP per head rises above about $750. The final phase of this process involves the emergence of "late industries" (paper and printing; basic metals; metal products and machinery) with powerful economies of scale. Since these industries account for 80 percent of the growth in manufacturing after per capita income passes $750, the effect on the size distribution of enterprise is considerable.

Although changes in the industrial composition of manufacturing thus contribute to rising establishment size, we find that only one-fifth of the observed increase can be attributed to this cause. The remaining four-fifths represent rising average size within individual industries. We believe that the main reason why larger plants gain an increasing share of the growing market within most industries is that falling transportation costs break down the natural protection formerly enjoyed by small, local firms and give growing scope to economies of scale in production. Instead of buying bread from small, local bakers, for example, consumers rely increasingly on large, centralized bakeries. Eventually, the small bakers go out of business.

Some of the large firms that increasingly dominate manufacturing as income rises start out large. This is true, for example, of most foreign-

owned enterprises. Others begin in the medium size group and grow to be large. The skimpy evidence available suggests that only rarely does a small enterprise (1–20 workers) grow into a large enterprise (over 100 workers). Rising average firm size thus results primarily from the displacement of SMEs by large enterprises. Although firm "graduation" to higher size categories also contributes to the rising average, its contribution is relatively small. Most small firms are squeezed between falling prices and rising wages and eventually go out of business. This is the process of "creative destruction" that Joseph Schumpeter (1934) characterized as an essential feature of capitalist development.

Hollis Chenery and Moises Syrquin (1975) have shown that industrial sector growth is most rapid while a country is climbing from per capita GNP of $500 to about $2,500. Industry's contribution to GDP peaks (at 43 percent) in the upper-middle-income countries ($2,500 to $7,500). Although more than 80 percent of world manufacturing still takes place in the high-income countries, the upper-middle-income countries as a group have increased their share since 1970 and now depend more on manufacturing than the high-income countries.[11] The locus of world manufacturing may be shifting gradually in their direction.

Large enterprises typically provide more than 60 percent of manufacturing employment after per capita income passes $1,000. This rises to 70 percent in high-income economies.

Declining Wage, Productivity, and Profit Differentials and Establishment Size

Chenery and Syrquin (1975) found that productivity differentials among the broadly defined agricultural, industrial, and service sectors narrow sharply as GNP per capita rises. Our research identified a similar trend among establishment size groups in manufacturing. In most (although not all) low-income countries, the smallest enterprises have much lower productivity levels (according to most measures of productivity) than medium and large enterprises. They survive only because they pay much lower wages. As economic development raises the real wage level, SMEs come under pressure to raise labor productivity much closer to the levels found in large establishments. Most SMEs, especially the smallest, are unable to respond and thus go out of business in due course. The comparatively few that remain after the economy reaches a high-income level are likely to be nearly as capital-intensive, high-tech, and profitable as large firms, and pay wages that are nearly as high.

In the United States, United Kingdom, France, and most other developed countries, SMEs (establishments with 1–99 workers) make up only 25 percent or so of manufacturing employment. There are, however, a few developed countries (notably Japan and Italy) where SMEs still provide

more than 50 percent of manufacturing employment. These deviant cases appear to depend in large part on imperfections in the capital and labor markets. In both Japan and Italy, banks are controlled by large enterprises, making it hard for small firms to get credit. In Japan, large firms also provide lifetime employment guarantees to their permanent employees, so they are reluctant to expand employment in response to an increase in demand that could prove to be temporary, preferring to rely on subcontracting. This helps the SMEs survive.

SMEs in developed countries follow "niche strategies." They use high product quality, flexibility, and responsiveness to customer needs as means of competing with large-scale mass producers. Taiwan's SMEs have also proven themselves capable of making a major contribution to national industrialization, among other things spearheading the national export drive (Chapter 7). The deviant path followed by Japan, Italy, and more recently Taiwan raises intriguing questions about what is required for a developing country to base more of its industrialization on SMEs and depend somewhat less on the traditional large factory model.

The Role of Government in SME Promotion

Our research in this area addressed two major questions. First, in what ways and to what extent do government policies unintentionally inhibit the development of SMEs? Second, what should governments do to promote the healthy development of SMEs? The second question contemplates both the possibility of eliminating policy bias ("leveling the playing field") and that of actively favoring SMEs through policies, promotional programs, or both.

The development role of the small industrial enterprise can be compared to that of the small farm. Both are important in early stages of development and both have some growth potential, which the government should encourage in the early stages of development for reasons relating to both efficiency and equity goals. They can be upgraded to some extent and a few of them may become either large enterprises or efficient small enterprises some day. But if development succeeds, most of them will eventually disappear.

Policy Bias and Its Amelioration

Many different government policies affect SMEs, either positively or adversely. Most of them work by affecting prices in markets in which SMEs either buy inputs and factors of production or sell their products. Our review of efforts to quantify the effects of government policies on SMEs (Chapter 3) suggests that trade and exchange rate policies usually have the

largest effect, followed by fiscal policies, financial policies, and labor market policies.

Many of the policies that influence enterprise size in the manufacturing sector were enacted as part of either an import-substituting industrialization (ISI) policy package or an export-oriented industrialization (EOI) package. In the 1950s and 1960s, most developing countries pursued ISI. The East Asian newly industrializing economies (NIEs) started moving toward EOI in the 1960s and were followed by many other countries in the 1970s. This usually did not mean that ISI was abandoned, since some industries were encouraged to import substitute while others were urged to export. Critically, however, exporters were sheltered from some of the adverse effects of the ISI policy. Today, nearly all developing countries retain elements of the ISI package while at least experimenting with EOI. This is important for our present concerns, because the two approaches to industrial promotion have different implications for the development of SMEs.

In the typical ISI policy package, domestic industry is highly protected through tariffs and quantitative restrictions, the currency is overvalued, access to foreign exchange and imports is licensed, interest rates are controlled, credit is directed toward favored firms, and fiscal incentives are offered for industrial investment. Often there is a legal minimum wage. Our research and literature review suggests that most parts of this policy package are biased against SMEs.

In general, direct controls over any form of economic activity impose transaction costs. These are more easily borne by large enterprises than by SMEs because they always contain a fixed-cost element. Since it may cost as much to arrange a license for a small transaction as for a large one, the smaller enterprises pay more as a percentage of sales, exports, or the amount borrowed. This principle applies to import licensing, foreign exchange licensing, negotiations for fiscal incentives granted on a case-by-case basis, and other forms of regulation. It virtually ensures that ISI-type policies will favor large enterprises over SMEs, even when the government has no conscious intention of doing so.

In addition, a rapidly growing literature on the political economy of industrialization shows that government officials and large-scale industrialists are often closely allied in efforts to collect the rents generated by protected industries and use them for personal advantage.

Although the ISI policy package is thus biased against SMEs, it does give them two countervailing advantages. First, labor market policies are often biased against large enterprises. When governments enact minimum wages, mandate social benefits, or restrict the right to fire workers, SMEs may be legally exempted from some of these provisions, permitting them to hire labor more cheaply than large enterprises. Second, even when labor

regulations and impositions such as sales taxes and environmental regulations legally apply to SMEs as well as large enterprises, in practice they *may* be less stringently enforced on them. Alternatively, they may not; countries appear to differ in this regard (Levy 1991), and we do not know yet how many of each kind there are in the world.

In extreme cases, these two factors, together with explicit government preferences for small enterprises (as in India), protect SMEs so much that they are able to hold on further into the industrialization process than they otherwise would. In the process, unfortunately, they also discourage small enterprises from becoming medium enterprises. An EEPA team studying small business policy in the Philippines in the mid-1980s noticed that the size distribution of industrial enterprises had a "missing middle" (Chapter 6). There were many small enterprises and quite a few large ones, but a paucity of medium enterprises. The analysis suggested that this bimodal distribution resulted in part from a pattern of policy and enforcement that strongly penalized SME growth. The team calculated that if a small enterprise was evading sales tax and paying its workers less than the minimum wage, it could easily face an 85 percent tax on marginal profits if it grew large enough to have to start paying sales tax and the minimum wage.

In response to such problems of policy bias, officials at the World Bank and USAID often advocate policy neutrality between large and small enterprises, the so-called level playing field. In the real world, however, the playing field always seems to be slanted.

The current consensus is that developing countries should pay more attention to export promotion. Significant deregulation has taken place in many developing countries as a result of this change in emphasis. These countries have reduced levels of protection, liberalized financial markets, and simplified tax codes to reduce marginal rates and eliminate many special tax breaks. They now keep their exchange rates closer to equilibrium. Many interpretations of the export success of the East Asian NIEs stress that even as they protected some of their domestic markets they created something close to a world price regime for exporters. Only Hong Kong really came close to a free-market economy. While South Korea and Taiwan both intervened in many ways to help exporters, a lot of their interventions really only offset costs imposed by the protection system. For example, exporters were permitted to obtain imported inputs at world prices through a duty rebate or blanket exemption system. Other measures, however, such as cheap export credit and special tax breaks, were genuine subsidies.

How do SMEs fare under an EOI policy regime? We find that they generally do better than under ISI but still tend to decline in relative importance over time. In most countries, large enterprises export more of their output than do SMEs. One reason is that EOI policies implemented

on a case-by-case basis are biased against SMEs just as similarly interventionist ISI policies are. But even when policy bias is weak or absent, SMEs often find it hard to cover the transaction costs involved in selling to overseas markets. Use of a marketing agent such as a trading company (as in Taiwan) or foreign affiliate (as in the garment industry of Bangladesh) can help overcome this difficulty.

The contrasting experiences of South Korea and Taiwan show that a range of outcomes is possible for SMEs under an EOI approach. Korean industrial policy has been strongly and intentionally biased in favor of large enterprises, and the patterns of both industrial structure and exports show it. South Korea actively encouraged the formation and development of corporate groups (*chaebol*) that have been able to introduce many new brand names into world markets. Unlike their counterparts in Japan, however, these groups seldom subcontracted to SMEs. The role of SMEs declined sharply until a policy decision was made to stimulate them in the early 1980s. Although its per capita income was still only $5,400 in 1990, South Korea's industrial structure was already similar to those of the United States and other developed countries.

Taiwan also grew amazingly fast and was able to export rapidly growing amounts of increasingly sophisticated manufactures. As these successes were being recorded, employment in microenterprises (1–9 workers) fell from one-third of all manufacturing employment to about 10 percent, while employment in large enterprises (100 workers or more) rose from about 40 percent to more than 60 percent. Small enterprises declined in relative importance in Taiwan as in other rapidly developing countries, but medium-sized enterprises were far more important than in Korea or elsewhere. Taiwan stuck mainly to making components that were sold under other countries' brand names, so-called original equipment manufacturing (OEM), and did not try to establish *chaebol* or its own brand names. In 1981 establishments with 500 or more employees accounted for only 27.5 percent of manufacturing employment in Taiwan, versus 40.5 percent in South Korea. Taiwan has grown about as fast as South Korea but started at a higher level and is therefore richer today, with GNP per capita of approximately $8,000.

A fascinating feature of the Taiwan experience is extensive SME participation in exports. During the 1980s, SMEs (using the broad official definition) contributed 40–50 percent to manufacturing sales each year but 60–65 percent to exports. In other words, they were more export-oriented than large firms, in contrast to experience in most other countries. Large enterprises in Taiwan tend to serve the domestic market, whereas smaller firms tend to export. How can Taiwan's SMEs export so successfully? One answer is that trading companies relieved them of some of the transaction costs of exporting. Many of these were Japanese trading companies, which were better accepted in Taiwan than in South Korea.

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What is the best policy approach for encouraging dynamic SMEs in the manufacturing sector? We suggest a few general principles: (1) Developing country governments should try to reduce biases against SMEs that may have crept into their policies and administrative procedures. (2) Slanting policy *in favor* of SMEs is probably not a good idea in most developing country settings; we tend to agree with Little, Mazumdar, and Page (1987) when they say that enterprise scale is not a good general criterion on which to base policy. (3) More attention should be paid to helping labor compete with capital in enterprises of all sizes, and exports to compete with import substitutes.

Alice Amsden (1989), Robert Wade (1990), and others have argued that South Korea and Taiwan both intervened successfully to encourage manufactured exports, including, in the case of Taiwan, exports from SMEs. Cannot other countries follow their examples? Probably not, if they are "soft" rather than "hard" states (Biggs and Levy 1991). If governments do intervene, the rewards that they offer should be performance based. To offer appropriate incentives, these rewards must be withdrawn if the desired performance is not forthcoming. This can only be done in a hard state. Even in a hard state, however, interventions that must be administered case by case are inevitably biased against SMEs, as the experience of South Korea shows. For SMEs to participate fully, incentives must be more automatically available, as in Taiwan, or in Indonesia since 1986.

SME Promotion Programs

Our study touches on the instruments most frequently thought of in connection with SME promotion—programs designed to provide credit, technical and managerial advice, and sometimes physical facilities to SMEs. Hundreds of agencies and thousands of people are involved in these activities worldwide, and billions of dollars have been spent on them. Our review of some of the more important evaluation studies that have been carried out suggests that relatively little of this money was spent effectively (Chapter 4). Gradually opening up financial markets to SMEs is more promising than all the specialized lending agencies that have been established to make subsidized loans to special classes of borrowers. Technical assistance to SMEs is expensive. It shares with agricultural extension the problems of serving large numbers of clients and may be even harder because the output mix and technology of SMEs is much more varied than that of small farms.

Official attempts to assist microenterprises often encounter what might be termed the Admirable Chrichton syndrome.[12] Microentrepreneurs learn many tricks of survival, most of which are unknown to the middle-class developing country officials and foreign aid administrators who try to assist them. Although these officials may believe that their own higher educational and social status qualifies them to be teachers, there is in fact

much that they could learn from microenterprise proprietors about the requirements for microenterprise survival. It would indeed be useful for them to do so, since that might help forge an improved understanding upon which better government and foreign aid policies can be built. As Staley and Morse emphasized, modern business knowledge is more appropriately conveyed to growing medium-scale enterprises than to microenterprises.

These critical observations on traditional SME promotion programs are not meant to suggest that the fate of SMEs should be left entirely to the operation of the market, that there is no productive role for the government to play. On the contrary, government can support SME development in several important ways. These include the construction of physical infrastructure and public utilities, education, and other programs to improve human resources, and efforts to establish a rule of law so that business transactions become more reliable and predictable. Although such measures are not always conducive to the welfare or survival of existing SMEs, they do promote healthy development of industrial SMEs as a group.

Program-Policy Interactions

The effectiveness of program-oriented approaches to SME promotion is strongly influenced by government policies. If the policies are not "right," credit provision and other program approaches are less likely to succeed. In many developing countries, while programs of various sorts have tried to promote SMEs, government policies have probably done more than offset their effects by hampering the growth of SMEs and accelerating the decline in their relative prominence that normally accompanies economic growth.

Many developing country governments spend considerable sums on SME promotion programs, then offset any gains that may result through policies and administrative procedures that are biased against SMEs. They would achieve more, and save public funds in the process, if they reformed their policies and left more of the credit provision and marketing and other forms of business support activities to the private sector.

We close this chapter by noting an important issue that arose repeatedly in the course of the EEPA research. In its most general form, the policy prescription suggested here is that SME development be treated as a part of the broader process of economic development. The problems of the SMEs will be solved and their potentials realized only as the whole economy develops. It is easy to see how this happened in the East Asian NIEs and how it is happening in the rapidly growing economies of Southeast Asia. What, however, should be done about countries that are much poorer and are experiencing slow economic growth, or none at all, such as Bangladesh and many of the nations in Sub-Saharan Africa? How can

economic development solve the problems of their SMEs, when it is either not occurring at all or is still in such an early stage that many decades will be needed for a labor shortage to emerge? Isn't more active intervention justified by the dire need that people face in these circumstances? Unfortunately, one cannot answer this question affirmatively because the capacity to intervene effectively (whether through programs or policies) is also lower in these countries, so promotional efforts, however badly needed, are likely to be either ineffective or very expensive. There is, regrettably, no quick fix for these countries. In our opinion, their governments should concentrate on removal of policy bias and the types of general supporting measures mentioned earlier in the hope that these steps will help accelerate economic development, including the healthy growth of SMEs in the industrial sector.

SUMMARY

The following points summarize the discussion in this chapter:

- All developing countries feature industrialization among their major goals and hope to create a modern manufacturing sector with large factories. At the same time, nearly all seek to promote small- and medium-scale manufacturing enterprises, believing that this will help create employment, promote efficiency, improve income distribution, widen the geographic dispersion of industry, and nurture entrepreneurs.
- Cross-sectional evidence on the relationship between scale of operation on the one hand, and both productivity and labor intensity on the other, is, however, inconclusive. Results vary by country and industry. Very broadly, medium-sized firms may be more productive than small ones.
- As countries develop, average plant size in manufacturing rises and the importance of small firms declines sharply. The rise in the average for all of manufacturing is attributable partly to the growing importance of industries with strong economies of scale, but more to rising average plant size within most industries. In most developed countries, large plants account for 60 percent or more of manufacturing employment, but SMEs are more important in a few deviant cases such as Japan and Italy.
- Differentials in productivity levels, factor proportions, wages, and profitability among plants of different scales all decline as economies

develop. Reasons for these declines and the rise in average firm size are explored in Chapter 2.

- The effectiveness of most of the promotional programs through which governments frequently try to foster the development of SMEs is questionable (Chapter 4). Governments also affect SME development, often adversely, through their trade, exchange rate, fiscal, financial, and labor market policies (see Chapter 3). Correction of such policy bias may be an effective way of promoting the growth of healthy SMEs. Active policy intervention on behalf of individual SMEs deemed to be "winners," such as was practiced at times in Japan, South Korea, and Taiwan, is inadvisable in most developing country settings.

Chapter 2

Economic Growth, Structural Change, and the Small Firm

Although the development of SMEs in manufacturing is often treated as a sui generis phenomenon with its own experts and interest groups, a deeper and more useful understanding can be achieved by starting from the realization that it is really part of a far-reaching, dynamic process of economic development. Although it is well-known that development involves structural change, that the transformation extends to major changes in the nature, functions, and potentials of SMEs is less widely recognized. Policy making for employment creation and enterprise development will be more successful if it is based on an understanding of the structural transformation process and designed to support, rather than thwart, that process.

This chapter analyzes the changing roles of SMEs at various stages of structural transformation. It is divided into four sections. The first section lays groundwork for the analysis by reviewing relevant past work on structural transformation. The core of our analysis of the changing role of SMEs is then presented in the second section. Here rising average firm size in the manufacturing sector is discussed, and then declining interfirm differentials in productivity, wages, and profit rates are analyzed. These changes are closely related to the productivity increases that raise per capita income. Although all countries undergo similar structural changes, there are a few developed countries in which interfirm differentials in wages, productivity, and profits have narrowed but where SMEs continue

to be a significant presence. The next section analyzes these divergent cases and their relevance for developing countries. The last section then summarizes the conclusions of the chapter.

ECONOMIC DEVELOPMENT AND STRUCTURAL CHANGE

This section describes the process we believe is key to understanding the changing role of SMEs in manufacturing.[1]

The General Pattern

To develop, a nation must accumulate growing supplies of physical and human capital and learn to apply modern technologies in ever more effective ways to all forms of production. Economic structure is continuously transformed, at three different levels. At the highest level of aggregation, the relative importance of agriculture declines while that of industry and probably also services rises. A second level on which structural change occurs is within the manufacturing sector, as new industries emerge while older ones become relatively less important. A third level of structural change, discussed in the next section, involves the replacement of smaller with larger plants in manufacturing.

Four factors stimulate structural change at all these levels. The first is changing patterns of demand, including both final demand (foreign as well as domestic) and intermediate demand. Second, capital accumulation alters the relative efficiency (comparative advantage) of different sectors, industries, and plant sizes. Third, technological change, usually initiated by the importation of technologies from abroad, affects the productivity of resources in different uses, thereby inducing intersectoral resource flows. Fourth, government policies either promote or inhibit the growth of particular sectors, industries, and scales of production.

The overall tendency is for structural change to equalize the returns to inputs across sectors and scales of production, thereby improving the efficiency of resource allocation. In economic theory, a resource is allocated efficiently when it yields the same marginal rate of return in all its possible uses. Market imperfections in low-income countries cause the productivity of both labor and capital to vary widely among sectors, industries, and individual enterprises. Economic development narrows all these differentials; the marginal productivity of each resource is more nearly equalized in its various uses.

In successful economic development, industrial value added grows faster than gross domestic product (GDP). Investment is concentrated on

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the industrial sector. Agriculture, initially the dominant sector, gradually releases labor, land, and other resources to industry and services. These transfers require important changes within all three sectors. Labor productivity in agriculture must rise so that the sector can continue to feed the population yet release labor to the other two sectors. Changes in cropping patterns, technologies, and farm units are needed for this to occur.

Economic development is thus a complex process involving all sectors of the economy. Yet, except for a few oil-rich economies that have been able to achieve high levels of per capita income with minimal structural change, the industrial sector has been the main engine of economic growth in virtually all countries that have developed so far. While the service sector also usually expands in relative terms, its growth is strongly dependent on that of the industrial sector (Park and Chan 1989). The rise of industrial value added as a share of GDP is particularly strong during the phase of development in which gross national product (GNP) per capita rises from about $500 to $6,000 (Syrquin and Chenery 1989b).[2] Three-quarters of all the structural change that takes place between the lowest and highest observed levels of income occurs within this income range. As the production structure changes, the shares of available labor and capital resource supplies absorbed by industry and its subsector, manufacturing, also increase.

Although structural change is continuous up to very high levels of development, research has identified important differences in the pattern at high, medium, and low levels of per capita income (Chenery and Syrquin 1986).

Primary Production Phase

In low-income countries (those with GNP per capita below $600 in 1990), primary products are a large share of tradable goods production. The agricultural sector often contains large amounts of underemployed labor and thus has low output per worker. Economic growth tends to be slow, in part because technological and natural resource constraints usually hold the growth of agricultural output to 4 percent or less per year.

Even if manufacturing grows rapidly in a low-income economy, its small sectoral share limits its contribution to overall economic growth. In this early phase of development, the main sources of growth are increases in the supplies of capital and labor resources. Total factor productivity (TFP), a measure of the productivity of all resources used in production, grows slowly and contributes little to output growth.[3]

Industrialization Phase

To enter the middle-income group ($600–$7,500 per capita), a country must grow faster than others in the low-income group. The largest sectoral

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contributors to such rapid growth are typically manufacturing, services, and social overheads (construction; electricity, gas, and water; transportation; and communication). But the growth of services is limited by a domestic income elasticity close to one[4] and by the difficulty of exporting, whereas social overheads require heavy investment. This leaves manufacturing as the key to economic growth during the middle phase of development, although agriculture plays an important supporting role by widening the domestic market for manufactures, supplying food and raw materials, and earning foreign exchange.

TFP growth, especially in manufacturing, becomes a more important source of growth during this phase. The relative contributions of the growth of capital and labor resources fall slowly—in the case of labor, partly because of the demographic transition (Syrquin 1986). Before a country is fully developed, TFP growth has become the most important source of economic growth.[5]

The Developed Economy

In this final phase the income elasticity of demand for manufactured goods declines. Exports may maintain manufacturing's shares in GDP and employment for a while, but ultimately both decline in relative terms. Resource growth contributes less to economic growth (the labor force may have stabilized), and TFP growth (now less concentrated in manufacturing) becomes the main driving force behind economic growth.

Table 4 shows the cross-sectional relationship between economic structure and GNP per capita. In 1990 manufacturing's value added share was over twice as great in an upper-middle-income country with GNP per capita of $2,500–$7,500, as that in the average very-low-income country with less than $250 per capita. But high-income countries with per capita GNP above $7,500 (once known as the "industrialized countries") now derive the same share of GDP from manufacturing as the upper-middle-income countries. In 1990, the GDP share of industry broadly defined peaked at 45 percent of GDP on average in the upper-middle-income group and fell to 36 percent in the high-income countries, which derived 61 percent of their GDP from service activities. The richest economies are now significantly less dependent on industry and manufacturing than they once were, partly because of demand shifts (the income elasticity of demand for services is generally higher than the income elasticity of demand for goods at high-income levels) and partly because of shifts in comparative advantage. Yet industrialization remains a key element of economic development from low- to upper-middle-income levels.[6]

Although intersectoral shifts in the allocation of capital and natural resources are harder to trace, the dramatic reallocation of labor force that typically accompanies development is well documented. In cross-sectional

TABLE 4 Sectoral Value Added as a Percentage of GNP, 1990

Development category (GNP per capita in $)	No. of countries[b]	Sector (% of GNP)[a]			
		Agriculture	Industry	Manufacturing[c]	Services
Low income					
250 or less	14	47	16	9	36
250–600	21	31	27	15	43
Lower middle income					
600–1,200	18	21	30	17	49
1,200–2,500	18	13	37	18	50
Upper middle income (2,500–7,500)	14	9	45	21	47
High income (7,500 or more)	16	3	36	21	61

NOTES:
a. In unweighted averages.
b. Includes only World Bank member countries with populations greater than one million for which data are available.
c. Manufacturing is a subsector of industry, which also includes mining, construction, and public utilities.
SOURCE: World Bank, *World Development*, 1992: 222–23.

TABLE 5 Sectoral Employment as a Percentage of Total, 1985–1988

Development category (GNP per capita in $)	No. of countries	Sector (% of total)[a]		
		Agriculture	Industry	Services
Low income				
250 or less	18	78	7	15
250–600	25	64	9	28
Lower middle income				
600–1,200	20	50	15	35
1,200–2,500	21	33	22	45
Upper middle income				
(2,500–7,500)	17	26	22	53
High income				
(7,500 or more)	24	7	23	70

NOTES: Countries are classified according to their development category in 1987.
a. In unweighted averages.
SOURCE: United Nations Development Programme 1991: 150–51, 183.

data for 1985–1988 (Table 5) employment in industry, initially less than 10 percent of labor force, rises to 22 percent at around $1,000 per capita, then remains essentially stable. Employment in services now increases dramatically throughout the range of economic development, from 15 percent in the poorest countries to fully 70 percent in the richest.

These structural shifts are accompanied by important changes in relative factor productivity in the three major sectors. As first noted by Chenery and Syrquin (1975), in low-income countries output per worker in the agricultural sector is far below the economy-wide average while output per worker in industry and services is far above the average. As GNP per capita rises, output per worker in agriculture dips still farther below the (rising) economy-wide average for a time, while output per worker in industry and services comes closer to the average. In time, however, as labor continues to be drawn out of agriculture, output per worker in that sector rises, approaching the economy-wide average. In a developed country, intersectoral differences in output per worker are much smaller. Average productivity in industry and services is close to the all-economy average, while agriculture, by now a small sector, still has below-average productivity. Table 6 and Figure 1 depict the cross-sectional relationship in 1985–1988.

Although value added per worker is a crude measure of productivity and relates to average rather than marginal productivity, the pattern just described suggests that the reallocation of labor (and by extension other resources) that occurs in the course of development improves efficiency. A

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TABLE 6 Value Added per Worker, 1985–1988

(expressed as a ratio of average value added per worker in the economy)

Development category (GNP per capita in $)	Sector (value added/worker[a])		
	Agriculture	Industry	Services
Low income			
250 or less	0.6	2.8	2.6
250–500	0.6	2.7	1.5
Lower middle income			
500–1,000	0.4	2.3	1.5
1,000–2,000	0.5	1.6	1.1
Upper middle income (2,000–6,000)	0.4	1.7	1.0
High income (6,000 or more)	0.7	1.6	0.8

NOTES: Countries are classified according to their GNP per capita in 1987. Four "high-income oil exporters" with exceptionally high GNP per capita (Libya, Saudi Arabia, Kuwait, and United Arab Emirates) are excluded from the data set.
a. Expressed as a ratio of average value added per worker in the economy.
SOURCES: World Bank, *World Development Report*, 1987–1990; United Nations Development Programme 1991.

low-income country employs capital and human resources in different uses at widely varying rates of return, thus inefficiently. In a developed economy there are fewer barriers to intersectoral flows, so rates of return are more nearly equal across the range of possible uses.

Systematic variations in these patterns arise both from differences in "initial conditions," particularly country size and natural resource endowments, and from strategic and policy choices made by governments (Chenery and Syrquin 1975; Chenery et al. 1986; Syrquin and Chenery 1989b). More populous countries have larger domestic markets at given levels of per capita income and are likely to possess a wider range of resources. They thus tend to be more self-reliant than small countries, which must specialize in production and export surpluses of goods that they can make particularly efficiently in exchange for domestically consumed goods that are less efficiently produced at home.

Production and trade patterns are also strongly influenced by natural resource endowments, particularly in small countries. Valuable mineral resources and ample land that can be devoted to crops or grazing lead a country to rely more on primary exports at all levels of development. Small countries that lack natural resources base their development on capital, human resources, and technology. They often export manufactures, beginning with simple labor-intensive products and later moving up to more skill-intensive and high-tech products. Japan, South Korea, and the

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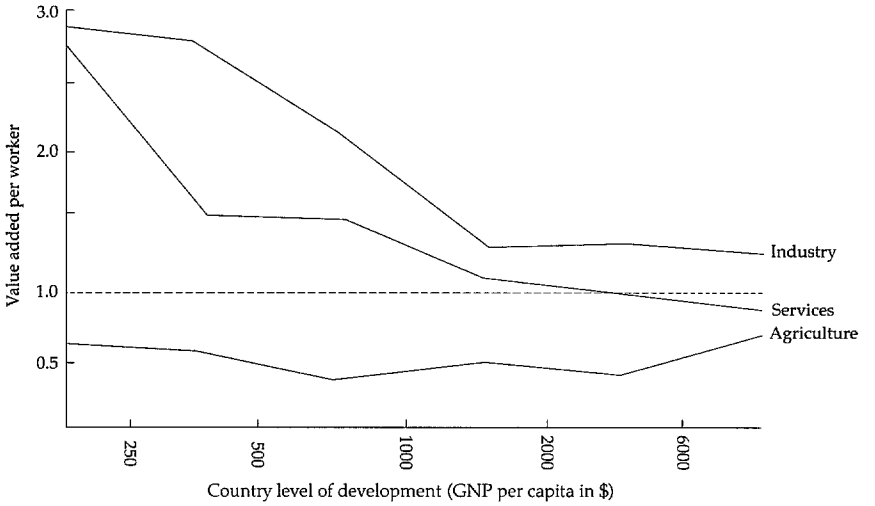
FIGURE 1 Labor Productivity Index, 1985–1988



SOURCE: Author.

city-states of Hong Kong and Singapore all developed rapidly by substituting high-quality human resources and an ability to absorb and adapt new technologies for the natural resources that they lacked.

Structural Change within Manufacturing

As incomes rise, demand patterns change. Although the production structure need not match demand perfectly in an open economy, most services and some goods are nontradable (they must be produced where they are consumed), and domestic producers enjoy cost and other advantages in the production of many tradables. In practice, therefore, demand and production structures are closely linked.

Private consumption is by far the largest component of demand, even though its GDP share typically falls from nearly 80 percent to around 60 percent as a country develops (Syrquin and Chenery 1989b). Food consumption falls sharply (typically from 39 percent of GDP to 15 percent) and is partially replaced by nonfood consumption, which normally rises from 40 percent of GDP to 45 percent. Manufactures, particularly consumer durables, take a growing share of private consumption.

The GDP shares of investment and government consumption both rise as countries develop. Investment typically goes from 14 percent of GDP to

26 percent, while government consumption edges up from 12 to 14 percent. Investment's growing share of total demand impacts more on the construction industry, which supplies about 60 percent of investment goods, than on manufacturing.

Production becomes more roundabout as a country industrializes. A rising share of output is bought by other producers rather than final users. On average, intermediate use rises from 33 percent of gross output to 43 percent (Chenery and Syrquin 1986). Use of intermediate products in agriculture goes from less than 20 percent of gross output to nearly 50 percent. Greater use of manufactures as inputs in all sectors of the economy is an important source of demand growth for the manufacturing sector.

A third major cause of industrialization is the transformation of international trade. The opportunity to export frees a country from the domestic demand constraint, permitting it to raise production of particular items faster than domestic consumption and even to produce items that are not consumed in significant amounts at home.

As a country develops, its comparative advantage shifts from primary products toward manufactures. Reasons include accumulation of human and physical capital, growing availability of intermediate products, and economies of scale created by a growing domestic market for manufactured goods (Chenery and Syrquin 1986: 63–64). While the newly industrializing economies (NIEs) of East Asia have registered the most dramatic gains in manufactured exports, many other countries have benefitted from a shift to a more neutral trade policy that permitted rapid growth of manufactured exports.

The early work of Chenery and Lance Taylor (1968) on growth patterns for two-digit manufacturing industries was updated by Syrquin and Chenery (1989a). Because some industries are far more accommodating to SMEs than others, understanding structural change within manufacturing is important for our concerns. Two-digit manufacturing industries can be sorted into early industries, middle industries, and late industries.

Early industries (food; beverages and tobacco; textiles and clothing) supply the essential needs of the poor, generally using simple technologies. In low-income countries, they make up more than 50 percent of the manufacturing sector. The income elasticity of demand for their products averages around 1.0; their share of total consumption thus changes little as income rises, while their share of GDP falls slowly. As other industries grow at higher rates, early industries' share in manufacturing value added usually declines to 25 percent or less.

Middle industries (wood and wood products; chemicals and rubber products; nonmetallic minerals) typically go from 3 to 6 percent of GDP as per capita income rises from $300 to $1,000, then remain a constant share of

GDP. Chenery and Taylor found that these industries account for 40 percent of the increase in the industrial share in large countries from $300 to $1,000 but contribute little to industrialization thereafter. Half the output of middle industries consists of intermediate inputs into other industries; the other half is finished products with income elasticities of 1.2 to 1.5. Much of their growth in the $300–$1,000 range results from import substitution.

Late industries (paper and printing; basic metals; metal products and machinery) keep growing faster than GDP up to the highest income levels. They produce a mixture of investment goods (machinery), intermediate products (for example, paper and printing), and durable consumer goods with high-income elasticities of demand (for example, metal products). After per capita GNP passes $750, these industries account for 80 percent of the increase in industry's share. In low-income countries they typically contribute no more than 2 percent of GDP, but in industrial economies their share can be 10 percent or more.

These patterns can be affected by differences in initial conditions or by government policies. In larger countries, economies of scale can be achieved at lower income levels than in small countries. Industries that emerge sooner in large countries as a result are basic metals, chemicals and petroleum, paper, and some types of metal fabricating (for example, automobiles).

Small countries with strong natural resource endowments rely more on primary product exports than either large countries or small, natural resource–poor countries and thus have less manufacturing at each level of GNP per capita. The industries whose emergence is thus delayed are basic metals, paper, rubber, chemicals, textiles, wood products, and metal products.

National development strategies and policies also affect industrial structure. Countries select different roads to industrialization, as the contrasting experiences of South Korea and Taiwan indicate (Chapter 7).

STRUCTURAL TRANSFORMATION AND THE CHANGING ROLE OF SMEs IN MANUFACTURING

Two important changes typically occur at the firm level over the course of development.[7] First, average plant or firm size (however measured) increases. This happens within most industries as markets expand, owing to a number of factors discussed below. Average firm size in the entire economy is further affected by a shift in the product mix toward industries with strong economies of scale. Second, the wide interindustry and scale-

related differentials in wage rates and economic performance observed in low-income countries narrow as income per capita rises. As income levels approach those of advanced countries, only small, if persistent, differentials remain. SMEs in developed countries earn about the same long-term profit rates as large firms, even in highly concentrated industries.

Rising Average Firm Size

Many studies find a negative correlation between the level of development (income per capita) and the relative importance of small producers, particularly very small enterprises (Hoselitz 1959; Staley and Morse 1965; Anderson 1982a and 1982b; Biggs and Oppenheim 1986; Cortes, Berry, and Ishaq 1987; Little, Mazumdar, and Page 1987). This reflects a transformation in the organization of production as development proceeds that is marked by gradual decline in the competitiveness of the traditional or craft technologies upon which most small firms in low-income countries rely.

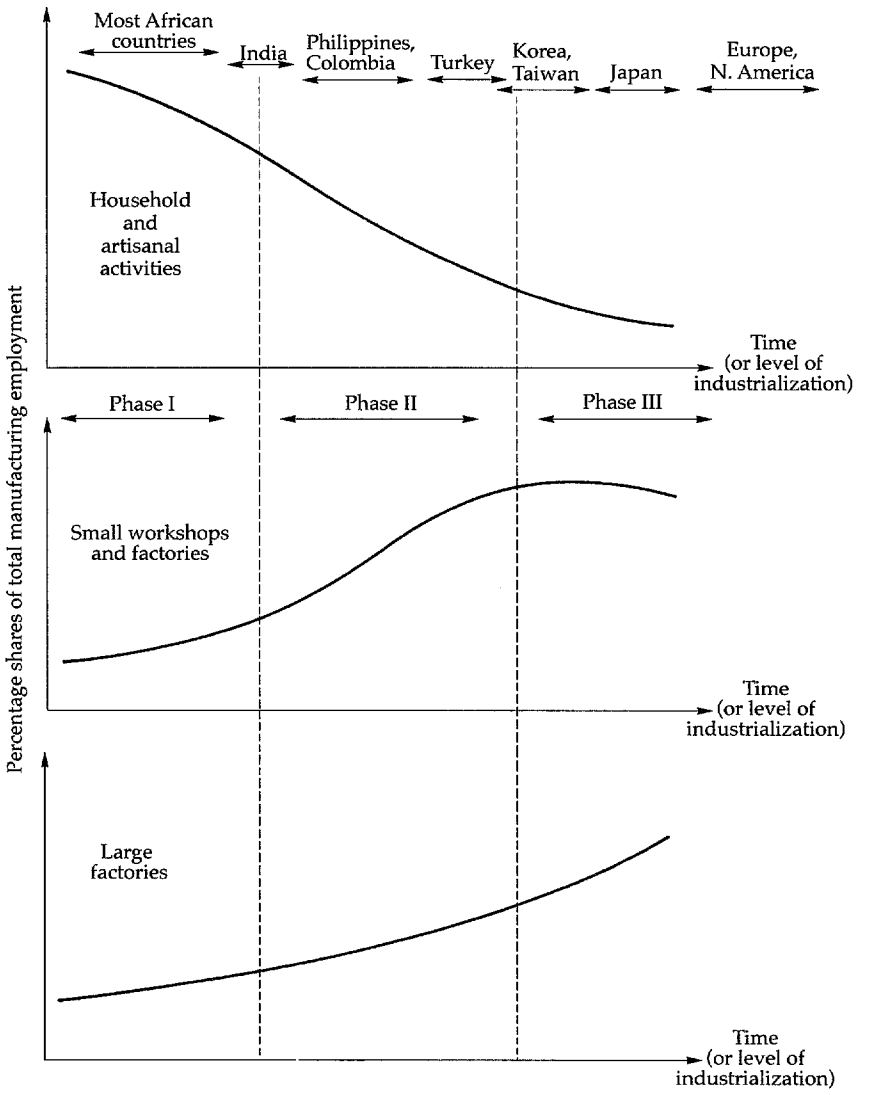
Comparative cross-country studies of manufacturing have established uniform patterns in this competitive transformation of the size distribution of enterprise (Staley and Morse 1965; Anderson 1982a and 1982b; Biggs and Oppenheim 1986). At an early stage of development, household or cottage shop manufacturing (roughly 1–4 workers) generally predominates (see Figure 2). As income per capita rises, these microenterprises are gradually displaced, first by small factories (fewer than 100 workers) and later by larger units. Recently, however, some of the countries that have achieved rapid growth in total manufacturing employment (for example, Korea, Malaysia, and Singapore) have bypassed the small-factory stage and moved directly from cottage shops to large, labor-intensive enterprises (Little, Mazumdar, and Page 1987: 13).

Despite such variations among countries, industries, and regions (Anderson 1982a), small-scale enterprise (1–19 workers) invariably plays a declining role as countries develop. The average manufacturing establishment is two to three times as large in high-income countries as in low-income countries. Evidence from industrial censuses taken in thirty-four countries shows the negative relationship between economic development and the importance of small plants (Table 7). Where per capita income is less than $1,000, 50 percent or more of manufacturing employment is typically in cottage enterprises. As income approaches $2,000 per head, microenterprises fall to 10 percent of manufacturing employment and large-scale producers become dominant in most cases. Time series data for thirteen countries confirm this view (Table 8).

Determinants of Firm Size Distribution

Several factors determine firm size distribution. We describe eight factors here.

FIGURE 2 Changes in the Size Structure of Industry over Time



SOURCE: Anderson 1982b: 918.

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TABLE 7 Cross-sectional Distribution of Employment, 1985–1988

GNP per capita ($)	No. of countries	Percentage of total employment			
		Cottage shops (1–4)	Small (5–19)	Medium (20–99)	Large (100+)
100–500	6	64	7	4	25
500–1,000	7	41	12	10	37
1,000–2,000	7	11	13	14	61
2,000–5,000	9	8	11	17	64
5,000+	5	4	6	20	70

NOTE: Data based on industrial census data from thirty-four countries, mainly in the 1960s and 1970s.
SOURCE: Compiled from industrial censuses for the countries concerned.

Market size and specialization: The question of why production shifts from small to large units goes back at least to Adam Smith (1776) and is thus one of the oldest questions in economics. Smith's famous answer was that larger firms gain competitive advantage by capturing the gains from specialization ("division of labor"), but their ability to do so is limited by the extent of the market. He celebrated the productivity gains associated with the shift from household production (in which a single craftsman performs all the operations necessary to make a product—in Smith's example, a pin) to small factory production (in which the manufacturing process is divided into distinct operations). This facilitates supervision of the work and permits each task to be performed faster and more expertly than before. Gains are realized from specialization on routine tasks, the assignment of individuals to jobs that exploit their respective talents, and reductions in time lost in switching from one task to another. These gains depend solely on the reorganization of work to raise productivity and require no changes in the engineering descriptions of the operations performed, in the workforce or in the tools used. The shift from cottage industry to unmechanized factory production in the early stage of industrialization in the American northeast raised productivity by more than 20 percent (Sokoloff 1984).

As the market expands, greater specialization becomes possible and continuing subdivision of tasks induces mechanization. This in turn creates economies of scale and multiplies the productivity gains from shifting to factory production. In early U.S. manufacturing, small mechanized factories were at least 40 percent more productive than cottage shops (Sokoloff 1984). Economies of scale were much greater in mechanized

TABLE 8 Changes in Distribution of Employment over Time

Country	Year	GNP per capita ($)	Percentage of total employment: Cottage shops (1–4)	Small & medium (5–99)	Large (100+)
1. El Salvador	1961	430	48.6	21.5	29.9
	1971	526	39.1	28.4	32.5
2. Peru	1963	573	18.2	46.3	41.5
	1973	705	14.8	22.8	62.4
3. Colombia	44/45	—	66.5	13.7	19.8
	1953	502	59.2	18.9	20.3
	1964	547	51.4	23.7	24.9
	1970	646	53.6	24.7	21.7
	1973	722	50.4	28.3	21.5
	1978	760	42.5	24.0	28.7
4. Korea	1958	332	—	—	—
	1963	356	17.0	40.0	33.0
	1975	810	15.0	42.0	43.0
	1977	980	4.0	22.0	74.0
5. Mexico	1960	540	18.7	26.9	54.4
	1970	900	12.6	19.6	57.8
	1975	1,000	11.2	26.4	62.4
6. Taiwan	1940	—	25.3	74.7	—
	1954	519	18.0	36.0	47.0
	1961	603	15.0	34.0	51.0
	1971	1,180	3.0	33.0	64.0
7. Panama	1961	732	19.4	39.1	41.5
	1971	1,225	4.4	36.3	59.3
8. Costa Rica	1963	849	31.9	40.2	27.9
	1975	1,287	6.4	27.3	66.3
9. Brazil	1959	—	8.6	26.0	65.4
	1970	901	7.0	27.3	65.7
	1975	1,306	5.6	28.8	65.6
10. Argentina	1964	1,454	19.9	29.8	50.4
	1974	1,945	14.9	26.3	58.8
11. Japan	1955	1,454	20.0	40.2	39.8
	1965	3,255	16.1	37.1	46.8
	1975	6,182	19.1	36.6	44.3
12. Canada	1950	—	2.9	31.2	65.9
	1955	—	2.8	30.5	66.7
	1959	—	2.5	31.9	65.6
13. USA	1947	—	1.1	23.9	75.0
	1967	7,450	1.1	22.3	76.6
14. Philippines	1967	—	77.8	7.2	15.0
	1975	—	66.0	8.0	26.0

NOTE: Dash indicates data not available.
SOURCE: Census of Manufactures data, various years.

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plants. Although nonmechanized factories deriving their competitive advantage solely from the division of labor were 20 percent more productive than cottage shops, as noted earlier, economies of scale in their technologies tended to be exhausted around the twenty–employee level.

Engineering data for industries like cement, steel and other metal products, and chemicals indicate substantial scale economies (cost reductions of 30–60 percent) over size ranges relevant for many developing countries (Teitel 1975: 98–99). In other industries, cost reductions of 20 percent were achieved as scale increased.

In low-income countries some markets are so small that production by specialized firms is not viable. The cost advantage of factory production over cottage or household production can be realized only as markets expand (because incomes increase, transportation costs decline or the government lifts restrictions) and additional opportunities for specialization and mechanization arise.

In the history of advanced countries, competitive displacement of cottage production took about 100 years to complete. For some twentieth-century developers the transition has been much faster. In Taiwan, the share of cottage producers in manufacturing employment fell more than 90 percent in just twenty years. Fast-moving changes on the demand side, far-sighted state policies to develop infrastructure, and efficient factor and product markets all contributed to the rapidity of the shift. Most important, however, Taiwan was able to shift factory cost curves down quickly by adopting superior technologies acquired from advanced countries. Since the production costs of cottage enterprises remain unchanged during such a transition, factories enjoying falling costs can quickly boost their shares of markets once dominated by cottage producers.

Factories also carry out a wider range of activities than cottage shops, including purchasing and storing materials, transforming materials into semifinished products and semifinished products into finished products, extending credit to buyers, and marketing and distributing. Some of these activities are subject to increasing returns and others to decreasing returns. As markets expand, firms concentrate more on the activities that they can pursue most efficiently and leave other functions to a growing number of firms specializing in accounting, marketing, and distribution services.

The ability of larger firms to exploit economies of scale[8] and scope[9] provides the classic explanation for their growing dominance as markets widen. Jacob Viner's rigorous investigation of cost curves (1931) demonstrated how technology and market size influence a firm's costs and thereby its level of operation. Higher production levels vindicate investments in cost-reducing technologies and allow workers to become more specialized. At some point in the firm's expansion, however, unit costs normally bottom out and then turn up. Viner cited diminishing returns to some fixed factor of production as the reason for this cost upturn. If for any

reason costs do not increase, the largest firm is likely to monopolize the product market.

Small markets limit specialization and impede realization of scale economies. Several studies have shown that plant and firm size are sensitive to the size of the national market. Given minimum efficient scale (MES) in any industry, market size (the amount of output that can be absorbed) limits the feasible number of establishments.

F. M. Scherer (1973) showed that when national market demand is fragmented by barriers such as high transportation costs or is exceedingly small for reasons such as small population or low income, the growth of establishments can be held below the optimum, with detrimental effects on technical efficiency. Frederic Pryor (1972) and Richard E. Caves, Michael E. Porter, and A. Michael Spence (1980) found that industrial concentration ratios are higher in smaller markets and that this reduces competition and efficiency. Industrial concentration (the market share of the largest firms) is higher across the board in developing than in developed countries, probably because of smaller markets (Kirkpatrick, Lee, and Nixson 1984: 75). High costs of transportation, communication, and information, along with regulatory barriers, often fragment markets in developing countries, widening "survival space" for less efficient producers. Not only are firms kept from reaching optimal production scales but the diffusion of more advanced production technologies is constrained, providing protection for traditional technologies.

The Smith-Viner technology-based story about the development of the firm is not, however, the sole reason why large firms tend to replace small ones in the course of economic development. Other important influences on firm size have been suggested.

Random shocks and historical accidents: The skewedness of firm size distributions—a few large firms, more medium-sized ones, and many small ones—has led some analysts to suggest that these distributions are generated by an accumulation of stochastic (random) events (Mansfield 1962; Simon and Ijiri 1964; Ijiri and Simon 1977). According to this view, industrial concentration reflects an accumulation of random events or historical accidents that permitted a few firms to grow large.

Firm size differences within industries: How can different sized firms coexist within particular industries? If scale were determined entirely by efficiency (cost) considerations, all firms would gravitate to the level of operation at which long-run average cost is minimized; smaller or larger firms would be eliminated by market competition. Joe Bain (1956, 1966) showed that in some industries cost curves are L-shaped: increasing returns exist up to some MES, followed by constant returns. This permits firm size to range from the MES up to a scale determined by the extent of the market in a steady-state equilibrium.

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Bain did not explain how firms smaller than MES can exist. Investigating this question, F. M. Scherer (1973) found that L-shaped cost curves and other factors such as limited market size, high transportation costs, and product differentiation cause establishments within industries to be both above and below MES. Others attribute heterogeneity within industries to imperfect competition (Eastman and Stykolt 1967) or fluctuating demand (Mills and Schumann 1985).

In developing countries, technological dualism explains much variation in firm size within industries. Establishments of different sizes can coexist in an industry if some have adopted newer, probably foreign, technologies while others still employ traditional techniques. The newer technology is likely to be more capital-intensive and thus associated with larger scale production, while the older technology is used by smaller scale producers. Such dualism is possible if (1) the products are not exact substitutes but differ in some important respect; (2) the older technology is technically less efficient but survives because of limited market size or market fragmentation resulting from low demand, high transportation costs, limited information, or government policies that restrict entry to portions of the market; or (3) the traditional technique is technically efficient but allocatively inefficient and coexists with the advanced technology at distorted factor prices; that is, firms using the old technology face lower labor costs and higher capital costs.

In low-income countries firm size runs the gamut from tiny traditional firms that use almost no capital to modern corporations that employ capital-intensive technology. As discussed in the next subsection, "Declining Interfirm Differentials," technological dualism in developing countries is largely a disequilibrium or transitional phenomenon, part of a development process that progressively reduces market distortions and imperfections and gradually diffuses advanced technology, which reduces the viability of older technologies and ultimately puts them out of business.

Technology influences average firm size in two ways: (1) *Between industries*, the production structure shifts toward products for which average establishment size is larger because of economies of scale. (2) *Within industries*, average size rises if cost curves exhibit constant or increasing returns as elements of dualism recede. Random processes and market size are intervening influences in both cases.

The importance of between-industry effects on the firm size distribution is suggested by the stability of rankings of industries by average establishment size across countries and through time. Ranadev Banerji (1978a) found that rank orderings of two-digit industries by firm size were similar across twenty-three developing and developed countries, even though average establishment size differed greatly. As noted earlier, heavy industry becomes relatively more important as per capita income rises.

TABLE 9 Share of Employment and Value Added in Small Establishments and Heavy and Light Industries

Country dev. level and industry group	Industry share: Value added (% of total)	Industry share: Employment (% of total)	Small-Establishment share[a]: Value added (% of total)	Small-Establishment share[a]: Employment (% of total)
Lower-income countries				
Light industries	62	70	37	50
Heavy industries	38	30	22	37
All manufacturing	100	100	31	46
Higher-income countries				
Light industries	41	44	33	36
Heavy industries	59	56	13	15
All manufacturing	100	100	31	24

NOTE: a. Computed as weighted averages of industries within each group.
SOURCE: Author.

Table 9 shows that smaller establishments (firms with fewer than fifty employees) are far less significant in heavy industries than in light industries, presumably for technological reasons. Moreover, the small-firm shares decline in both types of industry as income rises. The reduced importance of small establishments at higher levels of per capita income reflects both within-industry changes in the size distribution of establishments and the rise of industries in which small establishments are less important. A simple fixed-weights decomposition of the difference in shares of small establishments in employment between high-income and low-income countries indicates that the interindustry or product-mix effect accounts for about 20 percent of the growth in average size of establishment.[10]

Infrastructure costs: Other important links between establishment size and market size are the influence of transportation and other nonproduction costs on market size (and thus firm size), the effects of foreign trade, and fluctuating demand. If transportation and communication costs were zero, optimum plant size would depend entirely on production cost functions. High transportation and communication costs limit establishment size and make it harder for firms to realize economies of scale in production. Optimal plant size is positively related to population density and income level and negatively related to transportation and communication costs.

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Foreign trade: Domestic market size has less influence on the size of the individual enterprise when local producers can overcome the substantial transaction costs involved in exporting or when import competition is effective. Evidence from many countries confirms that industries exposed to trade have different firm size structures from those that are sheltered. Caves, Porter, and Spence (1980) found that the average establishment is significantly larger, relative to the optimum efficient scale for the local market, in industries with access to export markets. Many country studies indicate that firm size is positively associated with the percentage of sales made to foreign buyers.

In most industries, the largest firms supply most of the exports (Rapp 1976 for Japan; Glejser, Jacquemin, and Petit 1980 for Belgium; Auquier 1980 for France; Hannah and Kay 1977 for Great Britain; Ho 1980 for Korea; Caves 1985 for the United States). The high and essentially fixed costs of entering overseas markets are an entry barrier for small firms. In addition, access to export markets permits fuller realization of economies of scale, so firms that export tend to grow larger. If small firms export at all, they generally export a high proportion of their output (Caves 1987).[11]

Opening a domestic market to competition from imports should have the same effect as pressure to compete in export markets. Domestic producers challenged by imports may try to differentiate their products or seek tariff protection that will shelter them from the increased competition. If successful, they may be able to keep domestic prices high enough to permit inefficient technologies and suboptimal scales to survive.

Demand fluctuations: Fluctuating demand may help smaller firms survive, even if they have lower static efficiency than larger firms (Mills and Schumann 1985). Small firms may have an advantage in small but profitable specialized niches of differentiated product markets, where division of labor is limited by the need to be flexible. Concentration on such niches may enable them to offset size-related disadvantages and realize high returns based on mobility barriers (Mansfield 1962). Small firms may also be more responsive to demand fluctuations. If available technologies offer a trade-off between static efficiency and flexibility, small firms may be able to survive despite higher minimum average cost by staying flexible and absorbing a disproportionate share of industry demand fluctuations (Mills and Schumann 1985). Because flexibility is achieved by relying more on variable factors of production and less on fixed capital, it can be a successful strategy for SMEs. Similarly, the NIEs have found that they often can compete more effectively in products and market niches with highly fluctuating demands by adopting flexible production technologies.

Human capital and other scarce factors of production: Although pervasive, economies of scale are limited by scarce factors of production. Entrepreneurship and managerial talent cannot always be multiplied as the

firm expands (Baumol 1962; Prescott and Visscher 1980). R. Kihlstrom and J. J. Laffont (1979), as well as W. Y. Oi (1983), argue that differences in entrepreneurial ability limit firm growth and create a variety of firm sizes and organizational structures within particular industries. Oi believes that abler entrepreneurs lower costs through superior managerial coordination and monitoring, permitting their firms to grow larger than those run by less capable managers. He suggests that as entrepreneurial ability is enhanced through education and experience, larger firms become possible.

Robert E. Lucas, Jr., (1978) notes that people with entrepreneurial talent must choose between running their own firms and becoming hired managers. Growing demand for hired managers as a country develops raises the opportunity cost of running one's own small business. This is yet another reason why the number of small firms declines. Based on a cross-sectional analysis of industrial census and labor force survey data for thirty-four countries, Richard Caves and Masu Uekusa (1976) found that self-employment in manufacturing falls as per capita income rises to $5,000–$6,000 per capita, then flattens out.

Transaction costs: The technological/market size view of the firm neglects the role of institutional factors in determining firm boundaries. The institutional (contractual) view of the firm takes the transaction as its basic unit of analysis. Transactions are exchanges that require explicit or implicit contracts. Since such contracts are costly, we can speak of transaction costs, defined by Kenneth Arrow (1969) as "costs of running the economic system." Following Ronald H. Coase (1937), Oliver E. Williamson (1975, 1985) theorizes that firms are organized to minimize the sum of production costs and transaction costs. Transaction costs are economized by assigning transactions to appropriate "governance structures" (organizational frameworks intended to safeguard the integrity of contractual relations). Large firms ("hierarchies," in Williamson's terminology) and small firms operating in spot market contracts are alternative "governance modes," with a number of mixed forms in between. The form of economic organization, in this view, depends largely on the transaction costs associated with allocating resources through markets or hierarchies and on contracting problems such as bounded rationality, opportunism, and asset specificity (Williamson 1985: 42).[12]

In the institutional view, problems of organizing transactions through spot market contracts influence the control, ownership, and integration of enterprises, and therefore their size. Coase (1937) was the first to suggest that the boundary between the firm and the market is determined by the relative cost (including transaction costs) of allocating resources through either the market or the firm. Caves (1987) argues that firm boundaries evolve in a Darwinian process: more efficient production units (accounting for transaction costs as well as production costs) gradually displace less

efficient ones. This process works differently across industries and through time. It also differs among countries, since the transaction-cost efficiencies of firms and markets are shaped by the level of development and "embedded" in the laws, culture, and social structure of specific countries. This explains the existence of distinctive national forms such as the Japanese *keiretsu* and Korean *chaebol*, as well as the subcontracting relationships characteristic of France, Japan, and Italy.

Large, quasi-integrated firms in Europe and East Asia represent organizational responses to common problems with spot markets. D. Encaouna and A. Jacquemin's (1982) work on corporate groupings in France and Caves and Uekusa's (1976) study of *keiretsu* in Japan both found that large, quasi-integrated firms (including banks, large suppliers, and subcontractors) are more common in industries with substantial scale economies, when there is a need to mobilize resources to overcome barriers to entry (notably research and development and large-scale or "lumpy" investments specific to the industry), and when mutual assistance is called for to deal with unexpected reverses.

Alfred Chandler (1977, 1990) shows how technology, market size, and transaction costs have interacted to raise average firm size and alter the form of business organization in the United States, Great Britain, and Germany. He demonstrates how differences in economies of scale and scope among industries, countries, and time periods were caused by differences in the technologies of production and distribution and in the size and location of markets. Innovations in production technology, changes in market size, and shifts of population to cities or suburbs continually alter the firm's environment and induce changes in production and related activities.

A broad hypothesis that grows out of this work on the "new institutional economics" is that as production costs fall in the course of economic development, transaction costs rise relative to production costs. Large, integrated firms thus become an increasingly efficient form of productive organization.

In developing countries, imperfections in both financial and commodity markets can motivate efforts to internalize transactions within business groups. Lawrence J. White (1974) notes that banks and insurance companies were added to Pakistan's industrial groups because financial markets were underdeveloped. The point applies equally to Latin American *grupos* (Corbo and de Melo 1985). Nathaniel Leff (1978) argues that industrial groupings in low-income countries also improve the otherwise poor allocation of inputs such as "honesty and trustworthy competence on the part of high-level managers."

Relations among firms in developing countries tend to be more informal than is assumed by transaction cost theory. Reliance is often placed on

a firm's reputation to sustain cooperation and efficiency. A firm that cheats risks losing profitable future deals. Reputation allows the firm to avoid the costs of writing formal contracts (Tirole 1988: 34), but it also exposes it to the threat of opportunism. Thus, one would expect informality to be most prevalent when specific investments are limited and exchanges are frequent enough to reduce the incentive to cheat.

For informality to work when specific investments are significant and cooperation in production is important (as in firm clusters), social support systems are required. This is why small business transactions in developing countries frequently occur among members of a single family or of an ethnic, a regional, or a religious group. In *Terza Italia* (The Third Italy—the region that lies between the developed north and less developed south), stable, relatively tightly knit communities have, in effect, a comparative advantage in stabilizing patterns of cooperation among numerous small firms that earn joint rents. By bringing shared values to bear on the informally transacting parties, they narrow the range of uncertainty and track the entrepreneur's reputation for fair bargaining and postcontract performance (Goodman and Bamford 1989). Heterogeneous or highly mobile "melting pot" societies are much less able to use reputation as a substitute for contracts or integration. Business communities such as the ethnic Chinese in Southeast Asia, Asians in East Africa, and Lebanese in West Africa have developed social sanctions that reduce transaction costs for small businessmen operating within the community. This kind of informal mechanism gives the community an advantage in competition with businessmen from other communities that is hard to duplicate or neutralize through public policy.

Declining Interfirm Differentials

Development economists have analyzed many different types of disequilibrium in developing countries: underutilized (surplus) labor (Lewis 1954; Chenery 1955; Jorgenson 1961; Kelley, Williamson, and Cheetham 1972); a "trade limit" to increased output that leads to underutilization of both labor and capital in some parts of the economy (Chenery and Strout 1966); technological dualism between the modern and traditional sectors (Jorgenson 1961; Nelson 1968; Eckaus 1955); financial dualism in domestic capital markets (McKinnon 1973; Krugman 1978). Here we note yet another type: the pervasive and persistent disequilibrium that exists among manufacturing enterprises.

Besides rising average establishment size as per capita income goes up, the second "stylized fact" noted earlier was narrowing variance in the economic performance of large and small firms. Factor productivities, long-term profit rates, and benefit-cost ratios summarize the economic

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performance of firms and serve as indicators of market disequilibrium. Export-to-sales ratios, product differentiation, production flexibility, product innovation, and other strategies indicate differences in market conduct. Both types of indicator register substantial but narrowing disequilibrium as firms are consolidated and smaller firms upgrade and develop competitive strategies to offset size-specific disadvantages.

Explanations for Intraindustry Differences in Performance

If profit rates and factor productivities reflect internal rates of return and marginal factor returns, respectively, for different sized firms in an industry, these rates should be roughly equalized in competitive equilibrium. Why, then, are systematic scale-related differences in performance observed? Possible explanations may or may not be consistent with the existence of a stable long-run equilibrium for the industry (Caves and Pugel 1980). Four steady-state explanations have been suggested for observed scale differentials: (1) large and persistent factor price differentials across firms of varying size; (2) scale-related differences in production functions; (3) strategic mobility barriers; and (4) scarce factors of production.

Persistent factor price differentials: Explanations citing persistent factor price differentials note that labor costs typically rise with firm size while capital costs typically fall. This leads to higher capital/labor ratios in large firms and thus higher labor productivity and wage rates. Charles Brown and his associates (Brown and Medoff 1989; Brown, Hamilton, and Medoff 1990) found that larger employers in the United States pay higher wages because they generally hire higher-quality workers (this accounts for about half of the scale-related wage differential) and are subject to heavier pressure from unions. L. F. Katz and L. H. Summers (1989) observed large steady-state wage differentials among industries (for example, export industries pay more than import-competing industries).

There is ample evidence that small firms pay more for capital. Small borrowers are riskier on average because they have higher rates of firm death and default and because the relative cost of acquiring information about a borrower and his project declines sharply with loan size.

Differences in production functions: Capital deepening in larger enterprises may also cause differences in the production function. When the production function is nonhomothetic[13] and factor price ratios also differ by scale of establishment, it is impossible to predict the exact relationship among scale, the capital/labor ratio, and the factor productivity ratios (Banerji 1978b: 63–64). Most studies speculate that differences in both production functions and price ratios increase capital intensity in larger firms and thus are responsible for a substantial part of the scale-related productivity differential.

Mobility barriers: Firms may find themselves unable, for various reasons, to take up strategic positions enjoyed by their rivals (Caves and Porter 1977). Like barriers that limit entry to an industry, mobility barriers restrict access to certain strategic positions within an industry, reducing the ability of some firms to earn higher profits. This permits members of particular strategic groups to out-perform other firms on a consistent basis. Strategic group membership does not have to vary with firm size, but it often does. Large enterprises with access to extensive capital assets, multiproduct production capabilities, and research and development and marketing prowess often attain profitable strategic positions in an industry (and also in exports) that are not open to small firms.

Scarce factors of production: Sustained efficiency differences based on scarce factors of production are another explanation for scale-related performance differentials. H. Demsetz (1973) and R. B. Mancke (1974) argue that significant and persistent differences in entrepreneurial and managerial ability contribute to a positive correlation between establishment size and economic performance. A firm that is more efficient than its rivals because it controls specific inputs not available to them (better managers, natural resources, or technology) can claim a larger share of the market and earn rents in the form of higher profits or factor returns.

Disequilibrium: Interfirm productivity differentials can also be traced to disequilibrium. Reasons why an industry might be out of equilibrium include changes in government policy, technology, or the many factors that determine transaction costs. If the shock favors large firms (because economies of scale and scope have increased), the number of firms may decline and the market share of large firms increase. Slow and incomplete adjustment to structural disturbances can result in continuing heterogeneity in firm size and performance. Adjustment lags occur when the costs of adjustment are high, when there are market imperfections, or when policy-induced distortions are present, reducing the effectiveness of market forces and protecting less efficient firms from market discipline. Efforts to shelter weaker firms can block or slow the transition process and leave a part of the labor force in low-productivity employment longer than necessary.

Technological diffusion: A supply-side disturbance that is fundamental to industrialization is technological diffusion. New technologies are imported into developing countries mainly by large domestic or multinational enterprises, after which they may filter down to smaller firms (Nelson 1968; Nelson, Schultz, and Slighton 1971). Technology diffuses unevenly because firms have differing technical and managerial capacities to absorb new production knowledge and machines, and also to deal with investment risk. Factor and product market imperfections, as well as

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policy-induced distortions, affect the pace of diffusion. At any given time, firms may be using technology of widely varying vintages.

The adjustment to technical change is not benign. As new technologies are imported and begin to be diffused, the profitability of less efficient techniques is progressively squeezed by falling product prices (assuming a downward-sloping demand curve and expanding output from adopters, whose costs have fallen). Because larger enterprises are more likely to possess the financial and engineering resources that favor quick adoption, the introduction of new technologies lowers their costs and hastens the displacement of cottage and small-scale production.

Several factors can slow the pace of adoption and create survival space for inefficient technologies. One is limited human resource endowments. Shortages of skilled engineers, managers, and technicians can slow the adoption of factory technology. Distortions in factor or product markets (for example, low labor mobility or wage rigidity) can also retard adjustment, or even suspend it (Jones 1971). Protection of product markets from foreign competition has similar effects. Subsidies for small firms also help them delay structural adjustment. Finally, the process can be slowed by capital limitations, which may require the economy to wait for adequate amounts of capital to be accumulated before it can shift all its workers into higher productivity units.

Difference between small firms in developed and developing countries: This final explanation for intraindustry differences in performance is often overlooked. Disequilibrium explanations for differences in economic performance are important in developing countries but not in high-income countries, where intraindustry differences between firms have been found to be quite stable over long periods and neither large nor small firms within an industry have consistently higher profit rates (Marcus 1968; Mancke 1974; Mueller and Hamm 1974; Caves and Pugel 1980). The heterogeneity found in developed countries (in firm sizes, performance, and conduct) is not explained, to any substantial degree, by disequilibria occurring within major sectors of the economy or enterprise size classes. Darwinian adjustment mechanics work more effectively in high-income countries because of their superior markets, physical and institutional infrastructure, and human capital. Some countries (for example, Japan) even formulate industrial policies to speed and smooth the adjustment process.

The smaller degree of intraindustry heterogeneity present in the high-income economy results largely from the strategic positioning of firms, mobility barriers, and differences in firm-specific assets. Small firms offset economies of scale and other advantages of large firms by competing in product-differentiated market niches, by innovating products, and by

adopting more flexible production technologies. In this way, they earn profit rates similar to those of larger firms, even in highly concentrated industries.

As per capita income rises, interfirm disequilibria narrow. The displacement of older technologies by superior technologies and the resulting redeployment of resources from lower to higher productivity activities raise average productivity. Meanwhile, rising incomes, growing international trade opportunities, and falling transportation costs all help shift demand toward the higher-wage, higher-productivity industries found in advanced countries. Gradually, traditional products and small dispersed production units are displaced or consolidated into a modern production system with much higher capital intensity and less heterogeneity.

Thus, structural transformation at the enterprise level involves not just rising firm size but also progressive reductions in the variance of enterprise performance. These reductions have occurred both in Korea, with a firm size distribution weighted towards very large enterprises, and in Taiwan, with a distribution weighted towards SMEs. Both countries have sharply reduced productivity differentials in the past two decades and benefited substantially from this move toward equilibrium.

The Transition in Factor Markets

Factor market imperfections allow many inefficient small producers to survive in the presence of superior technology. The large productivity differentials set out in Tables 10 and 11 show that in early stages of development a worker in a small firm (10–49 workers) produces on average 30–40 percent of what a worker in a large firm produces. This productivity disadvantage is offset, however, by a wage differential in favor of small firms, which pay, on average, only 30–40 percent as much as large firms (Table 12).

Discrimination in the capital market runs the other way: against small firms. Differences in loan contracts (interest rates, collateral requirements, and administrative requirements and fees) favor large enterprises beyond recognized risk premia. High information and transaction costs induce financial institutions in developing countries to ration credit and discriminate in loan contracts against small producers. Small firms may pay 50 percent more for credit than medium sized firms and 100 percent more than large firms. As financial markets become better integrated, these scale-related differentials decline. Even in developed countries, however, significant differentials remain between large and small firms in loan markets.

In early stages of industrialization, small producers, despite their inferior technologies, are protected by the large wage differentials in their favor. While labor is still plentiful, large firms can expand their

TABLE 10 Scale-Related Productivity Differentials in Manufacturing in Selected Countries

Plant size (no. workers)	India 1983	Philippines 1983	Thailand 1981	Colombia 1975	Korea 1976	Taiwan 1976	Britain 1967	France 1968	Japan 1967	USA 1967
	Value added/worker[a] (percentage)									
500+	100	100	100	100	100	100	100	100	100	100
100–499	71	71	74	73	71	66	97	91	72	90
50–99	53	48	59	52	58	52	94	87	53	83
10–49	40	41	36	32	40	51	92	85	47	85
1–9	28	10	28	34[b]	32	54	—	80	40	94[b]

NOTES: Dash means not available.
a. Value added/worker in 500+ plant size category is 100 percent.
b. For plant size of 5–9 employees.
SOURCE: Censuses of Manufacturing.

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TABLE 11 Productivity and Wage Differentials between Small and Large Firms in Manufacturing

Per capita income ($)	Wage differential (S/L)	Productivity differential (S/L)
300	0.40	0.38
900	0.46	0.36
1,800	0.51	0.48
9,000	0.68	0.64

NOTES: Small (S) = 10–49 employees; Large (L) = 500+ employees.
SOURCE: Estimated from industrial census data.

employment by offering better wages and working conditions, without forcing up the wages that small firms must pay. Later, as superior technology is diffused and economic growth occurs, demand pressures begin to be felt in the labor market. Wages for skilled labor usually rise first. Later, as surplus labor in agriculture disappears, real wages for unskilled labor begin to increase. After this "labor market turning point," small enterprises find that to recruit labor (and sometimes even to retain the workers they already have) they now have to raise wages. Since large firms were already paying a premium, their wages rise less rapidly. Unless small firms can find a way to match wage (cost) increases with productivity increases, their survival space contracts.

As labor moves to larger firms, some small firms survive by raising their prices, adopting more modern technology, or producing in industries where economies of scale are small, where demand fluctuations are large, or where firm-specific assets permit them to compete in product-differentiated niches. A few find the finance needed to expand and become large firms themselves. Many go bankrupt.

Interfirm wage differentials narrow rapidly at this stage of development. In Japan, the coefficient of variation of wage differentials among two-digit industries fell by more than half between 1951 and 1986 (Caves and Uekusa 1976). In Korea, the proportional variation among industries declined 50 percent during the 1950s. Narrowing wage differentials help shift labor to larger firms, which gain a cost advantage because they do not have to raise wages as fast as smaller firms.

Workers move to higher-productivity activities in three different ways: (1) new labor force entrants are disproportionately hired by higher-productivity segments of industry; (2) workers go from lower-productivity to higher-productivity units, that is, from cottage shops to factories; (3) some workers remain where they were but achieve higher productivity

TABLE 12 Scale-Related Wage Differentials in Manufacturing in Selected Countries

Scale of plant (no. workers)	India 1977	Colombia 1975	Korea 1970	Taiwan 1971	Italy 1978	Britain 1969	Japan 1982	France 1978	Germany 1978	USA 1983	Denmark 1978
	Average wage[a] (percentage)										
500+	100	100	100	100	100	100	100	100	100	100	100
100–499	60	68	82	77	93	90	83	86	92	74	97
50–99	43	52	75	71	}85	}92	}78	}83	}90	}67	}93
10–49	35	36	56	66							
1–9	30[b]	34[b]	45[b]	40							

NOTES: a. Average wage in 500+ plant size category is 100 percent.
b. 5–9 employees.
SOURCE: OECD 1985, Census of Manufacturing and for USA, France, Germany, Italy, Japan, Denmark, Britain.

through the adoption of superior technology, firm expansion, learning by doing, or a shift to higher-end products through new investment.

If enough better-educated new entrants are available, they are likely to supply most of the labor used in the more productive firms. But if the demand for labor in higher-productivity industries is too great to be satisfied fully by new entrants, large firms will be forced to reach down into the small-firm sector for additional labor. They may also wish to hire craft workers whose skills are more valuable to them than the formal education possessed by new entrants. The third adjustment path is likely to be least important because few small firms are able to respond successfully to the market pressure that they feel.

The Transition in Product Markets and the "Double Development Squeeze" on Small Firms

Technological diffusion and the downward-sloping demand curve put downward pressure on product prices. This combines with rising wages to create a "double development squeeze," in which small firms are pinched between rising costs and declining revenues.

Small firms virtually disappear in some industries but survive in considerable numbers in others. The outcome is influenced by income and price elasticities, by factors that protect production in small batches, and by capital/labor ratios. Basic wage goods like simple clothing, footwear, processed food, and soap products have relatively low income elasticities and high price elasticities. In early stages of development, they are generally produced in small batches in the villages and towns where they are consumed. As incomes rise and transportation costs fall, the natural protection of these small batch producers is stripped away. Cheaper factory-made goods enter their markets and displace traditional products. Industries in which labor intensity is high and it is difficult to substitute capital for labor are affected more by the upward pressure on wages than those that are, or can become, capital-intensive.

Surviving small firms in developed economies have relatively high levels of productivity and wages. Scale-related productivity differentials become relatively small, as Tables 10 and 11 show. At any stage along the adjustment path, the magnitude of the scale productivity differential suggests the potential for further gains from structural change.

Small firms that are able to raise productivity may be distinguished by superior management capability, by access to finance and information about superior technology, and by the ability to take up new strategic market positions by redeploying resources to new production techniques and higher-end product lines.

Connections with large firms can help small firms make the requisite shifts. Subcontracting links to larger manufacturers or large trading

companies help small firms obtain finance, technology, and technical assistance, often on concessional terms, to upgrade production capacity and improve product quality.

Increasing domestic and foreign competition puts pressure on large firms to seek subcontractors as a way of cutting costs. Subcontracting also allows the parent company to shift part of the risk of demand fluctuations to small firms and keep its own labor force busy on a more permanent basis. In industries where large upstream material manufacturers subcontract fabrication processes, the manufacturer's influence over price is extended one step further along the value chain (Commanor 1967). Regular subcontracting arrangements avoid some of the uncertainties of contracting at arm's length that Oliver Williamson (1971) cites as important reasons for vertical integration. Opportunities to do subcontracting for larger enterprises offer the stronger SMEs an additional survival strategy.

At high levels of development, efficient, small batch producers persist as a necessary complement to large mass producers. They may produce capital goods, such as specialized machinery and components, which have limited markets and require highly skilled craftsmanship. Low and fluctuating demand discourages mass production of these goods and provides a way for small firms to compete. At the fringes of almost every industry, medium-sized firms survive by supplying a changing array of differentiated products or responding to surges in demand. Yet technical progress is usually dominated by mass producers. Smaller firms may share innovations generated by large firms and occasionally innovate on their own, but they play a subordinate role in the flow of technological progress that marks modern industrial society and drives its economic growth (Piore and Sabel 1984: 29).

CONVERGENT AND DIVERGENT CASES

An enduring theme in economics since classical times, enunciated by thinkers as diverse as Karl Marx and John Kenneth Galbraith, is that use of a common industrial technology and similar tastes for industrial products cause advanced societies to converge on a common pattern (Dore 1973). In this simplified view, modern technology defines a unique efficient solution to the problem of organizing human beings, capital, and raw materials to produce goods. Domestic and international competition set up a Darwinian struggle among nations that is eventually won by the most efficient producers. Since industrial competition is assumed to be fundamentally about cutting costs to improve efficiency, all producers strive to discover and implement essentially the same techniques and strategies. To move

ahead, developing countries must first copy and then best the most efficient producers.

As an economy moves along the convergence path, an efficient allocation of resources requires consolidation of manufacturing firms. The required shake-out of small establishments is constrained by the country's evolving product mix, the rate of capital formation, and conditions in factor and product markets, as discussed in the previous section.

Although the economic histories of most industrial and semiindustrialized countries support the convergence thesis, a few countries have deviated significantly from the norm. In these cases, the narrowing of performance differentials among firms of different scales has occurred, as predicted by the convergence theory, but large shares of the labor force remain in SMEs. In Italy and Japan, more than 50 percent of manufacturing employment is still in firms with fewer than 100 employees. This contrasts with the situation in the United States, United Kingdom, France, and other advanced countries, where about 25 percent of manufacturing employment is in these firms. Among the NIEs, the most important divergent case is Taiwan.

These divergent cases suggest that key assumptions of convergence theory, that markets are competitive and technological options are limited, do not always hold. Demand fluctuations, technological trade-offs, and imperfectly competitive markets with nonprice as well as price competition all create greater than usual space for small-firm survival strategies.

As discussed earlier, the firm rests on contractual relations that unite and coordinate various fixed factors, including both physical assets and intangibles such as human skills, knowledge, and experience. These fixed factors differ among firms and countries. Entrepreneurs, including SME proprietors engaged in guiding their firms through the transition described here, base their strategies (long-run plans for profit maximization) on perceptions of the economic and social environment and their firms' fixed asset qualities (their strengths and weaknesses). Organizational structure can be viewed as a design that maximizes the expected value of the firm's chosen strategy, taking account of transaction costs (Caves 1980). Strategic differences involve production techniques, structural characteristics of the firm, and product characteristics.

Mass production and flexible specialization can be viewed as polar choices among strategic alternatives (Piore and Sabel 1984). Basically, mass production involves standardized products made in large, vertically integrated enterprises that organize production in long runs. Flexible production, by contrast, generally involves highly differentiated products made by smaller firms in short production runs, or even in "job shops." There are also mixed strategies between the two extremes. For example, flexibility can be achieved in mass production by finding ways to shift rapidly from one high-quality mass-produced item to another, as Japanese firms have

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been able to do. Yet a flexible production strategy, in all its variants, requires small firms to play a prominent role. It thus leaves its mark on the structure of manufacturing employment.

A country's strategic outlook is the aggregate of the choices made by its individual firms. Strategies evolve slowly as firms continually reassess their opportunities in the light of changes in economic, political, and social constraints and respond to changes in their tangible and intangible assets. Flexible production strategies in Japan, Italy, and Taiwan were not a deliberate national choice. Rather, they evolved because of a combination of market, political, and historical forces. Since these forces differed among countries and their firms mechanized at different times, different elements of the mass or flexible production model were adopted (Piore and Sabel 1984: 162–164). Four interacting factors had major impacts on the evolution of enterprise strategy and structure in each case: trade orientation, factor market distortions, prevailing institutions and contracting modes, and state intervention.

Trade Orientation

Exports played an important, often leading, role in the industrialization of each divergent country. To succeed in international markets, late developers (particularly smaller countries) had to adopt market strategies based first on low wages and specialization, then increasingly on product flexibility, differentiation, and innovation. As experience with nonprice competition grew, the quality and types of firms' strategic assets (tangible and intangible) gradually changed through learning and adaptation to the competitive challenge (Biggs and Levy 1991; Levy and Kuo 1987; Porter 1990). This enhanced the ability of firms to pursue flexible strategies. The need for flexibility, together with local differences in labor relations and prevailing institutional arrangements, made room for small firms, which were transformed through their relations either with large firms or with other small firms operating in clusters. Formal and informal collective institutions (legal, financial, and information-gathering) facilitated this transformation. The state influenced the evolution by promoting export development, affecting the degree of vertical integration, and by providing infrastructure, finance, and technology.

New entrants into world markets must fashion strategies that offset the competitive advantages of incumbents. These often rely on a combination of low wages, state subsidies and supports, and incremental productivity and quality improvements in existing products. As late developers learn more about markets and technologies, they venture into nonprice competition through improvements in quality and design. A focus on specialized or product-differentiated niches and on more flexible production allows less experienced and smaller rivals to assume strategic

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positions in small but often profitable markets and compete successfully where demand fluctuations are high.

Japan began its development of manufactured exports with cheap standardized products that emphasized its labor cost advantage. In the late 1950s, large firms, with state assistance, first copied and then began to enhance U.S. mass production technology in automobiles, machinery, and other product lines. Early efforts to adapt and then perfect imported technology in search of lower costs forced producers to make many changes in their assembly lines. Often these changes led in the direction of a more flexible orientation toward manufacturing.

Early Japanese attempts to break into mass production markets produced many failures and a few successes in relatively low value-added products where profits are slim (Friedman 1988). Initial efforts to penetrate the American auto market were unsuccessful. Low profits and market reversals prompted a shift to competition based more on differentiated products and production flexibility and less on price. Cars were made to be more reliable and fill specific market niches; model changes were frequent and extensive. Although production volumes were lower than in American auto plants, the flexibility of the plant and its workers enabled producers to develop and manufacture new models more rapidly (Friedman 1988; Womack, Jones, and Roos 1990).

Vigorous competition in Japan's domestic markets reinforced these strategic trends. Rivals often bid prices down below cost to obtain larger market shares. This encouraged firms to increase product differentiation and flexibility in an effort to insulate themselves from price challenges. They struggled continuously to move to higher quality products where profits would be greater. Throughout the process, large Japanese corporations retained subcontracting links with hundreds of suppliers as an essential complement to their flexible production strategies.

Market conditions elicited similar responses in Italy and parts of Germany and Austria (Piore and Sabel 1984: 194–220). Regional specialty steel, chemical, textile, and machinery producers all responded to market changes and shifted, with great success in the 1970s and 1980s, to flexible production strategies. Similar strategies are being adopted by Taiwan and Hong Kong.

Factor Market Imperfections and the Rationalization of Small Firms

Each country that diverged from the standard development path had a history of long-standing factor market distortions which provided survival space for numerous small, low-productivity firms.

Japan

Dualism in Japanese manufacturing has been attributed to characteristics of the labor market (Rosovsky 1961; Shinohara 1968; Tairu 1970). Notwithstanding rapid industrial growth in the 1950s and 1960s and the creation of a tight labor market, large wage and productivity differentials persisted between big and small firms. These reflected a segmented labor market, in which the long-standing hiring practices of large firms reduced the flow of labor between large and small enterprises.

These practices originated in the late nineteenth century, when the Meiji government's program to build a modern industrial state began to create shortages of skilled labor in large public and private enterprises. Previously, private enterprises had hired labor through labor contractors, who controlled stables of workers and provided the number required for a fixed fee (Morishima 1982: 105). Since the workers supplied by these contractors were relatively low skilled, enterprises in this period of rapid growth had trouble obtaining skilled manpower and frequently poached workers from rival firms. In an attempt to stabilize and upgrade their workforces, large firms tried to instill a spirit of loyalty to the company, installed seniority-based wage schemes, and offered lifetime employment guarantees to skilled workers. These practices continued after World War II, enabling large firms to draw their workers almost exclusively from the well-educated new entrants to the labor force.

The extreme selectivity of the large firms was made possible by their generous wage schemes and the large annual graduating classes coming from the state-financed educational institutions. Older, more experienced workers were hired on a temporary basis and paid wages comparable to what they would receive in small firms. Because large firms hired almost exclusively from the pool of new graduates, employment opportunities for others were limited mostly to SMEs or the temporary labor market, where wages and job security were lower. The postwar baby boom and the flow of workers from agriculture kept labor abundant enough that both small and large manufacturing firms could raise employment in the 1950s and 1960s.

The segmented labor market impeded the usual transfer of labor from SMEs to larger firms. To cut labor cost, large firms often resorted to subcontracting and the use of temporary labor. This enabled them to benefit both from their permanent skilled labor force and from the lower wages paid by SMEs. During the 1950s and 1960s small firms were relegated to a dependent subcontracting role, supplementing the operations of large producers during surges of demand and being squeezed by them during recessions.

Postwar capital shortages and credit rationing reinforced this dualism. The government, eager to build up an American-style mass production system, channeled credit to large, capital-intensive firms. Small firms were

rationed out of formal credit markets and forced to seek loans from informal financial intermediaries and large parent companies.

Several events, however, brought about changes in this pattern, beginning in the early 1960s. The new emphasis on production flexibility caused the large companies to rely more on their subcontractors. Although they initially tried to supervise the adaptation of SME suppliers to recurrent production modifications, they soon realized that close, continuous interaction was too costly (Friedman 1988: 155). By the early 1960s firms were using financial assistance and technical training to encourage small suppliers to develop their own ability to meet shifting demand.

SME productivity rose sharply. From the mid-1960s through the 1970s, much of Japan's overall productivity growth stemmed from technological and managerial advances in small enterprises. Simultaneously, the internal organization of large firms began to change. More autonomy was granted to operating divisions at different stages of the production process, and some were spun off as quasi-independent firms.

Italy

Italian subcontractors were not encouraged or helped to upgrade and become more independent as the Japanese subcontractors were, but they achieved similar productivity increases through their own efforts, motivated largely by a desire to remain independent of the mass producers. As in Japan, world market competition forced strategic and structural changes in Italian industry. Immediately after World War II, they were content to compete on the basis of price, but by the mid-1950s lower-wage competitors were squeezing their profits and market shares. An example of the response is Italy's famous textile district, the Prato, a group of towns in the provinces of Florence and Pistoia (Piore and Sabel 1984: 226–28).

Woolen producers in this area, like local manufacturers in Italy's other industrial regions, were able to develop new higher-end products and enter more sophisticated, faster moving, higher-priced market segments. Prato manufacturers also experimented with process innovations, such as new fabric finishes to achieve textures that gave ordinary products the appearance of luxury. Export of these products was supported by the home market, which demanded cutting-edge style and high quality. In response to these market conditions, large firms in the Prato began to disintegrate vertically, reducing their fixed costs and risks. Many sold or rented equipment to employees who became subcontractors. Over time, the industry became more fragmented and flexible, with a vast network of small and medium shops.

Factor market disruptions influenced these organizational changes. Throughout the 1960s Italy suffered from severe labor conflict and waves of strikes. In 1969 new laws pushed wages and the cost of social benefits much higher. Firing workers became difficult.

Problems with capital markets also played a role. Italians are high savers, but financial intermediation is poor and government deficits absorb a large fraction of domestic savings, pushing up interest rates. Equity markets were almost nonexistent until recently because of government regulation. In contrast to the important role that banks play in industrial finance in Japan, Italian commercial banks are not permitted to hold equities or make long-term loans. Most banks are controlled by the state and follow conservative lending policies. Private capital is concentrated in the hands of a small group of individuals, who mobilize it to create large companies.

For these reasons, Italian entrepreneurs are little involved with the formal financial system. Firms finance entry and expansion from private savings or profits or by rolling over short-term loans. This forces them to compete internationally in industries where entry-level capital requirements and scale economies are unimportant. Italy's comparative advantage is thus largely in fragmented consumer industries that feature frequent product changes. This creates demand for machines and inputs that can be adapted to frequent demand changes; Italy has also developed a capability in the production of such machines.

As in Japan, productivity gains in Italian manufacturing resulted largely from shifts of resources from low-wage, low-productivity small enterprises to high-wage, high-tech small enterprises. The small-firm sector was upgraded through technical change, shifts to high-end products and the entry of new high-tech firms. Unlike in Japan, links to large firms were unimportant. Instead, small firms formed industry-wide or regional federations that increased their collective capacities to devise innovative products and processes and gain increasingly independent access to markets and technology.

Formation of these federations was facilitated by middlemen such as the *impannatore* in the Prato region. Descendants of medieval merchants and early-modern putter-outers, the *impannatore* at first purchased raw materials and organized networks of small shops to produce cloth according to defined specifications, then brought the product to market or sold it to a merchant. As production shifted to higher-value market segments in response to international competition, the *impannatore* gradually became designers responsible for shaping and responding to fashion changes, as well as organizers of production (Piore and Sabel 1984: 215). *Impannatore* urged firms in their networks to experiment with materials and processes and encouraged them to form clusters that generated externalities, raising the productivity and competitiveness of all the member firms.

The role of the *impannatore* in the formation of small enterprise clusters that can compete successfully in world markets indicates the importance of supporting institutions in countries with anomalous firm size structures. Functions that would be handled by the firm in other settings must

be performed by supporting institutions operating through markets when production is organized through small firms. In Taiwan, trading companies and foreign buyers have played a role similar to that of the *impannatore* (Levy 1991).

Another characteristic of the divergent cases is the local or regional small-firm cluster, sometimes called the industrial district. Small firms cluster to generate economies of agglomeration that help offset the economies of scale and scope enjoyed by large producers. Concentrations of small producers were present in various parts of Europe during the nineteenth century (Piore and Sabel 1984) and can still be seen in northern and central Italy, in parts of Japan, and in Taiwan, Singapore, and Hong Kong.

Another type of flexible production structure is the business group, usually formed either to improve access to finance or to share common facilities. Affiliated firms may be in different businesses. Groups of large affiliated firms are prominent in Japan, Korea, Latin America, and Europe; small-firm groups are found in Taiwan and other Asian countries.

Satellite firms (affiliated groups of subcontractors orbiting around a large parent company) are a third type of flexible production structure. Satellite systems add flexibility and increased specialization to production structures. The system is particularly prominent in Japan.

The cohesion of these small-business groups often rests on a sense of community that shares ethnic, political, or religious roots. The community tempers competition within the cluster and protects member firms from damaging forms of cheating (postcontract opportunism). A breach of standards within the community violates not only an economic contract but also deeply held values. The formidable threat of exclusion from the community deters uncooperative behavior.

The other important source of cohesion in business groups is the family. Subsidiaries of a parent company are often founded by family members. Outsiders are adopted into the family after a long period of close association and demonstrated loyalty. Shared allegiance to the family frees companies to reallocate resources and respond to market demands within a trustworthy system of common financial reserves, marketing, and purchasing. It can also provide economies of scale in accessing financial and other services.

State Intervention

In the Japanese and Italian cases, state intervention influenced the creation of a flexible production structure, but not decisively. Government policy after World War II initially promoted systems of mass production in both countries. Only later were programs more supportive of the emerging structural pattern undertaken.

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Nevertheless, government policy did help in several ways. First, policies to stimulate export growth had a major influence on manufacturing strategy and structure. Second, national and local governments built infrastructure and provided some of the finance and technology for evolving flexible organizational structures. Third, government regulation set community health and safety standards and promoted product quality. Lastly, small-firm promotion programs provided finance, technology, and marketing support to help small producers meet the quality standards of the world market and large parent companies, and even to develop innovative products of their own.

In both Italy and Japan, government support for small producers was politically motivated. Small-town business owners and farmers became the core of the Liberal Democratic Party's postwar coalition in Japan because urban areas regularly elected Socialists and Communists to national and local offices. To defend its position, the conservative LDP created coalitions of farmers and small business owners and supported them with programs such as subsidized rice prices, special banks for small firms, and regional training centers. In parts of Italy dominated by the Christian Democrats, government intervention was motivated by a desire to stop the deterioration of rural parishes on which the party depended. Rural industrialization was seen as a deterrent, both to migration to the Communist-dominated cities and to revival of the Fascist bloc of the petty bourgeoisie and big capital (Piore and Sabel 1984: 228–29). Municipal and regional governments built industrial parks for small producers, improved roads, opened vocational schools, and in some cases operated regional technology research centers.

Although small-enterprise support programs were thus helpful in some instances in both countries, they were often poorly implemented, indiscriminately provided, and overly expensive (Komiya, Okuno, and Suzumura 1988: 513). Too many resources went to unproductive firms that could not have survived without program subsidies; little was done to target winners or base program benefits on firm performance.

SUMMARY

The following issues concerning economic growth and change were covered in this chapter:

- Economic development is characterized by structural change and improving the integration of markets at several levels. As the manufacturing sector grows in relative importance, the "early

industries" that supply the basic needs of the poor and dominate the sector in low-income countries gradually give way to "middle" and subsequently "late" industries, which possess greater economies of scale.

- The average manufacturing plant becomes larger as a country develops. This rise can be decomposed into a smaller component that reflects the increasing importance of industries with more capital-intensive technologies and greater economies of scale and a larger one that represents growing plant size within specific industries. Small and cottage enterprises with fewer than twenty workers, initially the most common form of manufacturing, decline sharply in relative importance.
- Scale-related differences in productivity, capital intensity, and long-term profit rates narrow substantially as a country develops. Rising real wage rates and falling product prices squeeze SMEs, forcing them to raise productivity or face eventual closing. The relatively few SMEs that survive to high levels of economic development have typically become as capital-intensive and high-tech as large enterprises, but have found some source of competitive advantage to offset the economies of scale and scope enjoyed by large firms.
- The classic explanation of the phenomena of rising firm size and narrowing interfirm differentials emphasizes the increasing division of labor and mechanization of production made possible by expanding and increasingly well-integrated markets. Later analyses suggest that other forces are also influential, including historical shocks and random accidents, foreign trade policy, human capital, other scarce factors of production, transaction costs, and connections with large firms that may help SMEs to adapt and survive.
- Theorists have postulated that the use of a common industrial technology and similar tastes for industrial products cause advanced societies to converge on a common pattern of industrial organization. While this tendency is visible in the industrial development of many countries, there are also some intriguing deviant cases (Japan, Italy, and most recently Taiwan) in which small firms have continued to play a large role in manufacturing at high levels of development. The latter countries have all elected to follow some version of the "flexible specialization" alternative to mass production. Factors that appear to have influenced their choice include export orientation, factor market distortions, particular national institutions and contracting modes, and state intervention.

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Chapter 3

The Double-Edged Influence of Policy

After surveying the debate over SMEs and their role in industrialization and economic development in Chapter 1 and then showing what happens to SMEs in cases of successful industrialization in Chapter 2, we now address the major questions of public policy. It has been seen that as countries develop the relative importance of SMEs in the manufacturing sector tends to decline through a competitive process that weeds out most small firms and forces the surviving minority to adopt flexible specialization strategies that help offset the economies of scale enjoyed by large enterprises. As countries climb from low- to high-income status, the SME share in manufacturing employment generally declines from as much as three-quarters to about one-fourth. In a few cases, however, SMEs continue to account for half or more of manufacturing employment; the reasons for this were discussed in Chapter 2 under "Convergent and Divergent Cases."

What should governments of developing countries do about these facts? Should they simply acquiesce to the transformation—let economic development run its course—or would it be better to intervene in some way on behalf of SMEs? In a country that is truly developing, economic development will eventually achieve most of the stated objectives of intervention to help SMEs. It will increase productivity, create jobs, improve income distribution, and even disperse industry around the countryside. Allowing economic development to run its course might be an alternative

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worth considering in the many low- and middle-income countries that grew at reasonable rates over the period from 1965 to 1990.[1] But are there better options, and what about the countries that are not achieving satisfactory rates of economic growth? Aside from pushing for economic development,[2] what actions by their governments toward SMEs would make sense?

To answer this question, we must begin by looking more closely at what, exactly, governments are trying to achieve when they intervene in favor of SMEs. For present purposes, the officially stated motives listed in Chapter 1 can usefully be regrouped into equity motives and efficiency/productivity motives. High-minded arguments for intervention often appeal to equity considerations. Many advocates of aid to microenterprises, for example, are moved by compassion for the poor. Although they may try to strengthen their case in a hard-hearted world by appealing to growth and efficiency objectives, we have seen that justification for such claims is weak. The valid point is that even though very few microenterprises will ever become efficient modern producers, some level of aid to them can be justified on equity grounds. Such aid should, however, be informed by a realistic understanding that the resources so used probably do have some cost in economic growth foregone.

The second basic rationale for SME promotion is improvement in efficiency and productivity, which contributes to economic growth. We have seen that this rationale is questionable, especially when applied in categorical fashion to SMEs simply because they are small. For intervention to be justified on efficiency or productivity grounds, it would have to be based not on the scale of an enterprise as such, but on its behavior. In other words, assistance would have to be limited to firms that meet defined performance targets, for example, by increasing their exports at a defined target rate. By the same token, aid would have to be withdrawn from firms that fail to meet performance targets. This is hard for most governments to do.

There is a third basic rationale for pro-SME intervention, which is the least defensible and least frequently enunciated but probably the most common one in practice. It is simply to shield SMEs from the negative consequences of the loss in competitiveness that they suffer as countries develop. Although some transitional assistance to declining sectors may be justified as a way of easing suffering, devoting any significant share of public resources to a vain attempt to stave off the inevitable is clearly wasteful. When such protection is extended over a wide range of industries and long period of time, as in India, it can become a significant impediment to economic development.

We have said that economic development delivers most of the benefits cited as justification for pro-SME policies. But it takes a long time to do in

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most cases and the main equity benefits of economic development are only realized after the labor market turning point has been reached, which occurs somewhere in the middle-income range. Even for a rapidly growing low-income country, this is far from an immediate solution to its problems. And aside from the substantial group of countries, mentioned in footnote 1, that are growing at a reasonable pace, there is another significant group of nations where average growth rates since 1965 have been low, nil, or even negative. This latter group includes most of the low-income countries and a fair number of middle-income countries.[3]

In slow-growing, stagnant, or regressing countries, where the passage of time has not been accompanied by a significant rise in GNP per capita, observed changes in manufacturing SMEs may be quite different from those described in Chapter 2. For example, SME employment and value added may well be growing in such countries, both in absolute terms and as a share of the total for the manufacturing section, and not declining as in more rapidly developing countries. What should governments of these countries do about SMEs? Should they be more willing to intervene on their behalf than governments of faster growing countries, or less so? This is a hard question to answer, since the equity rationale for intervention may well be seen as stronger in a poor and possibly stagnant economy, but the capacity to intervene effectively is likely to be weaker.

Another important issue to be faced in both growing and nongrowing economies concerns the most appropriate form of pro-SME intervention. Traditionally, developing country governments undertake SME promotion programs, particularly credit provision, but pay little attention to the effects that their policies have on SMEs. Would it be helpful to redress this imbalance by giving policies more emphasis and perhaps cutting back on promotional programs?

If policy reform is to be pursued, what should be its objective? In the next section, "Policy Bias," we show that developing country policies are frequently (although not invariably) biased against SMEs. This suggests that one possible aim of policy reform is to correct policy biases that impede the operation or growth of SMEs, thereby leveling the proverbial playing field. Is this the desirable limit of policy intervention, or should the government try to define and implement policies that actively encourage certain types of SMEs, or particular SME activities, such as investment, job creation, or exporting? And which specific policy measures are likely to be most efficacious: trade, tax, financial, labor, or regulatory policies? In the more usual area of program assistance, are efforts to target credit provision, technical assistance, and physical facilities to SMEs cost-effective, or would it be better to limit government's role to the provision of general legal and physical infrastructure that facilitates SMEs' survival and growth?

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All these questions arise in the context of national policy making in the developing countries but are echoed in discussion within international development agencies involved in SME promotion, such as USAID, the World Bank, the International Labor Organization (ILO), and the United Nations Industrial Development Organization (UNIDO). These agencies have the additional concern of how to induce and assist national governments to take initiatives that the international agencies regard as worthy.

The impact of policy on SMEs is the subject matter of the present chapter. Chapter 4 deals with SME promotion programs. After reviewing case studies at three stages of development in chapters 5–7, we summarize our general conclusions on all the major matters raised in the book in Chapter 8.

The next section defines and measures various kinds of policy bias. General issues regarding the use of policy, including the political economy of policy making in relation to SMEs and the role of international development agencies, are further considered in the second section, "Policy Choice."

POLICY BIAS

Many different economic policies influence the profitability and growth of SMEs in developing countries, with interacting effects that are complex and difficult to sort out.[4] Yet we can get a sense of their impact if we start from the observation that policies affect SME performance largely through their influence on two kinds of markets: those in which SMEs sell their products and those in which they buy factors of production and other inputs.

Although policies that affect SMEs are often conceived and adopted for reasons that have nothing to do with SMEs, their effects cumulate and interact to alter the incentives to which entrepreneurs respond. Table 13, developed by Steven Haggblade, Carl Liedholm, and Donald Mead under EEPA, provides an inventory of policies that have significant effects on SMEs arranged according to standard functional categories. In Table 14 the same information is regrouped to show how policies work through product and factor markets. This suggests which policies have at least a first-round impact on the price of capital, price of labor, prices of material inputs, profitability of various lines, and techniques of production and the structure of demand for manufactured products.

In the factor markets, for example, exchange rates, tariffs, import duties, and interest rates all affect the prices firms must pay for capital and may have differential effects on large and small firms. Minimum wage laws and other types of labor legislation, government salary structures, and policies affecting labor union activities all influence the price of labor.

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TABLE 13 Inventory of Policies Affecting Employment and SME Growth

1. Trade policy
   a. Import duties
   b. Import quotas
   c. Export taxes or subsidies
   d. Exchange rates
   e. Foreign exchange controls
2. Monetary policy
   a. Money supply
   b. Interest rate
   c. Banking regulations
3. Fiscal policy
   a. Government expenditure
      (i) Infrastructure
      (ii) Direct investment in production, marketing, or service enterprises
      (iii) Government provision of services
      (iv) Transfer payments
   b. Taxes
      (i) Business income/profits
      (ii) Personal income
      (iii) Payroll
      (iv) Property
      (v) Sales
4. Labor policies
   a. Minimum wage laws
   b. Labor codes covering working conditions, fringe benefits, etc.
   c. Social security
   d. Public sector wage policy
5. Output prices
   a. Consumer prices
   b. Producer prices
6. Direct regulatory controls
   a. Enterprise licensing and regulation
   b. Monopoly privileges
   c. Land allocation and tenure
   d. Zoning
   e. Health regulations

SOURCE: Haggblade, Liedholm, and Mead 1986.

Tariff rates, exchange rates, and price controls affect the prices of material inputs. Regulatory policies such as zoning and licensing laws affect the relative profitability of different enterprise groups.

In output markets, trade policies affect the demand for domestic products through either the price of competing imports or the price at which

TABLE 14 Impact of Factor and Product Market Policies on Production, Employment, and the Growth of SMEs

Factor and other input markets

1. Policies affecting the price and availability of capital goods
   a. Interest rates and credit availability [2b]
   b. Import duties and quotas [1a, 1b]
   c. Exchange rate and controls [1d, 1e]
   d. Capital-based taxes (e.g., accelerated depreciation) [3b]
2. Policies affecting the price of labor
   a. Minimum wage laws [4a]
   b. Labor legislation [4b, 4c]
   c. Public sector wages [4d]
   d. Policies towards unions [4]
   e. Labor-based taxes [3b]
3. Policies affecting the availability and price of other inputs
   a. Import duties [1a]
   b. Exchange rates and controls
   c. Price controls [5b]
4. Regulatory policies affecting the relative profitability of different producers and production techniques
   a. Zoning [6d]
   b. Licensing and registration [6a]
   c. Monopoly privileges

Output markets

1. Policies affecting demand for domestic products through the price of competitive traded goods
   a. Effective rates of protection (import duties or quotas on inputs and outputs) [1a, 1b]
   b. Exchange rates [1d, 1e]
   c. Export taxation [1c]
2. Policies affecting demand through sectoral income distribution (agriculture vs. industry; urban vs. rural)
   a. Differential structure of protection [1a, 1b]
   b. Differential export taxation [1c]
   c. Differential foreign exchange rates and access [1d, 1e]
   d. Differential expenditure on services and infrastructure [3a]
   e. Differential taxation [3b]
   f. Differential ouput pricing [3a, 3b]
3. Policies affecting demand through the size distribution of income
   a. Fiscal policy, transfer payments, and taxation [3a, 3b]
   b. Item 2 above
4. Price controls for finished products [5a]

NOTE: Numbers in brackets refer to policies listed in Table 13.
SOURCE: Haggblade, Liedholm, and Mead 1986.

exports can be sold. An even wider array of trade, fiscal, and price policies influences the sectoral and size distributions of income.

Most of these policies work through prices.[5] For example, any policy that causes the prices that small firms have to pay for their inputs to be higher than that which larger firms pay for the same inputs reduces the competitiveness of small firms. A policy that causes the prices these same firms can get for their output to be lower than those obtained by other firms selling the same products has a similar effect. Differential effects

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harmful to SMEs can be termed "policy bias." Often the bias is unintentional. For example, the common system of exchange controls combined with an overvalued exchange rate is usually intended to promote import-substituting industrialization (ISI), not to make capital goods more expensive for small firms than for large ones. Yet if machinery must be imported and the small firms have little or no access to the controlled foreign exchange and thus must buy it at higher rates on the curb market, that is its effect.

In a perfectly competitive market there is a single price for each good or service traded, but if markets are segmented, different prices can prevail in various segments of the market. This leads to allocative inefficiency and, hence, to lower output than would prevail in a distortion-free world. Biases in the trade, credit, and fiscal policies of many developing countries are widely believed to induce substitution of capital for labor by the larger, more formal enterprises, which can often obtain capital at an artificially low price and may have to pay an artificially high price for labor.

It is important to realize, however, that many observed price differences are not price distortions but instead reflect variations in either the quality of the commodities or services traded or the cost of serving different customers. For example, a small firm located outside the capital city may have to pay a higher interest rate than a large firm located in the capital city. Is that a price distortion, or merely a reflection of the bank's need to bear higher transaction costs and risk for the former borrower than for the latter? This can be a hard question to answer. Although price distortions are often hard to measure, or even identify, the policy analyst needs to be aware of their possible sources so that questions of their presence and magnitude can at least be addressed.

Relatively few attempts have been made to quantify policy bias and the distortions it produces in developing countries. Even for trade policies, the most intensively studied category, Anne Krueger observes in her comprehensive study that "little is known about the probable orders of magnitude . . . and their consequences" (Krueger et al. 1983: 120). Below we marshall the limited available evidence on the nature and magnitude of policy biases and the distortions they produce, emphasizing those that may impact differentially on small and large firms.

Factor Market Distortions

Our discussion of factor market distortions falls into the following categories: labor markets, domestic and capital market distortions, foreign trade regime–induced capital market distortions, domestic tax–induced capital distortions, and lastly the total magnitude of factor market distortions.

Labor Markets

Labor markets in developing countries are often described as segmented. Large and small enterprises may hire labor in different market segments. As we saw in Chapter 2, there is a gap between the average wages paid by large and small enterprises. The gap is wide in developing countries and smaller but still present in developed countries.[6] Although there is also considerable dispersion in the wages paid by small firms in developing countries, on average they pay only half as much for unskilled workers as large firms (Child 1977; Steel 1977; Mazumdar 1979; Page 1979; Byerlee et al. 1983).

Part of this gap represents differences in skill levels and labor turnover; large firms may be able to select the most proficient and reliable unskilled workers (Mazumdar and Ahmed 1978; Squire 1981). Another part is often attributable to policy interventions with differential effects on enterprises of different sizes. These include minimum wage legislation, mandated fringe benefits, restrictions on the employer's right to fire workers, and government-supported union pressures. Such interventions are common in developing countries, but they generally apply only to the larger, more visible enterprises. Smaller firms are usually either exempt from such laws or escape their application through lax enforcement. This may permit them to hire comparable labor at a lower wage than large enterprises.

Minimum wage legislation enacted in many countries can influence the wages of unskilled labor, but its actual effect appears limited (Watanabe 1976; Haggblade, Liedholm, and Mead 1986: 14–15). Some countries, such as the Sudan (Kannappan 1977), the Philippines (Anderson and Khambata 1981) and Thailand (Akrasanee 1981), exempt SMEs from the law. Others, such as Egypt and Zaire, set the minimum wage so low that the actual wage rates paid by small firms exceed the minimum (Page 1979). Most often, the minimum wage is simply not enforced on small firms (Watanabe 1976: 154). Surveys of small-scale entrepreneurs in many developing countries reveal that hardly any are directly affected by such legislation (Liedholm and Mead 1986a). This suggests that the wages paid by small-scale industrial enterprises are relatively undistorted and closely approximate the opportunity cost of labor.

Even for large firms, the effects of minimum wage legislation are often limited. They frequently pay more than the mandated minimum wage, either because of union pressures or more often because of firm hiring practices.

Table 15 shows that labor market distortions were almost nonexistent in a group of Asian countries surveyed in the late 1960s and 1970s. In a number of Latin American and African countries, which had minimum wage legislation and mandated social security schemes, large enterprises

TABLE 15 Policy-Induced Distortions in Labor Cost of Large-Scale Nonagricultural Enterprises

Country	Year	Increase in labor cost (%)
Asia		
Hong Kong	1973	0
Indonesia	1972	0
Pakistan	1961–64	0
South Korea	1969	0
Africa		
Ghana	1972	25
Ivory Coast	1971	23
Sierra Leone	1976	20
Tunisia	1972	20
Latin America		
Brazil	1968	27
Argentina	1973	15

SOURCES: Hong Kong: Krueger, et al. 1983; Indonesia: Pitt 1981; Pakistan: Guisinger 1981; South Korea: Hong 1981; Ghana: Ingraham and Pearson 1981; Ivory Coast: Monson 1981; Sierra Leone: Chuta and Liedholm 1985; Tunisia: Nabli 1981; Brazil: Carvalho and Haddad 1981; Argentina: Nogues 1980.

appear to have paid 20–25 percent more for labor than small or informal sector firms did. Since unskilled labor, the category most likely to be affected by minimum wages, accounted for a relatively small share of the total cost of these firms, the effect of these distortions on existing firms may not have been large. But they could have served as a serious barrier to the establishment of large, labor-intensive, export-oriented firms. Otherwise, the extent and magnitude of labor market distortions appears rather small (Webb 1977; Berry and Sabot 1978; Squire 1981; Krueger et al. 1983; Steel and Takagi 1983).

Other forms of intervention that may affect labor markets are job security and other employment regulations, direct government employment (which accounts for a large share of formal sector employment in many low-income countries), and government intervention in collective bargaining.[7] However, Richard Freeman (1993) concludes that while such interventions may have created significant distortions in the 1960s and 1970s, their effect declined sharply in the 1980s. In general, therefore, it appears that the effects of policy intervention on the wage structure were never large in East Asia and have declined over time in other developing regions.

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Domestic Capital Market Distortions

Like labor markets, capital markets in developing countries are often said to be segmented. Large firms with established credit ratings can usually borrow from banks and other formal sector financial institutions while SMEs rely almost entirely on traditional sources of funds, particularly personal and family savings. If small-scale entrepreneurs go outside their immediate circles for credit, they usually turn to informal sector sources such as traders, suppliers of goods, and moneylenders. In small enterprise surveys in several developing countries, most small producers said that less than 1 percent of their initial investment funds came from formal sources (Liedholm and Mead 1986a).

Capital costs in formal and traditional markets differ sharply. At least until financial sector reform gathered momentum in many developing countries during the 1980s, most developing country governments imposed ceilings limits on the interest rates that banks and other financial institutions could charge. A 1975 review of formal sector interest rates revealed that in more than two-thirds of the thirty-four countries covered the nominal rate was 10 percent or less; in several cases, real interest rates were negative (World Bank 1975). Similar results are reported by other surveys (for example, Page 1979). Faced with excess demand for funds, banks and other formal sector financial institutions generally respond by rationing the scarce funds and giving priority to larger scale clients.

The interest rates facing SMEs in traditional or informal markets are usually much higher than formal sector rates. An early International Monetary Fund (IMF) survey of "unorganized" money markets in twenty-three developing countries concluded that "usual" nominal interest rates ranged from 17 to over 100 percent, averaging 30–40 percent (Wai 1957). A World Bank survey of informal credit market studies in twenty-three countries in the late 1960s and early 1970s concluded that the median real interest rate worldwide was 40 percent; real interest rates in excess of 100 percent were not unusual (World Bank 1975). Table 16 summarizes this evidence.

As suggested earlier, at least part of this differential represents the higher risk and transaction costs of providing funds to small enterprises. Differences in the duration of loans made in formal and informal financial markets may also account for some of the interest rate gap. The percentage administrative costs and risk premiums associated with small loans greatly exceed those associated with large loans (see, for example, Page 1979). However, one reason why banks perceive SMEs as being riskier than larger scale clients is that banks have little experience lending to SMEs and thus find it hard to screen good borrowers from "lemons." They try to reduce this perceived risk by insisting on full collateral and dealing primarily with established borrowers.

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TABLE 16 Formal and Informal Nominal and Real Interest Rates, 1970s

	Informal rates		Formal rates	
Country	Nominal (%)	Real (%)	Nominal (%)	Real (%)
Africa				
Ethiopia	70	66	12	8
Ghana	70	64	6	0
Ivory Coast	150	145	10	6
Nigeria	200	192	6	−2
Sudan	120	120	7	7
Sierra Leone	75	60	12	−3
Asia				
Afghanistan	33	—	9	—
India	25	15	9	−1
Indonesia	40	29	14	3
Jordan	20	15	7	2
Malaysia	60	58	18	16
Pakistan	30	27	7	4
Philippines	30	24	12	6
South Korea	60	49	6	5
Sri Lanka	26	20	5	−1
Thailand	29	27	9	7
Vietnam	48	20	30	2
Latin America				
Bolivia	100	96	9	5
Brazil	60	38	15	−7
Chile	82	52	14	−16
Colombia	48	40	24	16
Costa Rica	24	20	8	4
El Salvador	25	23	10	8
Haiti	140	122	15	−3
Honduras	40	37	9	6
Mexico	60	57	10	7

NOTE: Dash indicates data not available.
SOURCE: Haggblade, Liedholm, and Mead 1986: 21. See this paper for methodological notes and further source notes.

Administrative costs, expressed as a percentage of the amount lent, tend to be higher for small loans than for large loans because it takes almost as much time and effort to process a small loan as a large one; there is a more or less fixed element in loan administration costs. But poor program design has often made small-loan administration costs unnecessarily high. In a well-designed program, administrative cost can be less than 6 percent of loan value (Saito and Villanueva 1981; Liedholm 1985; Snodgrass and Patten 1991). Moreover, the high arrears and default rates

of most small-loan programs contrast sharply with the good repayment experiences of a few well-designed programs (Hossain 1988; Patten and Rosengard 1991). The interest rate differential between small and large loans probably need be no larger than ten percentage points if the program is well designed and the lending institution has some experience in dealing with small borrowers. Banks will lend to SMEs if they can do so at a profit, and they are already doing so to an increasing extent in large parts of the third world today.[8]

Evidence on the magnitude of distortions in the domestic capital market for selected countries is summarized in Table 17. As far as possible, adjustments have been made for administrative and risk differentials between large and small borrowers, so the figures can be described as measures of capital market distortion between these two types of borrowers. Except for Hong Kong, these distortions are quite large, exceeding 30 percent. No significant differences are apparent among the major regions. Relative to what would exist in integrated and distortion-free capital markets, the actual cost of capital to large firms is unduly low. The cost of capital to small firms is higher and may approximate the opportunity cost of capital.

Foreign Trade Regime–Induced Capital Market Distortions

The tariff structure and the operations of the foreign exchange market also introduce distortions that differentially affect labor and capital use in large and small enterprises. The import duty structure introduces enterprise size distortions in two ways. First, many capital and intermediate goods used by SMEs, especially cottage producers, are classified as consumer goods (for example, sewing machines, hand tools, and outboard motors). Since in most countries consumer goods attract much higher import duties than intermediate and capital goods, small firms must pay relatively high duties on their equipment.

Second, firms certified by the government's investment promotion agency are often exempted from duties on imported capital goods for extended periods. Firms receiving these concessions are usually modern, large-scale, import-substitution activities, although sometimes "modern" export activities are included as well. In some countries firms below a certain size are legally excluded from these incentive provisions. More often, SMEs could apply but are either unaware of what concessions are available or unable to comply with the complex bureaucratic procedures required to obtain them.

There have been few quantitative estimates of the capital price distortion created by differential treatment of imported capital. Julio Nogues (1980) calculates that in Argentina investors eligible for duty-free imports of machinery received a subsidy of about 40 percent of their capital costs. In Sierra Leone, large firms accorded import duty relief on their capital

TABLE 17 Policy-Induced Factor Price Distortions in Large and Small Nonagricultural Enterprises

Country	Year	Difference in labor costs[a]	% of difference attributable to[a]: Trade regime	Interest rate	Taxes	Total capital	% difference in wage/rental ratio[a]
Asia							
Hong Kong	1973	0	0	0	0	0	0
Pakistan	1961–64	0	−38	−44	+22	−60	+150
S. Korea	1973	0	−5	−35	+10	−30	+43
Africa							
Ghana	1972	+25	−25	−42	+26	−41	+119
Sierra Leone	1976	+20	−25	−60	+20	−65	+243
Tunisia	1972	+20	−30	−33	—	—	—
Latin America							
Brazil	1968	+27	0	−33	—	—	—

NOTES: Dash indicates data not available.
a. Percentage difference in large-firm costs relative to small-firm costs.
SOURCE: Krueger et al. 1981, as reported by Haggblade, Liedholm, and Mead 1986: p. 31. See the latter paper for additional source notes and methodological notes.

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equipment obtained an implicit subsidy of about 25 percent compared with smaller scale firms in the same industry (Haggblade, Liedholm, and Mead 1986: 108–13).

Quotas and licensing requirements imposed on imports also distort the price of imported capital goods. Import licensing has been a major instrument of protection in several countries. Jagdish Bhagwati, in his authoritative study of exchange control regimes, comments that

> the majority of authorities like to think of themselves as biasing access to imports in favor of the smaller applicants and indeed in countries such as India and Pakistan, this . . . was considered one of the benefits of the import control system. [However,] in point of fact . . . *ex post* outcomes appear to have been disturbingly concentrated on the large-scale applicants. (1978)

For Ghana, J. Clark Leith (1974) found deliberate bias in favor of large importers, while in the case of India, Bhagwati and Srinivasan (1978) concluded that the control system discriminated against small enterprises. For Pakistan, Stephen Guisinger reported that

> in the 1960s, few small scale manufacturing firms . . . had access to import licenses, and when they purchased foreign equipment it was through import agents who appropriated the scarcity value of the import licenses for themselves. (1981: 333)

According to Bhagwati, the reasons for the bias against small producers include

> 1) ease of administration in dealing with smaller numbers of successful applicants; 2) a feeling that larger firms were more reliable; 3) a sense that larger firms would get better terms from foreign suppliers; 4) the greater access (and contacts) of the larger firms to the bureaucracy and politicians in general, and to the licensing authorities, in particular; and 5) the important edge obtained by the larger firms quite simply because nearly all the authorities tended to allocate to past shares or other quantity-related variables. (1978: 28)

What are the effects of such a system? Guisinger contends that in Pakistan during the 1960s import licensing was a far more important means of protection than tariffs. He estimates that the capital cost differential between large and small firms caused by the trade regime was approximately 38 percent. Even when small firms purchased locally made machinery, "prices generally reflected the full scarcity margins and tariff

duties on the capital and intermediate inputs used in their production" (1981).

Currency overvaluation further widens the differentials in capital prices facing large and small enterprises. Overvaluation requires that underpriced foreign exchange be rationed and lowers the prices paid for imported capital goods and other imported inputs by those with access to foreign exchange. Although there has been a trend toward freer exchange rates over the past two decades, currency overvaluation has affected a wide range of countries and remains significant in many today. Of the thirteen countries reviewed by Krueger et al. (1981) in their trade and employment studies, only Hong Kong avoided overvaluation throughout the postwar period up to the mid-1970s, although South Korea, Brazil, and the Ivory Coast maintained rates close to equilibrium much of the time. Among these countries, estimated exchange overvaluation ranged from 20 to 40 percent. Doris Jansen's (1980) review of fourteen African economies in 1979 found rates of overvaluation varying from zero in Cameroon to 330 percent in Ghana.

One way to ration overvalued foreign exchange is through the use of multiple exchange rates. At the end of 1984, some twenty-five countries maintained multiple exchange rate systems (Lizondo 1985). Usually under these systems, large firms operating in priority sectors can obtain foreign exchange at the lowest rates, while smaller enterprises must pay higher rates.

The orders of magnitude of capital market distortions caused by currency overvaluation combined with differential tariffs or licensing systems are suggested in Table 17. Pakistan, Ghana, Sierra Leone, and Tunisia were all following import substitution strategies at the time these data were collected. Sierra Leone and Tunisia regulated capital goods imports primarily through tariffs, while Ghana and Pakistan relied more on licensing. The capital price distortion between large and small enterprises in these four countries came to 25–40 percent. Distortions of similar magnitude existed in Uruguay, Argentina, Chile, and Indonesia (Krueger et al. 1983: 145). On the other hand, capital distortions induced by the trade regime were negligible in Hong Kong, South Korea, and Brazil, which were following export promotion strategies and did not have greatly overvalued currencies.

Domestic Tax–Induced Capital Distortions

Domestic tax policies can also have differential effects on large and small enterprises. Investment concessions frequently provide large firms not just with subsidized capital and import duty relief but also with other inducements such as income tax holidays, accelerated depreciation allowances, and property tax reductions. These direct tax concessions raise returns to capital in those large firms that receive them.

The direct tax component of the investment promotion package creates distortions between large and small enterprises. Many small, unincorporated firms are legally exempt from direct taxes, which gives them a differential *advantage* over those large enterprises that must pay taxes. In Sierra Leone, for example, no income tax was paid in 1965 if yearly income was below $560, a figure four times the country's income per capita. In other instances, smaller firms legally subject to tax escape payment because of lax enforcement and the difficulty of collecting tax from numerous widely dispersed small firms. In such environments, however, large firms may also be able to evade tax payments.

Data on the magnitude of these tax-induced differentials are particularly sparse, but information from a few countries is shown in Table 17. These are probably upper-bound estimates because it is assumed that, except in Korea, small firms pay no direct taxes and that all such taxes fall on the returns to capital of the large firms. The limited evidence indicates that, aside from the special cases of Hong Kong and South Korea, direct taxes increase the effective cost of capital to large firms at most by 20–25 percent relative to small firms. Investment concessions, special tax provisions, and tax evasion all reduce the larger enterprises' direct tax burden, sometimes by more than 50 percent of profits. The heavier tax burden on the larger firms thus partially offsets, but does not eliminate, the capital cost advantage that they enjoy over smaller enterprises.

In summary, capital market distortions, whether caused by domestic or foreign trade policies, appear significant in nearly every developing country. Differences in capital cost between large and small enterprises vary from 30 to 65 percent. They are greatest in countries following import substitution strategies, where both foreign and domestic policies contribute, often in roughly equal amounts, to the capital price distortion. Yet significant distortions exist even in export-promotion countries, primarily as a result of domestic policies. Most of the distortion comes from the unduly low price of capital facing large firms. The price of capital to the smaller enterprises is closer to the "shadow" or social price.

Total Magnitude of Factor Market Distortions

Besides these distortions in the workings of labor and capital markets, biases also arise in the availability and pricing of other inputs and in regulatory policies. These also affect the relative profitability of different producers and technologies, but little information on their effects is available. Impressionistically, municipal regulations often have, on balance, a negative effect on SMEs, which may be excluded from certain urban areas for aesthetic, health, or safety reasons. The net effect of registration and licensing requirements is problematic. The smallest firms generally do not register and are not licensed by public authorities. When SMEs are

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excluded by law from these requirements, they acquire a competitive advantage over larger registered firms. When they are legally subject to these rules, however, the scope for haphazard and discriminatory enforcement grows, particularly for the more visible medium-sized firms.

The last column of Table 17 measures the effect of capital and labor market distortions on the wage/rental ratio (relative prices of labor and capital) of large and small enterprises in selected countries. The large positive values for all the countries shown (except Hong Kong) indicate that large firms in these countries could obtain capital far more cheaply relative to labor than if factor markets had been undistorted. Labor markets, capital markets, and foreign trade regimes all tend to raise labor costs and lower capital costs for the larger firms. Taxes work in the opposite direction but provide only a partial offset. The factors operating to raise the wage/rental ratio for large firms provide a cumulative effect of substantial magnitude. In Sierra Leone, Ghana, and Pakistan, for example, the wage/rental ratio facing large firms was more than twice that facing smaller enterprises. In Argentina, according to Nogues (1980: 149), it may have been eight times as great at one time.

Product Market Distortions

Although many different types of policy affect production, employment, and the size distribution of firms through their effects on product markets, trade policies are the most important member of this group, as well as the one whose effects are most quantifiable.

The foreign trade strategy a country adopts plays a central role in determining the nature and extent of product market distortions. Import substitution regimes, which persist today in many countries even though they have lost much of their earlier popularity, are usually characterized by (1) high levels of protection for many industries, with a wide range of rates of effective protection; (2) extensive quantitative controls and bureaucratic regulations, particularly with respect to imports; and (3) overvalued exchange rates. Export promotion regimes, by contrast, generally have (1) minimal or zero levels of protection for local activities; (2) few quantitative restrictions on imports; (3) equilibrium, or even undervalued, exchange rates; and (4) some subsidization of exports. Taiwan, South Korea (beginning in 1961), Hong Kong, and Singapore—the "NIEs"—along with Brazil (after 1967), Colombia (after 1970), and the Ivory Coast (after 1960) were among the first developing countries to adopt export promotion strategies.

In an export promotion regime, tax incentives, tariff exemptions, and direct subsidies per unit of sales are frequently offered as incentives to

exporters. Jose L. Caravalho and Claudio L. S. Haddad (1981: 44) estimated for Brazil that only 68 percent of the sales price was required in the 1970s to compensate an exporter for a loss of domestic sales, once export inducements were taken into account. For South Korea, Larry E. Westphal and K. S. Kim (1977) estimated that exporters received subsidies worth about 30 percent of the good's total value when selling abroad during the same period. As these and other studies make clear, the export success of these countries, far from arising from the free play of market forces in a *laissez-faire* environment, was substantially assisted, particularly in its early phases, by incentives provided to those who exported successfully (Scitovsky 1985; Streeten 1985; Amsden 1989; Wade 1990).

To what extent has the structure of tariff protection and export assistance varied by enterprise size? Unfortunately, most trade studies have paid little or no attention to this issue, so evidence is scanty. On the import side, Anderson and Khambata (1981) found that sectors that provided over two-thirds of the small-scale employment in the Philippines had negative rates of effective protection,[9] while sectors in which large-scale enterprise predominated had effective protection rates ranging from 25 to more than 500 percent. In Indonesia, Mathias Bruch and Ulrich Hiemenz (1984) found a negative correlation between the share of small enterprise production in an industry and its effective rate of protection. For Malaysia, Kurt von Rabenau (1976) showed that average plant size was much higher in highly protected industries (those with effective protection rates above 100 percent) than in less protected ones. The few available studies thus suggest that industries in which there are more SMEs tend to receive less tariff protection. No direct evidence is available on the differential effect of other product market distortions.

On the question of what types of enterprise benefit from export incentives, Krueger et al. (1981: 41) contended that "an important feature of export regimes is that these incentives are provided to anyone who exports. They provide a uniform degree of bias among exporting activities." There is, however, contrary evidence. In Korea, for example, it appears that only the larger exporting enterprises were eligible for subsidies. Frank, Kim, and Westphal (1978) note that the Trade Transaction Law of 1957 defined minimum export values that had to be achieved before an exporter could be registered by the authorities and thus become eligible for subsidies. Since many SMEs were unable to meet these norms, which rose over time, they were excluded from the program. This could have contributed to the dominant role played by large firms in Korea's export boom (Scitovsky 1985). In Taiwan, on the other hand, export promotion policy has been less discriminatory and small firms have played a much greater role in industrial development and exports.

Agriculture and industry: The trade regime also has indirect effects on

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the enterprise size distribution that operate through the structure of production and income in the economy, working back through the pattern of demand to the level of output and employment. An important aspect of this topic is the impact of the trade regime on the distribution of income between the agricultural and nonagricultural sectors. Considerable evidence supports the widely held belief that policies in many developing countries have been biased against agriculture and in favor of industrial activities. The tariff structure often discriminates against agriculture, particularly in countries following import substitution strategies. Industrial products are protected by relatively high tariffs, while agricultural products are not. Protection thus acts like a tax on agriculture, raising the prices of industrial products in relation to agricultural goods on the domestic market. In five of the eight countries shown in Table 18, effective protection of manufacturing was more than double that of agriculture; in one country agriculture faced a significantly negative rate of effective protection. Little, Scitovsky, and Scott (1970) estimated the contribution of agriculture to GDP with and without protection in six countries (Brazil, Mexico, India, Pakistan, Taiwan, and the Philippines) in the 1960s. Without protection or overvaluation, they estimated, agricultural valued added in these countries would have been 8–48 percent higher, while manufacturing value added would have been 8–94 percent lower.

The relatively high taxes levied on agricultural exports in many countries magnify the distortions caused by protection. In Sierra Leone, for example, farmers received less than half the world market price from the marketing board for several agricultural commodities (Byerlee et al. 1983). This situation remains common throughout Africa. After reviewing information relating to major export crops in thirteen African countries in the 1970s, the World Bank concluded that African farmers' "tax burden, defined as the ratio of farmgate producer price to economic value at the farmgate, is on the average in the 40 to 50 percent range." Subsidies on farmers' inputs "soften the impact very little, by 1–15 percent in most cases" (World Bank 1981: 55).

Policies biased against agriculture are widely believed to harm SMEs, many of which may be located in rural areas and devoted to producing consumer goods (and sometimes also capital and intermediate products) used by farmers. This is discussed further in the next subsection.

Economic Impact of Policy Distortions

The pervasive policy distortions just described affect economic efficiency, employment, and the distribution of income. Many studies have tried to estimate the economic impact of these distortions, but their coverage and

TABLE 18 Effective Rates of Protection

Country	Year	Trade strategy[a]	Sector		Production category[b]		
			Agriculture	Manufacturing	Consumer goods	Intermediate goods	Capital goods
Brazil	1966	ISI	46	127	198	151	33
Chile	1961	ISI	58	158	226	150	16
India	1968	ISI	12	95	128	82	78
Korea	1968	EOI	18	−1	−2	1	100
Mexico	1960	—	6	32	50	40	21
Malaysia	1965	—	22	11	7	17	1
Pakistan	1963	ISI	−19	188	348	160	110
Philippines	1965	—	33	53	72	45	10

NOTES: Dash = not available.
a. ISI = import-substituting industrialization and EOI = export-oriented industrialization, as characterized by Balassa.
b. Aggregates for consumer, intermediate, and capital goods are unweighted averages of the disaggregated data.
SOURCES: Balassa 1971: 55 for all but India and Korea; Korea: Westphal and Kim 1977; India: Bhagwati and Srinivasan 1978.

methodologies have varied widely and few studies have specifically examined how such distortions affect the size distribution of firms and the role of SMEs.

Although the factor market distortions reviewed earlier in this chapter appear considerable, some estimates of the resulting economic inefficiency are remarkably small. Berry and Sabot (1978) calculated that the cost of the resource misallocation resulting from labor market distortions in developing countries is normally less than 2 percent of GNP. A computable general equilibrium (CGE) model for Colombia estimated that urban labor market distortions lead to inefficiencies equal to 2.7 percent of GNP if capital stocks are assumed to be fixed and 10.7 percent if capital is mobile among sectors (de Melo 1977). This relatively large estimate of efficiency loss from labor market distortions is based on a broader definition of distortions than we have been discussing and assumes a number of price and quantity interactions.

Analysts who look beyond labor markets have commonly found greater efficiency losses. Losses from capital and output market distortions have been placed as high as 6–16 percent of GNP in several developing countries, much larger than distortions arising out of labor markets. However, some estimates are smaller.

Employment and the Size Distribution of Firms

Factor market distortions affect employment not only through their effect on output but also by means of firm-level decisions on choice of technique. Many analysts have estimated the impact of a changing wage/rental ratio on factor utilization. Most do this by measuring the elasticity of substitution between capital and labor.[10] Henry Bruton (1972), David Morawetz (1974, 1976), William F. Steel (1977), and Lawrence White (1978) report estimates for twenty-five developing countries, which generally place the elasticity of substitution in the 0.5–1.2 range. Jere R. Behrman's (1982) later estimate, based on data for twenty-three manufacturing industries in seventy countries, is that most elasticities of substitution are not significantly different from 1.

A few factor substitution estimates have been made specifically for small firms. Chuta and Liedholm (1976) estimate a constant elasticity of substitution (CES) production function for a range of small enterprise activities in Sierra Leone and obtain elasticities close to one. Page (1984) finds the elasticity of substitution between capital and unskilled labor to range from 0.4 to 1.0 for both large and small firms in India. Jae Won Kim (1984) computes elasticities of substitution separately for large and small firms in South Korea. He obtains elasticities of substitution ranging up to 0.9 for SMEs and 1.6 for large enterprises. In some industries, small firms have a higher elasticity of substitution than large firms.

Some analysts combine estimates of the elasticity of substitution with knowledge of the magnitude of factor price distortions to estimate the employment-reducing impact of factor pricing policies on firms subject to these distortions. Norongchai Akrasanee (1976) uses this procedure to estimate the impact of minimum wage legislation in Thailand. Based on what he believes to be a 26 percent premium of minimum wages over the shadow wage rate for unskilled labor, he estimates that eliminating the minimum wage would increase employment in manufacturing by 20 percent. These calculations were based on firms hiring five or more workers and may be an overestimate for these firms, many of which probably succeed in evading the minimum wage regulation.

Richard W. Hooley (1981) projects the employment impact of removing the capital market distortions embodied in a set of capital-biased trade incentives in the Philippines. Assuming that one-fourth of all manufacturing firms benefit from capital subsidies, Hooley estimates that removal of the subsidies would lead to a 5.4 percent increase in the share of manufacturing employment generated by firms with five or more workers.

All these exercises must be treated with caution in view of the widely acknowledged problems with elasticity of substitution estimates that have been discussed by S. St. J. O'Herlihy (1972), Howard Pack (1972), Morawetz (1974, 1976), J. Gaude (1975), Michael Roemer (1975), Steel (1977), and White (1978). Particularly disconcerting is the fact that in the estimating form most commonly used, the indirect CES function regressing value added per worker on wage rates, causality may flow in either direction. Higher wages may not induce capital-labor substitution (or management-labor substitution, as Pack [1972] suggests) but may instead reflect a rise in wages following increases in worker productivity. Thus a finding that the elasticity of substitution is positive does not conclusively establish that removal of policy-induced factor price distortions would lead to greater labor use.

Lloyd G. Reynolds and Peter Gregory (1965) and John R. Eriksson (1970) used a related technique, regressing employment on wage rates to determine the effect of wage rates on labor use. A review of many similar efforts concludes that "measurements of the effects of wage changes on industrial employment show consistently that higher rates of wage increases are associated with slower growth of employment" (Williams College 1972). Steel (1977) and Jerome Wolgin et al. (1983) concur, based on observations in Ghana and Malawi. Similarly, Gary S. Fields (1984) concludes, on the basis of a review of seven developing countries, that wage restraint is necessary if export-oriented strategies are to result in higher industrial employment. Yet Reynolds and Gregory (1965) and Steel (1977) caution that correlations between wages and employment may camouflage a variety of other important influences on employment levels.

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Although minimum wage legislation is frequently cited as a potential source of employment reduction, the few direct estimates of its employment effects suggest that its impact is small. Michael Lipton (1978) summarizes a study that noted little change in employment in Botswana's formal sector one year after a huge 80–100 percent increase in the minimum wage. Similarly, Pack (1972) notes a survey in which Kenyan factory owners stated that a wage rise of 200–300 percent would be needed to induce them to cut their labor force. Squire (1981), in a mathematical modeling exercise, finds that even a 46 percent cut in minimum wage rates would lead to only a 1.6 percent increase in total employment. Other studies (Lipton 1978; J. G. Williamson 1971) indicate that adjustment times are often long.

Capital subsidies compounded by minimum wage legislation reduce employment in large firms. Their impact on employment in small firms is less clear. If SMEs face artificially high capital costs, they may hire more workers than they would in undistorted input markets. If they face only the opportunity cost of capital, this is not be the case. Removal of all factor price distortions could thus raise employment in large firms but lower employment in small firms. The net impact on manufacturing employment is uncertain but is unlikely to be negative. It will be affected not only by intrafirm factor substitution but also by competition among small and large firms, which in turn will be affected by factors such as the geographic dispersion of markets, transport costs, substitutability of final outputs, and economies of scale.

Effects of Policy Interventions in Output Markets

Policy interventions influence the composition of final demand faced by manufacturers in many ways. The most important effects are on agriculture, on the balance of incentives to produce exports as opposed to imports, and on the distribution of income.

Policies designed to enhance agriculture can have important effects on nonagricultural output and employment as well as on the size distribution of enterprises, particularly those located in rural areas. In addition to the factor market linkages, two important demand relationships tie agricultural and nonagricultural activities together: the consumption linkage that arises from incomes generated by agricultural households and production linkages that stem from the agricultural sector's demand for inputs or from processing of agricultural outputs. Through these linkages, policies aimed at removing biases against agriculture can significantly influence nonagricultural activities.

Evidence on the strength of the influence of agricultural growth on nonagricultural employment, output, or the size distribution of enterprises is unfortunately rather sparse. Several studies have used input-output analysis to quantify the direct and indirect employment and output

effects of agricultural growth, or of alternative agricultural policies. For India, Raj Krishna (1976) measured the effects of an increase in agricultural output accompanied by a labor-displacing change in agricultural technology. He found that a 5 percent increase in agricultural output would lead, through intersectoral and multiplier linkages, to a 5.1 percent increase in nonfarm employment; the elasticity of nonfarm employment with respect to agricultural output was thus approximately 1. Similarly, Mellor and Mudahar (1974) found that "potential" employment growth in nonagricultural activities in response to a 4 percent growth in food grain output is 4 percent.

Studies by Byerlee (1973) on Nigeria and Byerlee et al. (1977) on Sierra Leone examined employment linkages between agriculture and different types of nonagricultural enterprise. Using data for 1950–1966 and 1974–1975, respectively, these studies calculated nonagricultural employment elasticities with respect to increases in agricultural output of 1.2 for Nigeria and 1.6 for Sierra Leone, somewhat larger than those found in India. Surprisingly, the measured elasticities were slightly higher for large enterprises than for small ones. In Nigeria, the nonfarm employment elasticity for large enterprises with respect to agricultural output was 1.5, while for small enterprises it was 1.1; in Sierra Leone, the corresponding figures were 2.0 and 1.5, respectively. Moreover, the urban coefficients were somewhat larger than the rural ones. Finally, the employment coefficients were found to vary with the simulated agricultural policy options. With an agricultural export promotion policy, which tended to benefit larger farmers, employment in small-scale nonagricultural enterprises fell while employment in large-scale enterprise rose. With a food crop production campaign aimed at small farmers, however, small-scale nonagricultural employment increased while large-scale employment remained virtually unchanged. These studies thus suggest that the type of agricultural policy selected can affect both nonagricultural employment and the size distribution of enterprises.

Two other regional studies measure the direct and indirect nonagricultural rural employment effects of agricultural activities. Arthur Gibb's (1974) study of the growth of nonfarm employment in a part of Central Luzon in the Philippines estimates the amount of nonfarm employment induced in rural areas by the growth of local agriculture. During the 1960s, a policy of encouraging small-farm agriculture led to rapid increases in agricultural output and incomes, which induced increases in local nonfarm employment opportunities. Gibb estimated that the elasticity of demand for nonfarm labor with respect to changes in agricultural incomes averaged 1.3 and varied from 0.8 for public services to 1.97 for trade, crafts, and construction.

A study by Clive P. Bell, Peter Hazell, and R. Slade (1982) estimated the

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indirect effects of an irrigation project in the Muda River region of Malaysia in 1974. Their well-specified model, built on a detailed database, localized the indirect effects of the project. The study indicated that for each dollar of income created directly in agriculture by the project, 90 cents of value added was created indirectly in the nonfarm economy. Two-thirds of the indirect rural nonfarm activity was attributed to increased rural household demand for consumer goods and services; the remaining one-third resulted from agriculture's increased demand for inputs, processing, and marketing services.

Finally, Gustav Ranis and Frances Stewart (1987) estimated linkages from agricultural output to nonagricultural activities in Taiwan and the Philippines and found them to be very substantial, even where policies are not especially conducive to promoting them. Increases in agricultural output in both countries were accompanied by significant increases in all types of linked activities, especially those with forward linkages but also including backward and consumption linkages. Although linkages were strong in both countries, far more rural nonagricultural jobs were created in Taiwan (primarily in SMEs) than in the Philippines because policies were more favorable and the government invested far more heavily in rural infrastructure such as roads and electrification (see Chapters 6 and 7).

All these studies suggest that linkages between agricultural output and nonagricultural output and employment are 1 or greater. Changes in agricultural policy and agricultural output thus can and do have important effects on nonagricultural activities, particularly those that take place in rural areas. Although few studies include firm size or location dimensions in their analysis, it seems likely that much of the impact of alternative agricultural policies falls on SMEs, especially those located in rural areas.

Exports versus Imports

Trade policies have major effects on economic efficiency. Bela Balassa et al. (1982) put the cost of the distorted output and capital markets that accompany protection at 7 percent of Brazil's 1966 GDP and 6 percent of Chile's 1961 national income. Using data from Krueger (1966), they estimated Turkey's loss at 7 percent of GNP. Jaime de Melo (1978) calculates the cost of protection in Colombia at 11–16 percent of GNP, depending on assumptions about the availability of surplus labor. An earlier estimate by Arnold Harberger (1959) measured Chile's loss as 15 percent of GNP. Other estimates, however, are somewhat lower.[11]

Employment can also be substantially affected by trade policy, both through the loss of efficiency and consequent reduction in overall output and through protection's effect on the composition of output. Available estimates indicate that output is the most important influence on employment and that employment elasticities of output close to 1 are common

when account is taken of compositional effects. Findings by Balassa et al. (1982: 58), Eriksson (1970), and others strongly indicate that significant employment losses can result when trade policy distortions reduce aggregate output as a result of allocative inefficiency.

Trade policy can also influence employment by shifting a country's commodity mix toward more labor-intensive export commodities. A rapidly accumulating body of evidence indicates that, as Heckscher-Ohlin-Samuelson would lead us to expect given the low wage rates prevailing in most developing countries, developing country exports tend to be more labor using than import substitutes. Studies by Little, Scitovsky, and Maurice Scott (1970) and Krueger et al. (1982) indicate that a shift from import substitutes to export-oriented industries generally increases employment. Table 19 indicates the magnitude of differential labor use in the two types of manufacturing in the 1970s. In Argentina, for example, one unit of value added in exports provided 30 percent more employment than did a unit of import substitutes. In all countries in the table except South Korea, where gains from export promotion had already been captured (Watanabe 1972), export promotion promised significant increases in labor use.

Krueger acknowledges that these estimates may be biased, since they are based on technical coefficients taken primarily from large-scale

TABLE 19 Increase in Employment Obtainable by Shifting from Import Substitution to Export Promotion

Country	Increase in Employment[a] (%)
Argentina	30
Brazil	107
Chile	34
Colombia	91
Indonesia	26
Ivory Coast	21
Pakistan	41
South Korea	0
Thailand	70
Tunisia	23

NOTES: a. Based on shifting one unit of value added.
SOURCE: Krueger et al. 1983: 180 for all but Thailand; Krueger 1978 for Thailand.

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firms (Krueger et al. 1982: 24). Participation in export expansion by labor-intensive small firms might increase these employment gains, but the gains could be reduced if labor-intensive small firms supplying local markets are displaced by imports as a result of trade liberalization.

Although evidence on this point is limited, Ho notes that small enterprises in Korea and Taiwan expanded fairly rapidly during both countries' import substitution phases but grew more slowly in each case after the shift to an export orientation (Ho 1980: 90). During South Korea's import substitution phase, employment in firms employing 4–9 workers rose at 6.6 percent per year, but after the switch to export promotion this growth rate dropped to 0.3 percent. Similarly, in Taiwan, employment growth in the smallest firms (those employing 1–3 workers) fell from 2.3 percent per year under import substitution policies to 1.6 percent per year under export promotion strategies. Ho attributes the fall to the importance of economies of scale and small firms growing up through the size distribution, but large firms' preferential access to credit and other export incentives could also have played a part.

Albert Berry also notes the importance of the size distribution of firms in export strategies. He argues that while the Colombian trade liberalization of 1958 did result in decreased capital intensity in large-scale manufacturing and a modest drop in unemployment, the employment gains were less substantial than had been hoped, primarily because labor-intensive small scale enterprises did not participate in the export growth (cited in Ranis 1975: 15–16). He suggests that export-oriented strategies should be accompanied by measures to encourage the participation of small-scale, labor-intensive units, such as marketing arrangements to help funnel small-producer output to export markets (Berry 1972: 103).

Overall, the potential impact of export promotion on employment appears substantial. To realize this potential frequently requires conditions complementary to liberalization, such as wage restraint (Fields 1984), the availability of complementary factors of production, and possibly mechanisms for including small-scale, labor-intensive enterprises in the export growth.

Income Distribution

A final link among output markets, employment, and SMEs is through income distribution and its impact on employment. During the upsurge of interest in income distribution issues that occurred in the early 1970s, it was hypothesized that income redistribution toward the poor could shift demand patterns toward products amenable to labor-intensive production, leading to increases in aggregate employment. SMEs played a part in this speculation because they were believed to be labor-intensive and devoted largely to meeting the needs of the poor.

A number of simulation studies investigated the relationship between income distribution and employment. Morawetz (1974) and William R. Cline (1975) review the results of these studies, most of which confirmed that low-income groups do consume a more labor-intensive basket of commodities than the rich. Raising the income share of the poor would therefore increase employment. But some of the studies suggest that it would take a long time for the effect to be achieved, and virtually all of them indicate that the magnitude of the impact would be small. An important reason for this is the fact that the rich consume more services than the poor, offsetting employment creation through the shift in goods consumption. Even a major redistribution of income would normally lead to no more than a 5 percent increase in employment (Morawetz 1974). Felix Paukert, Jiri Skolka and Jef Maton (1975) estimate that a huge redistribution of income in the Philippines—one that lowered the Gini coefficient from .47 to .25—would raise employment by 10 percent initially but lead to a 0.5 percent lower employment growth rate in ensuing years. It is unclear how resource transfers of this magnitude could be accomplished, even if their impact on employment were demonstrably greater.

Conclusions

The evidence cited above leads to several conclusions:

- Policy bias against SMEs is considerable in many developing countries, but it may have declined since the 1980s as EOI policy regimes replaced ISI regimes.
- Capital prices are typically more distorted than labor prices.
- These distortions lead to allocative inefficiency that substantially reduces aggregate output. Estimates of the size of the effect vary widely.
- The effect of the entire package of policy distortions on the size distribution of firms is poorly documented. Limited evidence suggests that the overall policy environment confers cost advantages on large firms, allowing them to hold a larger market share than they would in a neutral policy environment. Commonly, this occurs when capital subsidies are so large as to outweigh the higher wages and tax liabilities faced by large firms. Investment codes and nonpayment of taxes contribute to this result by significantly reducing the tax liabilities of large firms. Again, there may have been some decline in such distortion since 1980.

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- Nonagricultural employment is affected in many ways by policy distortions, but by how much and even in what direction is hard to say. Decreases in aggregate output induced by policy distortions clearly reduce employment, as do policies that discriminate against either agriculture or exports. Factor price distortions faced by large firms lead them to use less labor and more capital than they would in a neutral policy environment. But we have less evidence on the magnitude of induced employment increase in small enterprises and virtually none on the effect of policy on the size distribution of enterprises. Without such evidence, we can say that overall policy distortions lead to reduced employment in large firms but not how much of this loss is offset by increased employment in small firms.

POLICY CHOICE

As the preceding discussion indicates, many developing countries, whatever their policy pronouncements, have in practice formulated and implemented policies that disproportionately benefit large industrial enterprises and reduce the competitiveness of SMEs. The magnitude of policy bias ranges from substantial in countries with heavy protection of import substitutes, overvalued currencies, and widespread administrative intervention in commodity and factor markets to slight in nations with relatively open, competitive economies and little overvaluation. Policy bias against SMEs can also exist in EOI policy regimes if inducements to export are differentially available to large firms, but the degree of bias is generally smaller than in ISI regimes, which are inherently highly interventionist.

In most developing countries, policy bias against SMEs paradoxically coexists with a stated policy objective of promoting SME development. Virtually every developing country government has committed itself to promotion of SMEs and has launched programs to this end. Small enterprise credit programs are ubiquitous; many developing countries have several different ones. Technical assistance and facilities provision programs of various types are almost equally widespread.

Is the net impact on SMEs of government actions, including both policies and programs, negative or positive? Where policy bias is strong, the net effect is likely to be negative. This surmise follows from two points about SME promotion programs that are further developed in Chapter 4. First, the volume of resources devoted to these programs is usually quite small, compared to the amounts spent on development of large-scale industry and in other sectors. Second, these programs are usually not very effective in achieving their objectives. If policy bias against SMEs is at all

significant, therefore, the comparatively small sums rather ineffectively spent on SME promotion are unlikely to offset it.

In the third section of Chapter 2, "Convergent and Divergent Cases," we saw that in countries such as Japan and Italy, where SMEs have played a significant part in the industrialization process and remained important up to high levels of development, government support made a useful but not critical contribution to the creation of SMEs capable of competing successfully in domestic and international markets. In most of these countries, government policy was initially biased against SMEs: support for SMEs following a flexible specialization strategy materialized only after the viability of that approach became evident. Sometimes government support was implicit and even unintended: we have seen that the success of Italian SMEs is largely attributable to conditions in the government and society that make it harder for large enterprises to operate profitably.

In most cases, the inconsistent stance of developing country governments toward SME promotion has a political explanation. Accordingly, this section is divided into three subsections, the first of which examines the political economy of policy decision making affecting SMEs. This review provides a framework for evaluating (in the second subsection) two frequently advocated alternative policy stances: policy neutrality and strategic intervention. Finally, we consider the role of international development agencies in developing country policy making affecting SMEs.

The Political Economy of SME Policy Making

Systematic analysis of the processes by which public policy decisions are made and implemented is of fairly recent origin, even in developed countries. Recently, however, political scientists and economists have devoted a lot of attention to the political economy of policy reform in developing countries.[12] The underlying motivations for policy reform have variously been assumed to derive from the class interests of those in power,[13] pressures placed on policy makers by competing social groups,[14] bureaucratic politics,[15] state interests,[16] or the personal interests of those who make and implement policy.[17] Each of these theories focuses on a different set of variables and process of political and economic interaction. Although all provide insights into the process of policy and institutional change, they shed surprisingly little light on the reasons why particular developing countries do or do not adopt and carry out policy reforms at particular times in their histories. Research by Merilee S. Grindle and John W. Thomas (1991), carried out partly under EEPA auspices, identified four factors as significant in this connection: technical analysis, bureaucratic motivation, regime maintenance, and international leverage.

In the cases studied by Grindle and Thomas, decision makers were frequently influenced by *technical analyses* of the problem and advice on how it could be solved. The importance of technical analysis for decision making in developing countries may reflect the central role in policy making played by technocratic elites in many of these countries, as well as the relatively closed, even secret, nature of the decision-making process. Supporting factors may be the complexity of the issues that political leaders must address in shaping development policies and their need to explain decisions in terms of their impact on national development.

Second, the case studies confirmed the importance of the *bureaucratic politics* that surround decision making. Decision makers often take positions that enhance their own career opportunities or the fortunes (the budgetary resources, influence over programs, prestige, or clientele) of the bureaucratic entities they represent.

A third important element was the importance of *regime maintenance* as a decision-making criterion for political leaders and policy makers. Policy reform options are often assessed by decision makers in terms of their likely effect on the longevity of the regime in power or that of the current leadership faction. The application of explicitly political criteria to decision making indicates the importance of building and maintaining coalitions of support for incumbent political elites. Regime maintenance goals are often cited as reasons why certain policy options are "off-limits": the costs that they impose on certain groups might undermine support for the regime (for example, Haggard 1985). They can also explain the use of "pay-offs" to maintain the loyalty of important groups (Bates 1981; Haggard 1985) and the common influence of clientelism on the allocation of public resources. In many developing countries, the coalitions that support incumbent regimes are fragile and possess limited legitimacy: this makes them vulnerable when the performance expectations of their supporters are disappointed.

Regime maintenance criteria often explain why changes are *not* made. Fear that policy reform would provoke a key ethnic group or the military are commonly cited as reasons why reform is politically impossible. Similarly, arguments that economic liberalization is infeasible often focus on the negative reaction of industrial elites who have benefitted greatly from protectionist policies.

While policy makers rarely make decisions on the basis of regime maintenance goals alone, such concerns tend to take precedence over other criteria in determining decision outcomes.

Finally, the role of *international actors and international economic and political dependency relations* is significant in many policy reform decisions, especially during periods of economic crisis or when specific "rewards" are offered for accepting the advice of the international body.

From our point of view, a limitation of the burgeoning literature on the political economy of policy reform is that it pays little attention to policy reforms undertaken with the explicit aim of improving the performance of SMEs. The reason is less a lack of interest on the part of students of policy reform than the simple fact that policy reforms that impact SMEs are almost always undertaken with other objectives in mind, such as reducing inflation and fiscal and balance of payments deficits and accelerating the rate of economic growth.

Small business owners are seldom government insiders, but they do often represent a sufficiently potent political constituency that they cannot be totally ignored. They thus may have to be "bought off," as mentioned earlier. Their political influence is enhanced when many of the large industrial firms in a developing country are owned either by multinational corporations, foreigner individuals, or citizens who are members of an entrepreneurial minority, whereas most small firms are owned by citizens who are members of the ethnic majority. This can make small business policy an important part of nationalistic or ethnic politics. A related situation is one in which noncitizens or entrepreneurial minorities are so prominent and successful in small business that they are putting pressure on the generally less successful ethnic majority. In this case, small business owners from the majority group are likely to appeal to the government to redress the "imbalance" in resources such as wealth and business connections between themselves and the minority by providing them with forms of assistance not extended to their noncitizen or minority counterparts.[18]

Resentment of competition from large business often causes small business owners to ask their governments for help. The success of their petitions will depend on the political clout of the petitioners, but they are likely to have enough force to merit at least some form of recognition. SME promotion programs serve as a visible sign that the pleas have been heard and provide the government with at least temporary relief from the small business owners' complaints. Recently, several developing country governments have taken steps to emphasize their concern for SMEs by establishing organizations analogous to the U.S. Small Business Administration, which are intended to centralize small business concerns within government policy making.

Such a move, however, is largely symbolic and does not alter the basic fact that the government has many other objectives that it wishes to pursue; small business promotion seldom ranks high on its list of priorities. Industrial development through large-scale enterprises is usually a far more pressing objective, for reasons that range from a desire to achieve national strength, through a sincere belief that modern countries need to have large factories, to the possibility that self-interested large-scale industrialists occupy high positions within the government (small-scale

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industrialists almost never do), or that high-value transactions provide opportunities for large kickbacks to government officials. Hence the frequent contradictions among government policy statements, policies, and programs.

We have seen that goals such as national strength, modernization, and industrialization are most likely to produce strong policy bias against SMEs when they are pursued through policy regimes that feature high levels of protection, significant overvaluation of the currency, and widespread administrative intervention in the economy. Fortunately, approaches to development policy that feature these measures have lost much of their credibility in the past fifteen years. Although elements of the ISI regime persist in most developing countries, there has been a general move toward lower levels of protection, more freely fluctuating exchange rates, and less distorted internal markets for goods and services, labor, and capital. These changes have been pushed in equal measure by the demonstrated successes of more market-oriented policies and by the equally well documented failures of interventionism and protectionism (see, for example, World Bank, *World Development Report*, 1987: 38–170).

Reduced government intervention in developing economies permits markets to function better, with results that may be either favorable or unfavorable to SMEs, in the sense that the SME sector may either grow or contract. But the more important point is that freer, better-functioning markets—the product of both market-oriented policies and the process of economic development itself—promote more efficient allocation of resources. This means that SMEs will be better able to do the things that they can do efficiently but will lose out in areas where they are uncompetitive.

As discussed extensively in Chapter 2, countries that succeed in significantly raising per capita income over time undergo profound structural transformation involving both changing and declining roles for SMEs. Anyone who retains a basic devotion to the traditional objectives of economic development—higher output per capita, a widened range of choice, longer life expectancy—should welcome and promote these changes as fundamental components of the development process, whether they benefit SMEs or not. Advocates of two possible policy approaches contend that their favored policies do just that.

Policy Neutrality versus Strategic Intervention

The "free-market," or "neo-classical," school argues that the overall policy objective should be a "level playing field," on which firms of many different sizes and types can compete freely. The winners in this game, the argument goes, will be those that have proved themselves best able to compete and survive. The policy maker does not need to know in advance

which firms these will be—whether large or small, foreign or domestic, in light industries or heavy industries, high-tech or low-tech; all that is required is to create the level playing field and permit the results to reveal themselves in time.

We saw in Chapter 2 that there are strong reasons to favor this kind of approach, based on ideas that go back to Adam Smith. Freer markets encourage firms to select the products, input combinations, technologies, and production scales that make the most efficient use of available resources. This powerful argument for competition has had to accommodate only one significant exception over the years: the infant industry argument, which contends that temporary protection of a newly established industry can help it survive an initial period of noncompetitiveness until, through expansion and learning, it is able to reduce its costs to a competitive level. Once that point is reached, protection is no longer needed and should be removed in the interest of efficiency.

Even temporary protection of new industries would not be needed if long-term capital markets were perfect. In that case, firms that were expected to be profitable at some predictable time in the future could borrow to cover their interim losses while selling goods at market prices and learning how to reduce their production costs. This would be superior to measures of protection and subsidization, since it would not distort prices. In practice, however, the period of time required to reach profitability might be so long (several years, or even decades) that neither domestic nor international lenders are willing to assume the risk involved, even when the firm's prospects are generally agreed to be favorable. Attempts to resolve this problem through the provision of capital by public lending institutions have been plagued by problems that frequently led to the bankruptcy of the lending institutions.

The infant industry argument furnished the intellectual justification for both the ISI approach popular in the 1950s and 1960s and the subsidized EOI drives that some countries later undertook. It also provides one possible rationale for assisting SMEs, either through subsidized lending and other forms of free or subsidized assistance or, more rarely, through protection of their product markets. In all these applications, the infant industry argument runs up against a major political difficulty, namely that protection and subsidization are easy to institute, especially when they benefit politically influential groups, but hard to terminate, particularly after those same groups have substantially increased their wealth and power as a result of the privileged position that has been created for them. That threats to end their protection at some time in the future commonly lack credibility weakens the incentive for protected enterprises to raise productivity and increase their competitiveness. The theoretical model of temporary protection or subsidization thus turns out to be difficult to implement in practice.

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The same point can be made with respect to the level playing field for interscale competition frequently advocated by the World Bank and others. Despite the theoretical attractions of laissez-faire, all governments intervene in the economy. Setting Hong Kong aside as a very special case, the East Asian economies that were being hailed as free market triumphs a few years ago are now increasingly regarded as examples of successful government intervention (Amsden 1989; Wade 1990). Their achievement of international competitiveness is ascribed less to the operation of free markets and more to differences between their form of interventionism and that practiced elsewhere.

Similarly, the argument of Little, Mazumdar, and Page (1987) that differences in factor use and enterprise performance among small and large industrial firms are not large or consistent enough to justify policy preference for any particular scale of production seems to fit both economic theory and the facts, insofar as the latter are known. Yet the resulting policy recommendation that governments abstain from scale-based or scale-biased interventions is universally honored in the breach. As we have seen, virtually all developing country governments intervene in many different ways that both help and hurt SMEs.

It is reasonable to assume that governments will continue to practice various forms of intervention intended to promote the development of SMEs. Since intervention is the actual state of the world, the job of the policy advisor is surely to try to make the form of intervention practiced as rational and effective as possible. What forms of scale-based intervention are rational and effective, and in what settings?

From the point of view of SME development, reduction in policy bias is always rational. Logically, from a broader point of view, policies biased against SMEs might be desirable if they achieve other important objectives. In practice, however, the same reforms that reduce policy bias against SMEs tend to make large enterprises more efficient, increase productive employment, and improve income distribution. They are thus valuable for several reasons and are more likely to be undertaken in pursuit of their other benefits than for their effects on SMEs.

In all types of developing countries—whether low income or middle income, whether located in Africa, Asia, or Latin America—the identification and measurement of policy biases against SMEs with an eye to their possible rectification is a legitimate, desirable activity. To achieve actual reduction of such biases, however, is likely to require linkage to other policy objectives, such as accelerating growth and reducing the extent and severity of poverty. Such actions, however, might well be thought of as reductions in government intervention, rather than as forms of intervention.

More explicitly interventionist activities in favor of SMEs have been identified as policies or programs. In early stages of economic

development, intervention is likely be costly and ineffective, as discussed earlier and elaborated in Chapter 4. In rapidly growing middle-income economies that are approaching or have passed the labor market turning point, however, a case can be made that judicious intervention can help things along, especially if it is *performance based*—that is, given in anticipation of achievement of defined performance norms and promptly withdrawn if the norms are not achieved. Such assistance has been provided to SMEs in Taiwan and South Korea, as discussed in Chapter 7. Only a "hard state" can apply such a policy successfully, however, since it is essential for maintaining incentives that nonperforming aid recipients be cut off and governments must be strong enough to take this action when circumstances warrant, even if it means that firms have to shut down (Biggs and Levy 1991). As Gunnar Myrdal (1968) observed, however, most developing countries are "soft states" in which firm and consistent pursuit of such an interventionist policy is impossible because it would be captured and controlled by the kinds of interest groups discussed earlier. The widespread preference for policy neutrality is implicitly based on generally correct assumption that developing countries are soft states.

Advocates of both policy intervention and policy neutrality are more severely tested when forced to apply their philosophies to countries that are poor and not developing very rapidly. Such countries have a crying need for economic development but may be decades away from achieving the substantial structural transformation needed for substantial inroads to be made on basic problems such as poverty, unemployment, and inequality. We will return to the issue of what to do in their circumstances when we discuss Bangladesh and Sub-Saharan Africa in Chapter 5.

Whether they try to achieve policy neutrality or attempt strategic intervention, developing country governments typically must make large changes in existing policies if they wish to promote the kind of efficient industrialization that we have been discussing. Donors seeking to initiate or otherwise take part in the policy reform process are often frustrated when their policy prescriptions are not readily accepted or implemented. Whether initiated by a donor or a developing country government, policy change is more likely to be adopted and carried out successfully if those who seek policy changes possess a basic understanding of the political economy of policy reform.

The Influence of International Actors

Policy and institutional reforms,[19] including those related to SMEs, are often undertaken by developing country actors with no outside intervention. Frequently, however, outside agents are involved to a greater or lesser extent. In principle, there are four ways in which an international aid

agency could influence national policy in a developing country so as to improve the performance of SMEs and increase their contributions to national development objectives. First, if it provides general assistance in the short-term credits or long-term loans, it could link such assistance to policy reforms, including measures intended to improve the policy environment for SMEs. The form of linkage could range from soft and unspecific exhortation ("persuasion") to hard and precisely specified conditions for receiving continued aid disbursements ("leverage" or "conditioning").

A second way to influence policies affecting SMEs would be to attach policy conditions to technical assistance and capital lending intended to finance SME promotion programs, such as loan funds, advisory services, and infrastructure.

A third possible path to policy influence is through high-level expert missions that try to define desirable policy reforms and persuade both government leaders and the public that they should be undertaken.

The fourth approach is to work through long-term advisory groups that operate at the staff level in government agencies and other bodies relevant to policy making. In addition to advising, such groups often engage in various forms of counterpart training and policy research, including in some cases primary data collection.[20]

We will comment briefly on each of these approaches.

Leveraged Policy Reform

The provision of outside aid "with strings attached" is as old as aid itself. It is an ancient saying that "he who pays the piper calls the tune." Efforts to link general economic support to policy in developing countries have been made continuously by the International Monetary Fund (IMF) since its formation in the late 1940s. The World Bank and USAID have also followed this practice at certain periods in their histories. Other aid providers have also attempted to leverage their assistance, but these are the three main practitioners.

The IMF imposes policy conditions on countries that need to draw extensively on the "credit tranches" available to them as IMF members. During the 1980s the Fund introduced the structural adjustment facility (SAF) and extended structural adjustment facility (ESAF), which are now being used more frequently than the regular credit facility. IMF lending conditions center on short-term measures intended to improve the balance of payments. They emphasize credit restraints and can also include tax policy statements and expenditure ceilings. Although it is assumed that accelerated economic growth will follow the establishment of economic stability, growth is not the explicit purpose of IMF credit. Issues of enterprise location or size are not known to have played any explicit role in the

design or implementation of IMF standby agreements. While the agreements have included policies relating to exchange rates, tariff structures, and other types of trade intervention, their key feature—particularly in recent years—has been the control of domestic demand through restrictions on the growth of credit.

During the 1980s controversy arose over the effects of IMF stabilization programs on poverty and income distribution. Officials from ILO and UNICEF and others joined critics from developing countries (for example, Onimode 1989) in charging that the burden of adjustment falls heavily on the poor, the informal sector, and children. Richard Cooper and Carlos Diaz-Alejandro both argued (in Williamson 1983) that the Fund should restrict itself to balance of payments assistance, leaving the particular means or working toward that goal within the welfare function to the policy makers of the host country. However, William R. Cline summarized several case studies of the distributional effects of stabilization programs by saying that

> stabilization (including that along orthodox lines) does tend to affect the distribution of income, but not inevitably in the direction of concentration. . . . To be sure, the overall level of economic activity will be important: if the stabilization package reduces output and employment (as the neostructuralists fear, under the orthodox package) real income of the poor will decline. . . . As for the distributional outcome in practice, the variety of experience suggests that (orthodox) stabilization can either concentrate or equalize the income distribution. (Cline in Williamson 1983: 195)

After long confining itself to project lending, the World Bank became heavily involved in policy conditioning when it introduced structural adjustment loans (SALs) and sectoral adjustment loans (SECALs) in the 1980s. These provide general financial support for countries engaged in reorienting their policies to change their economic structure, generally through policy liberalization. By 1988, SALs and SECALs made up almost 25 percent of World Bank loans (Weintraub 1989).

The principal concerns of the SALs and SECALs are (1) changes in trade regimes to improve the competitiveness of, and incentives for, exports; (2) mobilization of domestic and foreign resources; (3) improvement in the efficiency of domestic resource use; and (4) institutional reform (World Bank 1984: 1, 1985: 53). In relation to SMEs, their effect is to promote the kind of policy neutrality discussed earlier.

Much has been written about the strengths and limitations of the SAL program. Elliot Berg and Alan Batchelder (1984) argue that these activities are motivated by a particular (and, in their view, uncertain) perception of

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the process of policy change. They believe that the World Bank's primary goal was to help its representatives "get to the high table of decision-making of the country." The questionable implication is that once decision makers recognize the existence of a certain issue, the rest will follow relatively smoothly. World Bank representatives generally do have enough clout to get to the "high table" without any particular additional bribes, but that does not insure that policy changes which they recommend will be accepted, much less implemented. As Berg and Batchelder say,

> most LDC political authorities and probably most LDC technical people, including economists, do not agree with the views of, say, most Bank economists, on how markets and market institutions work in their country, or on the impact of proposed reforms. This is especially true, for example, in such key areas as agricultural marketing, industrial policy, trade and exchange rate policies and interest rate policy. (1984: 25)

Policy reform is not simply a matter of raising issues, but also of analyzing how the economy operates and then searching for effective ways of dealing with problems identified. The real key to policy reform lies in changing the minds of developing country decision makers. This necessarily involves discussion, even argumentation; it may also require research, perhaps new data collection. People generally do not change their mind on the basis of an argument based on generalities or ideology-driven positions. Outsiders who enter a developing country with a preconceived idea about how its economy operates are unlikely to be effective change agents. To prescribe needed changes, one needs a reasonably sophisticated understanding of the operations of the particular economy and society in question. Second, minds are most likely to be changed if the relevant decision makers understand—and preferably participate in—the analysis that leads to a particular conclusion. Third, if policy changes are dictated from outside and accepted only in order to receive an associated credit, the rethinking, reformulation, and continuing dialogue that must be a central feature of enduring and implemented policy change are unlikely to result. Conditionality imposed from the outside with only limited understanding or commitment on the inside is more likely to stand in the way of than to contribute to the changing of minds that is at the heart of meaningful and lasting policy reform.

The SALs have focused on the balance of payments, resource mobilization, efficiency questions, and institutional reform. Employment creation, the size distribution of firms, and the reform of policies affecting SMEs have not figured prominently among the concerns addressed.

USAID made extensive use of loan conditioning[21] in two periods: the 1960s and the 1980s. Experience in the earlier period was analyzed by

Clarence S. Gulick and Joan M. Nelson (1965) and Donald R. Snodgrass with Edward B. Rice (1970), while that of the latter period was studied by Robert Muscat (1984) and the U.S. Congress (1985). While these primary reviews of USAID experience do not agree in all respects, a number of common conclusions emerge. One of these is that stabilization policy is easier to condition than development policy because it works faster, is easier to quantify and monitor, and is less likely to involve institutional change.

A bold summary of the literature on leveraged policy reform suggests that four conditions are necessary for success. First, there must be a lever in the form of a significant aid program. Second, there must be credibility that aid will be withdrawn if the conditions are not met. Third, key issues must be kept few in number so that attention can be focused on them. Fourth, the analytical and administrative skills of developing country counterparts must be adequate.

Many attempts at leverage have failed because the value of the aid offered was insufficient to induce decision makers to take steps that would have high political costs at home, because the political relationship between donor and recipient made it unlikely that aid would be canceled in the event of nonperformance of policy commitments, because so many conditions were specified that compliance with all of them was recognized as an unrealistic expectation, or because host country officials did not understand or secretly disagreed with the policy commitments undertaken.

USAID's ability to exert leverage is more limited than in earlier times,[22] leaving the IMF and the World Bank to take the lead while USAID and other donors concentrate increasingly on development policies for which leverage is a less effective instrument of change than is persuasion. In addition, USAID now operates in smaller and poorer countries than it did in the 1960s; these countries have poorer databases and fewer trained analysts and administrators.

Influence on SMEs has seldom arisen as an explicit criterion for loan conditioning, even in the cases of USAID and World Bank loans. The need to keep the number of conditions small is a strong impediment to the inclusion of what is sometimes seen as a relatively minor issue. The aim of freeing up markets through deregulation, however, which has become increasingly prominent in recent years, does favor the development of SMEs along the lines sketched in Chapter 2.

Policy Conditions on Small Enterprise Loans

If general program lending is seldom conditioned with policy effects on SMEs in mind, what about using SME project loans as vehicles for leverage to induce policy reforms? After all, in many cases the project to be financed cannot be expected to succeed unless certain policies are changed.

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Customarily, policy conditioning of project loans has been limited to policies that have a major, direct influence on the success of the project. For example, facilities such as small business loan funds and industrial estates must be permitted to charge prices high enough to cover their costs if they are expected to be financially viable. We have seen, however, that the range of policies that has significant influence on the business success of SMEs is much wider than this. Could small enterprise loans be used to exert pressure for trade, tax, credit, and regulatory policies more favorable to SMEs?

Since 1975, the World Bank has given considerable attention to expanding loans for SMEs. This was a new undertaking; in 1972–1976, out of $2.2 billion that the World Bank lent to development finance corporations, only U.S. $100 million was designated for SMEs. Over the same period, the World Bank lent $3.1 billion directly for large-scale mining and industrial projects (Levitsky 1986: 1).

As the World Bank became increasingly involved in small enterprise lending, its concern about the policy context in which these enterprises operate grew. There were two reasons for this: (1) loan projects reach only a limited number of producers, while policy can have a much broader impact; (2) if policies discriminate against small producers in other ways, providing credit may have only a limited ability to facilitate their growth. Levitsky writes that "it became increasingly evident during implementation that there was a need for the Bank to concern itself more with the impact of policy framework" (Levitsky 1986: 17). He concludes that

> until realistic exchange regimes were established and until changes took place in trade, investment and financial policies . . . it was difficult to effect a substantial development of SSEs along healthy economic lines. It is hardly feasible to press for the use of appropriate technologies and maximum employment creation in a situation where subsidized finance for equipment purchase is offered and where it is possible to operate in a protected market where profits are high enough to justify equipment used for only a small part of the time. (1986: 33)

While the need for improved policy was recognized, the World Bank had trouble finding a way to work effectively towards this end. Efforts to include policy dimensions in small enterprise loans met with little success, largely (says Levitsky) because the discussions were with the wrong officials; those who negotiated small enterprise loans had no authority over macroeconomic and investment incentive policies. Also, the loans generally were too small to give the World Bank much leverage on broader policy issues. While SALs and SECALs seem well suited to deal with these

limitations, they have seldom been used in this way (World Bank, *World Development Report*, 1988).

High-Level Outside Experts

While donors have often sought to bring about policy change through analyses by high-level outside experts, the experience most relevant to our concerns is the ILO's World Employment Program. During the 1970s the ILO dispatched comprehensive, interdisciplinary missions to advise governments of several countries on "the strategy of employment promotion within the framework of development planning" (ILO 1973a: 1) to Colombia (ILO 1970), Sri Lanka (ILO 1971), Kenya (ILO 1972), Iran (ILO 1973a), the Philippines (ILO 1974), the Dominican Republic (ILO 1975), Sudan (ILO 1976), and Egypt (ILO 1982). The first seven missions all stressed the "comprehensive nature of their approach to the analysis of the employment problem and of the strategy to cope with this problem" (ILO 1973a: 63). Employment was viewed as part of the problem of poverty and income distribution in the countries concerned. Accordingly, the policy and project recommendations contained in the various mission reports ranged widely, from simple adjustments in labor laws to such major reforms as radical land redistribution, restructuring of the educational system, improvement in health services, and incomes policies.

There has been no formal accounting of how many of the policies recommended in the employment missions were actually put into practice. A 1973 ILO report on the first four missions (ILO 1973b) argues that the inherent complexity of the topic makes it impossible to evaluate the extent to which the missions influenced such fundamental goals as employment and distributional equity. It therefore emphasizes intermediate results, especially increased knowledge and understanding of the problems with which the governments are concerned and changed policies.

Richard Jolly, Dudley Seers, and Hans Singer, the leaders of the first three missions, argued that "in all three countries (Colombia, Sri Lanka, and Kenya), the thinking of the leadership, officials, and key individuals outside government and inside as well has clearly been influenced, and this is perhaps the most important outcome" (ILO 1973b: 31). Miguel Urrutia, representing Colombia, stated that

> the major effect on policy formulation of the mission to Colombia was through its impact on attitudes of the Government and politicians. A result of the mission was that employment and income distribution considerations, for the first time, were used as criteria for decision-making. (ILO 1973b: 146)

There were similar examples from other countries.

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Claims that the missions had actually influenced policy change were modest. Jolly, Seers, and Singer stated that

> implementation of all three reports has been very partial . . . one can hardly expect a complete change of development strategy to be implemented in every detail . . . our reports were a package, each containing dozens of proposals. In every case some proposals of each type have been carried out (though possibly they would have been carried out anyway). (ILO 1973b)

Cited as policy changes in Sri Lanka were increases in the price of sugar, partial removal of the rice subsidy, and a partial devaluation; in Colombia, changes in import controls, increased use of shift work, and increased credit to farmers. With respect to small industries, it was claimed that

> the (Colombia) Mission's recommendation strengthened the Industrial Finance Fund in its policy of financing labor intensive small scale industries and led to the elimination of some of the special concessions made in the case of capital goods under the import deposit scheme. (ILO 1973b: 86)

On the whole, it would appear that the missions' impact on changing policies was mixed at best.

The ILO excluded nationals of the country studied from the initial teams. Presumably the aim was to be independent of existing factions in the country, thereby supposedly ensuring both a more unbiased study and a greater willingness on the part of all in the country to treat the resulting recommendations seriously. The result, though, was that once the report was written, presented, and discussed, those involved in the underlying analysis generally all left the country. While some leaders may have been influenced by the discussions and by reading the report, the lack of participation by nationals of the country in the analysis probably limited the studies' long-run impact on the policy formulation process. In recognition of this problem, the Egypt mission, the last one undertaken, relied mainly on Egyptian professionals, who wrote commissioned reports on which the final report was based, and made only limited use of outside experts.

The ILO comprehensive employment missions recommended many policy changes intended to encourage the growth of nonagricultural employment and SMEs. They all advocated removal of distortions in factor prices so they would more accurately reflect social opportunity costs and thus encourage more labor-intensive methods of production. Abolition of artificial ceilings on interest rates was urged in all the reports. Interestingly, however, elimination of a minimum wage floor was usually not recommended (see, for example, ILO 1974: 19; ILO 1972: 24).[23] Modification of

restrictive labor laws was frequently advocated. Proposals to reduce exchange rate overvaluation and remove special tax concessions for duty-free importation of capital and other inputs were also featured in most reports.

The comprehensive employment mission reports made two important contributions to the understanding of policy related to employment and enterprise structure. The first was to recognize the need for a comprehensive approach to this set of issues; the second was to focus on the informal sector. The studies emphasized that any examination of policy influences on employment and enterprise structure must go beyond traditional labor market and industrial policies to include trade, foreign exchange, sectoral growth, and related policies. They also highlighted the link between income distribution and the pattern of rural nonfarm employment and enterprise development.

The ILO missions popularized the idea of the informal sector. Although this concept has been criticized as too fuzzy for meaningful quantification (see, for example, Lipton 1984; the special issue of *World Development* [1980]; Peattie 1987), it has led to fruitful recognition of microenterprises as sources of employment and exploration of the policy environment in which these small firms operate. While traces of the informal sector concept appear in the Colombia (ILO 1970) and Sri Lanka (ILO 1971) reports, it was most fully articulated by the Kenya mission (ILO 1972: 20), which argued strongly that the informal sector provides productive employment and income and has been discriminated against through a variety of policy measures. The mission urged the government to stop demolishing informal housing, review trade and commercial licensing with a view to eliminating unnecessary licenses, intensify technical research and development on products suitable for fabrication in the informal sector, induce larger firms to train and work with small subcontractors, and increase its own purchases from informal sector firms (ILO 1972: 22).

The ILO reports pay little attention to the political context in which policy reform decisions are made. They seem to assume that the key missing ingredient is information, that once the facts are made known results will follow. Experience indicates, however, that this assumption is too optimistic, even when policy reforms are advocated by world-renowned figures.

Long-Term Training, Research, and Advisory Teams

A fourth approach to policy change is to send teams of long-term advisors to work with nationals of a host country. Activities undertaken by the many institutions that have funded and organized such advisory teams have included short-term studies of focused topics, long-term planning advisory assistance, training, and policy research. Even in the days when

long-term planning was given a high priority in most developing countries, these planning advisory teams got deeply involved in day-to-day issues of policy formulation, interpretation, and even implementation. Over time, this focus shifted to providing the analytical underpinnings for decision making and training counterparts in analytical approaches and techniques. The shift was caused partly by increasing political sensitivity on the part of host country nationals but probably more by the growing analytical competence and administrative capacity of nationals of the countries in which the advisors worked. Recently there has been a growing emphasis on policy-relevant research, usually undertaken jointly between foreign advisors or consultants and nationals of the country.

The effect of these activities on policy varies among countries. Some advisory teams have been severely constrained by the local political scene and thus had little influence. Policies may change as governments come and go, in ways unrelated to the activities of the advisory teams. In other cases, however, advisors have been highly influential, in some instances even surviving changes of government and thus raising the potential for riding out the zigs and zags and providing long-term influence when people were ready to listen.

While issues of employment and income distribution have figured prominently in many aspects of the work of these advisory teams, there has been relatively little attention to issues of the structure and size distribution of employment.

Five conclusions are suggested from this review of possible mechanisms for donor influence on policies affecting SMEs.

- Leveraging of general aid has a long and uneven history. Although it is based on the accurate perception that recipient country policies must often be changed if the aid provided is to achieve the desired effect, it is an imperfect instrument for bringing about the desired changes.
- Although general aid could in principle be leveraged to improve policies relevant to SMEs, such conditions are rarely attached. The basic reason is that the number of loan conditions must be kept small if conditioning is to be effective and there are always stronger candidates for inclusion on the list.
- Nevertheless, although improving the policy environment for SMEs is almost never the *purpose* of loan conditioning, it is a not uncommon *effect* when policy conditioning goes beyond short-term stabilization issues. Policy reforms to reduce industrial protection, cut out controls, and increase competition can have large benefits for SMEs.

- Efforts to apply policy conditions to SME project loans have seldom gone beyond policies with immediate relevance to the success of the project itself. Such efforts are impeded by the relatively small size of SME project loans and by the fact that the bureaucracies that control SME promotion programs and facilities seldom have much influence on broader policies.
- Since real and lasting policy change requires that local policy makers and program implementers understand and accept the reforms involved, the strongest aid agency tools for influencing policy in the long run may be the persuasion that comes from long-term advisory, research, and educational work.

Chapter 4

Small Enterprise Promotion Programs

Most of the discussion in this book deals with the healthy development of small- and medium-scale industrial enterprises and with the effects of economic policies on this development. This emphasis makes our work an outlier in the literature on SMEs in developing countries, which is concerned primarily with *programs* intended to promote the development of SMEs. In this chapter we try to link our own concerns with those of most of the rest of the literature by examining the relationship between policies and promotional programs in their effects on SME development.

Scope of the SME Promotion Effort

The promotion of SMEs through credit, technical assistance, and other programmatic means is a large-scale international effort that enjoys widespread support and has created its own community of individuals and agencies deeply concerned with these efforts and committed to their continuation. Some governments of developed countries, including the United States, have long held policy positions that regard SMEs as worthy of special attention in their own countries and have passed laws and undertaken programs that seek to promote them. Others, such as Sweden and the United Kingdom, have come to this view much more recently, while still others (for example, Australia) do little to assist SMEs even today

(Storey 1983). The idea that SMEs have special merits and deserve special assistance commands wide support and has spread, as we have seen, to virtually all developing countries, whose governments, with few exceptions, have declared themselves in favor of SMEs and launched programs of different types to promote them.

Led by the U.S. Agency for International Development (USAID), World Bank, and International Labor Organization, international assistance agencies have undertaken and financed hundreds of SME and microenterprise promotion projects in developing countries.[1] Numerous private voluntary organizations (PVOs) in the United States and Europe have taken part in these activities, often with funding from bilateral and multilateral aid agencies. Growing numbers of nongovernmental organizations (NGOs) in the developing countries have joined the effort.

Striking evidence of the ability of SME promotion efforts to spark the popular imagination and attract wide-spectrum political support was seen in the U.S. Congressional resolution of 1988, which instructed USAID to lend a minimum of $50 million to microenterprises owned by the poor in FY 1988 and at least $75 million each in FY 1989 and FY 1990. Although inspired by a determined and well-organized lobby, this proposal was able to attract unusually broad support in Congress, ranging all the way from right-wing Republicans, who saw it as a way of promoting capitalism and political support for free markets in developing countries, to left-wing Democrats, who saw it as a way of helping the poor.

We are aware of no systematic or comprehensive accounting of either the number of organizations engaged in small enterprise promotion or the amounts spent in the overall effort, but the numbers are clearly significant. The World Bank alone reports having lent U.S. $3.2 billion for seventy projects in thirty-six countries from FY 1973 through FY 1989 (Webster 1991: vii). Besides the considerable funds committed by international agencies, additional large but (as far as we know) unmeasured amounts have come from the domestic funding commitments of developing countries themselves.[2] Many small enterprise advocates will protest that although these sums may sound large they fail to meet the needs and are tiny compared to what developed or even developing countries spend for many other purposes (the military, infrastructure, even large industrial enterprises). Yet they are far from trivial.

EVALUATING THE EFFECTIVENESS OF SME PROMOTION

How effectively has the money spent on SME promotion programs been used to achieve its objectives? A great many evaluation studies of different

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kinds have been carried out. Most of them have been financed by international agencies involved in SME promotion and carried out by consultants employed in the effort. In only a few cases have the results been published. This raises two general concerns. First, the results of these evaluations are often not readily available. Second, one feels a need to guard against possible upward bias, since both the agencies that sponsor the studies and the consultants who carry them out usually intend to continue their work on the same kinds of programs that they are evaluating and thus may be loathe to weaken popular and official support for SME promotion programs by dwelling on their weaknesses.

Even when carried out with utter objectivity, however, evaluations of SME promotion programs face serious methodological problems. In principle, the benefits of these programs are the improvements registered in various enterprise performance measures (sales, value added, employment, productivity) as a result of the existence of the program.[3] Such benefits would certainly be expected to accrue to firms that are clients of the promotional program, and perhaps also to other firms that are linked to them through demand and supply relationships. But this improvement cannot be measured directly because once the program is in fact implemented in the enterprises concerned, their performance in the absence of the program becomes an unobservable counterfactual. Most evaluation studies attempt to deal with this problem by comparing the performance of the client firm with one of two proxies for the unobservable counterfactual. They make either a before-and-after comparison, which uses the client firm's own performance before they entered the program as the standard against which improvement in performance is measured, or a with-and-without comparison, which uses enterprises that do not participate in the program as the proxy. A few studies (for example, Bolnick and Nelson 1990) go so far as to use both of these proxies, but even this painstaking effort cannot reveal what would have happened if the program had not been undertaken.

Difficulties in evaluating how effectively foreign aid and domestic funds are used in development programs are not, of course, unique to SME promotion programs. Standard techniques of project evaluation have been developed for use either in ex-ante project selection or in ex-post-evaluation of ongoing or completed projects. Three basic steps are involved: (1) a good faith effort to measure program benefits in the face of the difficulties just discussed; (2) a similar effort to measure program costs, in most cases including costs borne by program participants and other members of society as well as those financed by the implementing agency; and (3) calculation of the net present value of project benefits, or an internal rate of return on the resources used that can then be compared with some notional measure of the social opportunity cost of capital (that is, of what

the funds would be expected to yield if spent on some other program). The World Bank generally expects its projects to yield a minimum internal rate of return of 10 percent; to be regarded as good, a project must yield 15 percent or better. If net present value or a benefit/cost ratio is used to measure project effectiveness, the same sort of standard can be applied by employing a discount rate of at least 10 percent a year to reflect the social opportunity cost of capital. Discounting project benefits and costs that occur in the future is essential to reflect not only the opportunity cost of capital but also the fact that future benefits are less valuable than present benefits and future costs less burdensome than present costs. Since project costs tend to occur earlier than project benefits, use of an undiscounted benefit/cost ratio generally gives an upward-biased estimate of project quality.

Other types of evaluation criteria may legitimately be applied in evaluating SME promotion programs (Harper 1984). For example, institutional strengthening and program sustainability are appropriate criteria for evaluating aid projects that try to promote SMEs through intermediary local programs and institutions. Institutional viability and program sustainability are indeed necessary for the flow of benefits to be maintained over the long run, but it must be remembered that these are only instrumental or enabling variables, not program benefits in themselves. Ultimately, national as well as international efforts must produce benefits for program clients that can be measured through the kinds of techniques just discussed if these efforts are to be deemed successful and worthy of continuing support.

We have reviewed many recent evaluation studies of SME promotion programs, including those of Michael Farbman (1981), Robert W. Hunt (1983), John W. Page, Jr., and William F. Steel (1984), Jeffrey Ashe (1985), Robert G. Blayney and Maria Otero (1985), Jason Brown (1985), Peter Kilby and David D'Zmura (1985), Walter Elkan (1986), Jacob Levitsky (1986), Arun Ghosh (1987), Philip A. Neck and Robert E. Nelson (1987), J. C. Sandasera (1987), Robert C. Young (1987), Kilby (1988), James J. Boomgard (1989), Thomas A. Timberg (1989), Webster (1991), Bolnick and Nelson (1990), Jonathan Dawson (1990), Maryke Dessing (1990), Mike Laiser (1990), and John McKenzie (1990). While even this long list of ex-post evaluations of SME promotion programs and reviews of such evaluations represents only a small fraction of the work that has been done, it is sufficient to suggest two rather negative conclusions. First, few of these evaluations have rigorously applied program or project evaluation according to the normal best practice briefly summarized above. Second, such evidence as these studies do provide suggests that returns to resources used in SME promotion programs are often low, although the analysts frequently try to cast their findings in a more favorable light.

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Three instances can be cited in support of these generalizations.

Robert G. Blayney and Maria Otero (1985) reviewed USAID-sponsored small and microenterprise promotion projects in the mid-1980s. They began by summarizing USAID's experience, first with "traditional approaches" such as direct lending through private industrial finance corporations, rediscounting, and loan guarantee programs and later with "new approaches" launched in the 1970s under the PISCES (Program for Investment in the Small Capital Enterprise Sector) project. This was followed by a briefer discussion of the experiences of the ILO, World Bank, and Inter-American Development Bank. After a discussion of evaluation methods based on Goldmark and Rosengard (1985), Blayney and Otero analyzed nineteen small and microenterprise projects in fourteen countries. They concluded that most of these projects had a positive impact on income. Although they did not explicitly address the question of whether this impact was valuable enough to justify the use of resources in the program, they did mention that varying methodologies are used to measure income and employment impacts in the different projects. Next, they discussed three factors that they believe determine project effectiveness: the socioeconomic context of the project, project implementation institutions, and the delivery of program services (credit and in most cases technical assistance). The study concluded that USAID should sponsor more small and microenterprise promotion projects and subcontract them to PVOs for implementation. USAID should amend its private sector policy to encourage better understanding of the informal sector and small and microenterprise promotion.

The Blayney-Otero study is founded on two related assumptions. The first, drawn from the World Bank's Sector Policy Paper on *Employment and Development of Small Enterprises* (World Bank 1978b), is that small-scale industry is a necessary source of employment, especially for poor people. The second assumption, derived from the first, is that small-scale industry (SSI) should therefore be "promoted." The study is far ranging, but its analysis is weak and biased. Reading Blayney and Otero's report on their study, one gets the impression that its conclusion was never in doubt.

At about the same time, Peter Kilby and David D'Zmura (1985) also studied USAID-sponsored PVO microenterprise lending projects. Their work emphasized the identification and measurement of project benefits and also made a serious effort to learn what has worked and what has not. Kilby and D'Zmura were sophisticated in their appreciation of evaluation methodology but tolerant in their definition of project success. They developed three measures of net social benefits: (1) a "minimum estimate," which considers only increased value added in the client firms and nets out the opportunity cost of additional labor used in these firms; (2) a "maximum estimate," which assumes lower opportunity cost and adds

estimates of induced production increases in nonclient firms that either supply the client firms or benefit from the increased consumer demand that they generate; and (3) a "most likely estimate," which is placed between these two extremes, based on judgments about omitted variables.

Kilby and D'Zmura carefully analyzed five PVO microenterprise lending projects that dealt with one-to-five-person firms. The major conclusions of their benefit-cost analysis are as follow: (1) All projects had *undiscounted* [emphasis added] benefit/cost ratios greater than 1; "they were thus among the most successful aid projects" [sic.]; yet (2) none was able to generate enough interest income to cover administrative costs plus capital erosion; in only one case did interest income even cover administrative cost alone. Further, (3) the main benefit in the best projects is the output response in client firms; in moderately successful projects, linkages are important. (4) High inflation rates are severely detrimental to project performance because governments and PVOs are reluctant to charge positive real interest rates in these circumstances, leading to rapid capital erosion. (5) Projects yield greater benefits when the national economy is expanding than when it is contracting. (6) The simplest loan delivery systems are the most effective. (7) Technical assistance accompanying loans does nothing to increase benefits. (8) PVOs seem good at this kind of project (Kilby and D'Zmura 1985: x–xi).

While Kilby and D'Zmura 1985 is a serious, honest study and there is much truth in the conclusions just summarized, it runs into serious difficulties because it is addressing an impossible problem (for reasons just discussed, the value added increments resulting from the projects are basically unknowable) and in the end accepts exceedingly lax standards of project success. No justification is given for the failure to discount future benefits, in defiance of normal practice, which recognizes that "time is money." Similarly, one hopes that merely yielding undiscounted benefits that exceed project costs—a condition that could be satisfied even by projects that yield a negative rate of return on the resources used—is not really sufficient to place a project "among the most successful aid projects." The study fails to demonstrate that SME promotion projects make good use of USAID funds, relative to other purposes to which these funds could be devoted. If these are among the best aid projects, based on the information presented, foreign aid should probably be terminated!

Leila Webster (1991) analyzed the World Bank's experience in lending for SME credit and technical assistance projects through 1989. Up to this time, the World Bank had lent about $1 billion for such projects in Asia, another $1 billion in Latin America and $0.5 billion each in Sub-Saharan Africa and the EMENA (Europe, the Middle East, and North Africa) region. Over the period studied, World Bank SME activity was declining in

Asia, Latin America, and EMENA, but increasing in Sub-Saharan Africa. Despite the smaller amount lent (compared to Asia or Latin America), Sub-Saharan Africa was the region with the largest number of projects. While the World Bank's loans to local lending institutions were thus smaller on average in Sub-Saharan Africa than in other regions, the sub-loans that those institutions made to their clients averaged $83,000 in Sub-Saharan Africa, far above the worldwide average of $35,000. Webster offers four possible explanations for this disparity: (1) The firm size structure is more dualistic in African countries.[4] (2) More of the funds are channeled through public development banks, which tend to make larger loans. (3) The World Bank itself may have pushed for larger projects as a way of accelerating loan disbursement.[5] (4) The cost of doing business is generally higher in Africa.[6]

Webster posits (somewhat arbitrarily) that these projects should lead to three types of benefit: they should bring about small sub-loans, create employment, and strengthen the institutions with which they deal. By her reckoning, eighteen of the thirty-three completed projects included in her study achieved or surpassed the expected standard for at least two of these three objectives; four achieved one of the three objectives, while eleven achieved none of them. The author estimates that these projects created 600,000 jobs. Half of these new jobs are attributed to the large KIK/KMKP project in Indonesia, of which more later in this section. Excluding the KIK/KMKP project, for which ex-post data were inadequate, the average cost per job created was $4,675. While this is less than the cost of job creation in the World Bank's large-scale industry projects, it is far above per capita income in most of the countries involved. Moreover, this worldwide average is strongly influenced by loans in Asia, where the average cost of job creation was $3,171.[7] In Sub-Saharan Africa, the average cost of job creation was reported to be $9,851, more than three times as much (Webster 1991: 10).

A high rate of loan repayment is a minimal condition of program viability. Webster reports that repayment in the World Bank projects that she studied averaged 80 percent worldwide; regional averages ranged from 92 percent in Latin America to 60 percent in Sub-Saharan Africa. Yet only eight of the thirty-three projects achieved a repayment rate of 90 percent or better, which Webster rather tolerantly considers the minimum acceptable rate. Across the countries in the study, repayment rates correlated poorly with macroeconomic conditions or business regulatory environments. For example, repayment rates were generally high in Mexico, Peru, and Ecuador, countries that Webster characterizes as maintaining conditions that are not fully conducive to small business development. The closest correlate of a high repayment rate was competent banking. "A

consistent factor across successful projects has been the retail banks' abilities to select viable sub-projects, disburse funds efficiently and supervise projects at the levels needed" (Webster 1991: ix).

Webster reaches a negative conclusion on the technical assistant components that were included in most of the World Bank projects that she reviewed, especially of attempts to assist the entrepreneurs themselves:

> Technical assistance components are included in most SME projects to help SMEs build technical, marketing and management skill. Technical assistance agencies, usually public institutions, are strengthened through consultancies, staff training and various other programs. Technical assistance for financial institutions typically funds technical advisors, training for apex unit staff and courses for loan officers in participating banks. Most technical assistance components for entrepreneurs have failed to meet their objectives, in quantity and quality of services delivered. Discussions with World Bank project officers and analysis of technical assistance components suggest three reasons for such disappointing results: i) poor design of components, as seen in programs that have not met the needs of entrepreneurs and have not been well matched with the capabilities of implementing institutions; ii) inadequate preparation and supervision on the World Bank's part, particularly where the components are complex and implementing institutions are weak; iii) poor implementation by government and public institutions. (1991: xi)

The overall conclusion of Webster's study is nevertheless guardedly positive:

> The Bank's record in lending to SMEs is a fairly successful one. A good number of institutions, particularly financial institutions, have been strengthened. Many small and medium-sized entrepreneurs have received loans they presumably would not have received had the Bank's credit program not been in place. Although job creation figures must be approached cautiously because long term figures are not available, an estimated 600,000 jobs have been created at relatively low cost.
>
> At the project level, some SME projects have been highly successful operations, both meeting their objectives and achieving acceptable levels of sustainability. The majority of projects have met most of their objectives, but have been unable to establish programs that can be sustained without some level of external funding. A relatively small number, particularly in terms of percentage of total loan amounts, have failed both to reach their objectives and to become self-supporting. (1991: xii)

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Webster predicts that SME lending will remain an important part of the World Bank's portfolio for some time to come and urges that more attention be given to "new initiatives" such as greater private sector involvement, inclusion of microenterprises, and promotion of female entrepreneurs.

The Webster report is an interesting and important document that presents much valuable information. Despite the seeming objectivity of its analysis, however, its interpretations of the data often have a strong positive spin. For example, the author states that eighteen of thirty-three completed projects achieved at least two of the three objectives she defines, but a closer examination of the information given indicates that only sixteen projects achieved at least 90 percent of the defined standard on two criteria, while the remaining two were high on credit distribution, were low on job creation, and did not have sustainability as an objective; these projects therefore achieved only one out of two objectives, not two out of three (Webster 1991: 16).

The author fails to emphasize the important fact that there were no African projects in this "successful" group. Based on this point and the unacceptable 60 percent average repayment rate reported for the African projects, it appears that the World Bank has not yet devised an SME lending project that works well in Africa, surely a major failing.[8]

Finally, as mentioned earlier, half the global employment creation estimate of 600,000 jobs is drawn from the World Bank–sponsored KIK/KMKP program Indonesia, yet the repayment experience of this large project is omitted from the author's global estimates on the grounds that the project was not yet completed at the time of her review. Though the estimate of employment creation under the KIK/KMKP program may be objective (although it is surely very rough), the program suffered from deteriorating repayment experience during the 1980s and was prematurely terminated because the bad loan liabilities of the credit guarantee agency vastly exceeded its ability to pay. The inclusion of this large project in the author's analysis when it supports a favorable evaluation of SME lending and its exclusion when it would support a more negative reading tends to undermine one's confidence in the objectivity of Webster's analysis.

SOME FUNDAMENTAL DIFFICULTIES OF SME PROMOTION PROGRAMS

Besides the results of these surveys (as interpreted to remove any upward biases), there are a priori reasons for believing that the returns to SME

promotion programs are likely to be low. These emerge from consideration of what it is that these programs try to accomplish. The services they provide take several forms. By far the most common is credit. Others are technical assistance of different kinds (technical, managerial, and marketing), training, and the provision of physical facilities such as small industrial estates. In all cases some kind of face-to-face contact with the client, the small businessman or -woman, is required. (When international aid agencies are involved, they often work at one level removed, but someone must deal directly with the client.) Since small businesses by definition engage in relatively small transactions and are very numerous in low- and middle-income countries, as seen in Chapter 2, the implementing agency has many potential clients and small transactions to deal with. This has several implications that work against the effectiveness of SME promotion programs.

First, program coverage is likely to be severely limited relative to the population of potential clients. Budget, staffing, travel, and other constraints ensure that most SME promotion programs are likely to reach only a small percentage of their potential clientele.[9] In many developing countries, political factors such as ethnic, religious, and interparty rivalries further restrict coverage by causing some types of small business to be ignored while other types are favored. These sorts of limitations are inherent in efforts to promote SMEs through face-to-face client-oriented programs. By contrast, some (but not all) types of policy automatically reach everyone.

Second, transaction costs are high for clients who are served. As is well known, it is more expensive (as a percentage of the loan principal) for banks and other lending institutions to provide small loans than to provide large ones. This follows from the tendency for a fixed cost element to be present in loan appraisal and administration. For example, it may cost just about as much to verify collateral for a $1,000 loan as for a $1 million loan. This cost is magnified if the lender has little or no prior experience of dealing with the individual borrower, or with the class to which he or she belongs.

Transaction costs are further increased by the multiplicity of small enterprise products, services, technologies, and markets. Unless an SME promotion agency specializes on a narrow line of activity (in which case there must be many such agencies), it must deal with a wide, often dizzying, variety of enterprises. Although some enterprise functions and assistance needs are constant or at least similar across a wide range of activities, others vary widely among subsectors. It seems certain that the small-scale industrial establishments that an SME promotion agency must try to assist will possess far more varied characteristics than the small farms that are the clients of agricultural extension agencies and other promotional bodies

in the agricultural sector.[10] In addition, as Richard L. Meyer (1989: 121–23) points out, whereas the number of farmers decreases over time, the number of small nonfarm enterprises is likely to grow.[11]

Training of small-scale entrepreneurs can be conducted either at their places of business or in classrooms (Harper 1984). The difficulties just discussed are more obviously encountered in efforts to make face-to-face contacts in the workplace, but they apply also to some degree to training in the classroom, which has the added disadvantages of requiring entrepreneurs to take time off from their businesses and presenting them with a standardized curriculum that may be ill-suited to their needs.

Finally, we reiterate a point made earlier: there is a huge discordance between the culture of small, informal sector entrepreneurs and that of the large bureaucracy trying to help them. While the bureaucrats may assume that their social superiority qualifies them to act as teachers, in many cases the entrepreneurs could teach them a lot about how to survive in an adverse business environment.

INTERACTION OF PROGRAMS AND POLICIES

There has been little systematic research on the interaction between SME promotion programs and policies that affect SMEs. Many analysts of promotional projects note in passing that the fate of these projects depends not just on the quality of the projects themselves, but also on the prevailing policy framework, as well as on the pace and pattern of economic development. However, the nature and strength of these interactions are seldom specified.

Although it did not relate explicitly to SME promotion projects, strongly suggestive evidence that policies can have a significant effect on rates of return on development projects in general was presented in the *World Development Report 1991* (World Bank 1991: 82–87). Bank staff carried out post-evaluations on 1,200 World Bank projects implemented over a span of twenty years, calculating realized economic rates of return (RERRs) on all these projects. The RERRs averaged 15 percent but varied widely. The study conducted in conjunction with the *World Development Report* then sorted these post-evaluated projects into groups representing the policy frameworks that prevailed in the countries in which they were implemented. Aspects of the policy environment that were examined include the extent of distortion in trade policy, the degree of exchange rate overvaluation, the positive or negative nature of real interest rates, and the degree of fiscal imbalance.

With respect to trade policy distortions, the World Bank found that RERRs averaged 13 percent in highly distorted environments, 15 percent in moderately distorted environments, and 19 percent in environments with low distortions. RERRs in countries where the black market premium on foreign exchange was high averaged 8 percent; if the premium was moderate, the RERR averaged 14 percent; if it was low, the average rate was 18 percent. If the real interest rate was negative, RERRs averaged 15 percent; if it was positive, 17 percent. If the fiscal deficit was high, RERRs were 13 percent on average; if it was moderate, 15 percent; if low, 18 percent.

These are significant differentials, especially when trade and foreign exchange policies created significant price distortions. The findings are consistent with the review in Chapter 3, which indicated that trade and foreign exchange policies create the largest policy biases that tend to impede employment creation and the development of SMEs. The results for interest rate and fiscal distortions in the World Bank study, although less dramatic, are also significant. The World Bank went on to speculate that the effects of economic policies on rates of return to development projects are likely to be even greater than indicated by its study, although other factors are obviously significant as well.

> [E]ven with undistorted policies, a merely satisfactory project (one with an ERR of 10% or more) is not assured; the probability is about 70%. This raises the question of why many projects are unsatisfactory even with undistorted policies. One reason is that the indicators that measure the quality of the economic climate are partial, at best. The four policy indexes used in the research, even taken together, do not capture the quality of economic institutions (such as the legal and regulatory framework) and of complementary public investments. And possibly the biggest reason for variability in ERRs, even after accounting for the policy climate, is simply that some firms will always be more successful than others: success resides in firm-specific factors such as skill, drive, determination, willingness to take risks, a measure of luck, and an ability to learn from mistakes. (World Bank, 1991: 84)

These factors would seem as applicable to SME promotion projects as to other types of development projects.

What, then, constitutes the best approach to helping SMEs play a constructive role in industrialization and economic development generally? Should a developing country government that wants to pursue this objective concentrate on carrying out SME promotion projects? Or should it emphasize reform of its trade, exchange rate, capital market, labor market, and regulatory policies in an effort to remove, or at least reduce,

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biases against SMEs? Or, finally, should it try to do both? To answer these questions, one must consider the constraints faced by SMEs that have a potential to grow and transform themselves. Hubert Schmitz (1982) provides a useful schema for categorizing the constraints faced by small-scale manufacturing enterprises. These constraints, he says, are both internal and external. Internal factors include those related to (1) the motivation, drive, and adaptability of the entrepreneur; (2) his or her organizational skills; and (3) the technical skills present in the enterprise. Possible external constraints include (1) exploitation of SMEs and the informal sector; (2) difficulties that small firms face in establishing subcontracting relationships; (3) lack of access to markets; (4) technological gaps; (5) problems of access to raw materials; (6) lack of access to credit; and (7) discrimination against them by government. Although information on the prevalence and strength of these differing constraints is sparse, Schmitz concludes that external constraints are more important than internal ones. But all these constraints can be overcome in favorable circumstances: "the issue is not *whether* small enterprises have growth and employment potential but *under what conditions*" (1982: 445. Emphasis in original).

Schmitz argues that information must be sought in particular cases to determine which of these constraints is binding. He believes that

> we should emphasize that ultimately branch-specific studies must be situated in wider investigations which encompass the development in the national and international economy. Conversely, it should be said that the feasibility or quality of such wider studies will often depend on the availability of detailed branch-specific studies which include the small-scale producers. (1982: 445)

This is consistent with our view (see Appendix A).

In a recent empirical examination of the factors limiting the growth of SMEs in developing countries, Brian Levy argues that current structural adjustment efforts may place too much faith in the reform of macroeconomic policy:

> [I]t has increasingly become apparent that programs of reform that eliminate macro-economic imbalances, bring overvalued exchange rates closer to equilibrium, and promote pricing on the basis of market signals and opportunity costs are not necessarily sufficient to ease the constraints on development. In some countries, rather than securing a rapid and sustained supply response, these broad macro and incentive reforms have brought to the forefront a whole new set of constraints that inhibit the response of the private sector . . . many of these newly evident constraints

> are microeconomic and institutional in character, and do not lend themselves to the familiar analytical techniques and policy remedies of their macro-economic counterparts. (1991: 1–2)

To learn more about the factors constraining SMEs in developing countries, about variations in the nature of the problem from country to country, and finally about how the constraints might be loosened in specific developing country contexts, Brian Levy (1991, 1993) carried out a comparative study of Tanzania and Sri Lanka. In each country, he interviewed entrepreneurs in three subsectors: furniture, construction, and horticulture in Tanzania; leather products, ceramics, and gemstones in Sri Lanka. As did respondents in many other small business studies, these small-scale entrepreneurs characterized lack of access to finance as the leading nonprice constraint that they faced. Yet, as Levy observes, there are many enterprises to which it would be imprudent to lend, given the weakness of incentives for formal financial institutions to lend to SMEs.[12] Unsurprisingly in the circumstances, SMEs around the world tend to finance their business start-ups with the personal savings of the proprietor, support from family members, short-term credit provided by suppliers or buyers, or loans from informal, community-based financial intermediaries that are able to rely on local knowledge to judge the reliability of loan applicants and use community reputation sanctions to ensure loan repayment. In general, SMEs are able to tap into the resources of the formal financial system only after they have established a reasonable record of success and grown into the middle-size range (Levy 1991: 13–14).

In any case, Levy found evidence that finance is the binding constraint to be unambiguous only in Tanzania. In Sri Lanka, only the smallest and newest enterprises are credit constrained; the financial system works well for the larger and better established SMEs (1991: 20–21).

Regulatory constraints were found to be significantly more binding on SMEs in Tanzania than in Sri Lanka. The latter country fits the common generalization (see Chapter 3) that laws and regulations affecting business enterprises are enforced more laxly on SMEs than on larger establishments. In Sri Lanka, according to Levy, opportunities for tax evasion decrease with enterprise size and the formality of its legal status. Enterprises that grow in scope or incorporate to achieve limited liability status risk large tax bills. This appears to limit the potential for SMEs to serve as a seedbed for the emergence of dynamic national firms in Sri Lanka (Levy 1991: 25–26), as was the case in the Philippines according to EEPA findings reported in Chapter 6.

But not all developing countries fit this generalization. Tanzania, for one, appears to be different. According to Levy,

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> As in Sri Lanka, Tanzania's formal tax and regulatory requirements are demanding. However, unlike Sri Lanka, enforcement is comprehensive, albeit with pervasive lubrication and renegotiation of formal obligations. The net effect of the Tanzania pattern is to impose entry and expansion-deterring costs on all enterprises, both financial costs and the opportunity cost associated with the diversion of scarce entrepreneurial time and effort away from socially efficient wealth-generating activities . . . the relative burden of these costs appears to fall with increases in firm size. (1991: 26)

In Tanzania, even the smallest firms reported that they had to obtain licenses and pay taxes. But the amounts they paid often differed from the officially specified fees. Strict enforcement of laws and regulations on even the smallest firms created opportunities for official corruption. Since the costs of this corruption fall more heavily on small enterprises,

> Tanzania's regulatory environment has the paradoxical (and presumably unintended) consequence of strengthening the competitive position of large, often non-indigenous enterprises in relation to indigenous SMEs. (Levy 1991: 30)

As Levy observes by way of general conclusion, SMEs function in complex environments and confront a wide array of constraints. It is unrealistic to think that there is a single binding constraint that, once released, will set in motion a process of dynamic SME development. Not only is the identity of the binding constraint likely to differ among countries, and even among industries within countries, but its release is likely to do no more than bring forward another constraint, which immediately becomes binding (Levy 1991: 45). Even so, it is worth trying first to understand and then to ease the policy and implementation constraints that limit the development of SMEs.

> It is by now broadly accepted on a priori grounds that a well-functioning regulatory and tax regime should be characterized by a minimum of bureaucratic requirements, and by transparent, moderate obligations imposed across a broad spectrum of enterprises. The empirical analysis uncovered four ways in which the regulatory and tax regimes in Sri Lanka and Tanzania depart from the efficient, a priori model: high formal tax obligation (in both countries); pervasive lubrication (in Tanzania); high bureaucratic costs (especially in Tanzania); and a pattern of selective enforcement that excludes the smallest enterprises from the regulatory net (in Sri Lanka). (Levy 1991: 46)

Levy argues that government policies impinge on SMEs in three distinct but interrelated ways. They impose (1) a fiscal burden through the taxes they levy;[13] (2) a bureaucratic burden through the procedures they require entrepreneurs to comply with;[14] and (3) a threshold burden to the extent that businesses become increasingly subject to taxes and regulations as they grow larger.[15] The remedies recommended by Levy are (1) to cut taxes if they are "too high"; (2) to scrutinize prevailing regulations and eliminate those with no social purpose; (3) to increase the transparency of the regulatory and bureaucratic apparatus to reduce the bureaucratic burden and ensure that enterprises pay all rather than part of the taxes they owe; and (4) to decide on the appropriate range of coverage of tax and regulatory obligations (Levy 1991: 48–49).

PROGRAMS (MINIMALIST OR COMPLEX) VERSUS THE MARKET

Richard L. Meyer (1989) framed the fundamental issue of what should be done to improve the flow of credit to SMEs when he asked which should be emphasized, markets or programs. A voluminous literature has documented the general failure of programmatic efforts to solve the credit problem and has advocated the competing rural financial markets development approach as an alternative (Anderson and Khambata 1982, 1985; von Pischke, Adams, and Donald 1983; Adams, Graham, and von Pischke 1984; Adams and von Pischke 1992; and many others).

Should an effort to meet the financial needs of small-scale producers (nonfarm SMEs as well as agriculturalists) emphasize the creation of specialized lending institutions whose purpose is to lend to such borrowers, or should it instead emphasize the general development of financial markets and commercial banks, in the expectation that these will eventually meet the needs of the SMEs, or at least the larger of them? Or, finally, should developing countries and aid agencies be willing to tolerate a degree of financial dualism by regarding the traditionally despised moneylender and other informal credit providers as the most efficient sources of credit for very small scale producers? Meyer, Adams, and von Pischke, members of the rural financial markets school, opt firmly for markets over programs, while Levy argues that markets can be expected to serve the needs of the larger SMEs but renewed efforts should be made to develop more directed institutions along the lines of Bangladesh's famous Grameen Bank to assist microenterprises, which can never be able to meet the profitability standards of conventional commercial banks (Meyer 1989; Adams and von Pischke 1992; Levy 1991).

Experience in Indonesia over the past decade suggests that Levy may be giving up on the banks too quickly while Meyer and his co-believers may exaggerate the extent to which improvements in financial markets prompted by policy reforms can be expected to solve the problem without a determined effort to reform and develop institutions. Ensuring that loans to SMEs are made at "commercial" interest rates so that lending institutions have a chance to cover their costs and even, perhaps, make a profit, proves to be the start of the reform process, not its end.

The experience of the KUPEDES (General Rural Credit) program carried out by the Indonesian People's Bank (Bank Rakyat Indonesia, or BRI) shows that commercial banks can make small loans to low-income businesses while maintaining a high (97 percent) repayment rate and making a profit in the bargain (Snodgrass and Patten 1991; Patten and Rosengard 1991; Robinson forthcoming). Levy's conviction that special programs such as Grameen Bank are needed to reach the poor notwithstanding, KUPEDES has reached borrowers nearly as poor as Grameen's, has operated on a far larger scale, and has provided benefits both to borrowers, who find its "commercial" interest rate attractive relative to what they would have to pay in the informal financial sector, and to the lender, which has made a sizeable profit. The transferability of this approach to environments other than rural Indonesia deserves much more active consideration and testing than it has received so far. Although Grameen Bank has succeeded in reaching poor borrowers (there is a large literature; see, for example, Hossain 1988), it has been unable to achieve financial self-sufficiency, despite the urging of the international bodies that are called upon to subsidize it, because Grameen's leaders remain ideologically committed to offering low interest rates on loans made to the poor.

There is thus strong and growing evidence that the credit needs of SMEs in developing countries can be met, if not by the commercial banks (which undeniably prefer to deal with the larger enterprises) then by NGO-type lenders such as Grameen Bank. Better results can be expected from the gradual penetration of the rural and small-scale sectors by commercial banks that offer savings and other services in addition to credit than ever could be attained by specialized lending agencies.

If the potential for extending financial services to SMEs by improving rural and small-scale financial markets thus appears relatively promising, what about the other types of services normally provided by SME promotion programs? A recent issue in Washington and elsewhere has been whether credit should be provided on a "minimalist" basis, or accompanied by technical assistance and the other sorts of promotion activities (Biggs, Snodgrass, and Srivastava 1991). Although the results of these activities have undoubtedly varied widely from case to case, there is really very little evidence of overall success. At least where microenterprises are

concerned, Malcolm Harper, a well-known and long-time advocate of SME promotion programs (Harper 1984), now concedes that

> technical assistance, as opposed to credit, has a limited role to play. . . . There is little that outsiders from a formal environment can do for those who are in the informal sector, and the numbers are so vast that even if it was possible to run a cost-effective program, it would only reach a very small proportion of the potential target group. Most people who operate microenterprises are already managing their limited resources rather well and it is difficult for any program to achieve better results than could be achieved by the microentrepreneurs themselves, if they were to be given the resources used by the program and allowed to use them as they wished.
>
> There is a need to train government officials and others who so often harass microenterprise, and possibly to study in depth the reasons why officials do this and to devise ways in which they can be motivated to act otherwise. This may be difficult and is certainly less dramatic than trying to work for microenterprises themselves, but will probably be of more lasting value to them. (Harper 1989: 187–188)

It is worth noting once more that even Eugene Staley and Richard Morse (1965), the pioneers of a comprehensive programmatic approach to SME development, clearly specified that their recommendations referred to "modern"—and thus, in effect, medium rather than small—enterprises.

That most technical assistance projects intended to assist SMEs appear to have been either ineffective or, if to some degree effective, uneconomic, does not of course prove that cost-effective projects could not be devised (Young 1987). We saw in Chapter 2 that most of the SMEs found in low-income countries are survival enterprises that have little development potential and can be expected to disappear once economic development has proceeded far enough to offer better employment opportunities to their proprietors and their families. But we also observed that a few industrial SMEs are able to survive and transform themselves to compete successfully in more advanced economic environment. This transformation capacity, as we saw, has been particularly evident in a few countries—Japan, Italy, Taiwan—where policies and social institutions have permitted SMEs to play an especially vital role in economic development. What types of programmatic assistance can support this kind of transition?

Possible answers to this question are suggested by a recent World Bank study on the development of support systems for exporting SMEs in Japan, Korea, Indonesia, and Colombia (Itoh and Urata 1994; Kim and Nugent 1994; Berry and Levy 1994; Escandon and Berry 1993; Levy 1994). The researchers tested the hypothesis that *dynamic* SMEs need forms of

financial, technical, and marketing support that reduce their transaction costs and thereby enable them to compete more effectively. They found that SME exporters in the countries studied (who are presumably among the most dynamic smaller scale entrepreneurs) relied mainly on private channels (buyers and traders, similar firms, suppliers and subcontracting principals, and banks) for the three forms of external support considered. However, access to such private support mechanisms differed widely among SMEs, depending on factors such as whether they possessed the collateral needed to get bank loans, whether they could claim membership in preexisting interfirm or community-based networks, whether they were a pioneer or participants in an already-mature subsector, and how high their country's profile was in the export market. Collective support mechanisms (that is, those provided either by government or by private groups such as industry associations and NGOs) were used mainly (and valued more highly) by firms that lacked such connections. Although the delivery record of collective support programs was checkered, in some cases they did help SMEs to export. The study found that programs of financial support for SMEs work best when combined with broader efforts to develop a disciplined and sustainable financial system. The best programs for technical and marketing support of SME exporters used what Levy calls a "light touch"; that is, they involved decentralized delivery mechanisms and attempted to support, rather than supplant, the private marketplace.

> In all, the empirical results suggest that . . . the overall business and incentive environment is the most important determinant of the effectiveness of marketing, technological and financial support systems for SMEs. However, the results also caution against complacency, against the presumption that a liberalized marketplace will be sufficient to secure industrial development. On the contrary, the results suggest that for many firms, subsectors and countries, well-functioning collective support systems are likely to be important ingredients of industrial success. (Levy 1994: 56)

CONCLUSIONS

The following list summarizes the authors' conclusions on SME promotional programs:

- The promotion of SMEs through credit, technical assistance, and other programmatic means is a massive international effort that enjoys widespread support and has created a complex of individuals

and agencies deeply concerned with these efforts and committed to their continuation.

- The success of SME promotional programs (especially their credit provision components) has often been evaluated, but rigorous evaluation standards have seldom been applied. Some of the evaluations appear to be biased in a positive direction.
- Stripped of such bias, the evidence of the evaluation studies suggests that, while results vary widely, SME promotion projects have generally not been very successful. This should not be surprising, since several a priori considerations suggest that cost-effective promotion of SMEs through official programs is likely to be difficult.
- Although most of the systematic evaluation has focused on credit provision, there appears to be a consensus that technical assistance and other program components have been even less cost-effective, at least where microenterprises are concerned.
- International efforts to promote SMEs are focusing increasingly on Africa, where results to date have been even more disappointing than in other developing regions.
- The outcomes of SME promotion programs are likely to be strongly influenced by the policy regimes under which they are implemented, especially the trade, fiscal, financial, and regulatory policies followed. While this relationship has not yet been demonstrated for SME promotion projects in particular, the prevailing policy framework has been shown to have a significant effect on the realized rates of return of World Bank projects in general.
- Measures to improve the workings of financial markets appear to offer considerable hope of improving credit access for at least the larger and better established SMEs. Far more work is needed to determine the extent to which—as well as the circumstances under which—formal financial institutions can extend their reach into areas served hitherto only by informal institutions and (on a small scale) by heavily subsidized NGOs.
- Analogous possibilities probably exist for stimulating private provision of nonfinancial services normally included in official SME promotion programs (including nongovernment collectives such as NGOs and industry associations), but research on this subject is still in its infancy.

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Part II

Small Enterprise Policy at Different Levels of Economic Development

Chapter 2 showed that the number and nature of SMEs in the manufacturing sector both change profoundly as a country moves from low-income through middle-income to eventual high-income status. Chapters 3 and 4 then reviewed the impacts of various policies on SMEs and the cost-effectiveness of programmatic approaches to their development. Chapters 5–7 extend the discussion by examining the position of SMEs in selected developing countries and regions at different levels of development and considering which policies and programs are most conducive to the development of SMEs in these varied settings. We embark on this review in the belief that not only a country's stage of development but also its physical and social environment and its political system affect both the state of its SMEs and the feasibility and desirablility of alternative policy and program measures.

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Chapter 5

SME Development in Low-Income Countries

Some typical structural characteristics of low-income countries were already noted in Chapter 2. One of their most important features for our purposes is the presence, in most cases, of "surplus labor." In terms of the dual economy model formulated by W. Arthur Lewis in 1954 and elaborated in 1964 by John Fei and Gustav Ranis (and subsequently by others), these countries have not yet reached the labor market turning point. This point is reached when the industrial sector (or, in related conceptual schemes, the modern, urban, or formal sector) becomes a large enough part of the economy that it can no longer expand employment without causing wages to rise in the agricultural (or traditional, rural, or informal) sector. Before the turning point, the industrial sector is seen as a tiny enclave that can expand through investment in physical capital and draw labor at a constant real wage out of the agricultural sector, where it is available in abundance. The Lewis model sees the labor market as segmented before the turning point: industry pays a fixed premium over the wage in agriculture. After the labor market turning point, the market becomes more unified, the intersectoral wage differential declines, and further employment increases in either sector require that real wages be bid up to draw labor from alternative uses.

Although the dual economy model only roughly approximates reality, even in the densely-populated low-income countries, which it fits best,[1] it remains a useful conceptual scheme for understanding most low-income

countries. As we saw in Chapter 2, intersectoral wage and productivity differentials are generally wide in such countries and the industrial sector is so small that it probably can continue to increase employment for some time without raising the much lower wages paid by the agricultural sector, as assumed in the model.

Aside from a country's *level* of economic development, the *pace* of its development is also important for SME development. It makes a big difference whether a country is actually achieving economic growth. The changes in the numbers and types of SMEs described in Chapter 2 characteristically accompany a rise in per capita income and cannot be expected to occur if income is stagnant or declining. Since the early 1980s, developing countries have divided rather sharply into two groups: those that are growing, often at quite satisfactory rates, and those in which GNP per capita is stagnant or declining. In point of fact, many low-income countries have experienced little or no economic growth, or have even seen their per capita incomes fall, since 1980.[2] This absence of economic growth poses a fundamental problem for the healthy development of SMEs that has to be overcome before much can be done to make SMEs more productive. In such circumstances, on the other hand, microenterprises, SMEs, and the informal sector serve as important survival mechanisms for the substantial number of people who are unable to find a niche in the more or less static modern sector. This has its own policy implications.

Yet another sizeable group of low- and middle-income countries was able to grow at moderate or even high rates over the same period.[3] Their growth was in many cases accompanied by high growth rates of industrial output—rates that often exceeded those experienced by the developed countries in the early phases of their own economic development. As we saw in Chapter 3, rising industrial output strongly boosts the demand for labor, even allowing for the negative effects of policy biases on that demand. Rapid output and employment growth have not, however, eliminated labor surplus in most of these countries. The main reason is that strong demand for labor in the modern sector has been more than offset by population growth, which has far exceeded that experienced by the developed countries during their industrial revolutions.

Population growth has predictable consequences, fifteen to twenty years later, for increases in the labor force. Dramatic increases in school enrollment in most low-income countries have postponed but not avoided the demographic impact on labor force growth. Given high rates of labor force growth, industry has seldom been able to absorb even a large fraction of the annual increment in labor supply. Since open unemployment is not a viable option in countries where people have few resources to fall back upon, the common result has been rapid growth in self-employment and work as a paid employee or unpaid family worker in small-scale and informal enterprises.

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While the "push" of labor supply is thus one important cause of employment growth in small-scale nonagricultural enterprises in low income countries, a second contributing factor is policy biases that limit the willingness of larger scale modern enterprises to hire labor. These can increase the size of the informal sector at any stage of development, as seen in Latin America (Chapter 6).

In countries that are still far from the labor market turning point, microenterprises and informal enterprises are likely to remain prominent features of the economic and social landscape for decades to come. Whatever their longer term development potential, they will serve for some time as important sources of income for large numbers of people and sources of cheap goods and services for low-income consumers. The first principle of policy toward these tiny firms should therefore be the Hippocratic Rule: Do no harm. Do not discriminate against SMEs. Whether and how to "promote," "develop," or subsidize them is a more complex and controversial question, touched on later in this chapter and further addressed in Chapter 6. But government should at least not treat them less favorably than it treats larger scale formal enterprises, since doing so impedes their ability to meet the day-to-day needs of some of the poorer members of society.

Paradoxically, perhaps, one important way to promote industrial and other nonagricultural SMEs in low-income countries is to develop agriculture. Often located in small towns and rural areas, these SMEs are closely tied to agriculture through demand and supply linkages. Nonagricultural activities provide important income supplements for rural households. In some cases, rural workers are "pushed" into nonagricultural activities by an inadequate supply of, or access to, cultivable land.[4] In such circumstances, the SMEs involved are likely to be very small, capital-poor, and low productivity. In other cases, expansion of rural nonagricultural activities represents an early stage of structural transformation; workers are "pulled" into them by superior earning prospects.

The main economic policy challenge in any low-income country is to launch or accelerate a process of economic development that will eventually lift the country out of its low-income status. Once a degree of success has been achieved and the country crosses the threshold into the middle-income group (defined by the World Bank as $600 per capita in 1990), reaching the labor market turning point becomes the next important goal. Industrial sector growth must be pushed hard to generate demand for labor in well-paid, high-productivity jobs. As at the earlier stage of development, smaller firms should not be discriminated against, but it now becomes increasingly important that policies toward SMEs not impede the general industrialization process, which requires the development of whatever sizes and types of enterprise are most efficient in the country's most promising lines of production. As this process gains momentum, the

relative importance of SMEs declines, as discussed in Chapter 2, and surviving SMEs find ways to compete successfully in an increasingly challenging environment. Policy options at this stage are heavily influenced by political and institutional factors.

While a country's level of development is thus an important factor in determining appropriate policies toward SMEs, environmental, political, and institutional influences may also be significant. Important environmental factors include country size and population density. This is illustrated in the following discussions of the contrasting situations in Bangladesh, a large and densely populated South Asian country, and Sub-Saharan Africa, a region where small national populations and sparse settlement patterns appear to influence the structure, performance, and development potentials of SMEs. The importance of political and institutional factors is brought out particularly in Chapter 6.

BANGLADESH

Bangladesh,[5] one of the world's poorest and least industrialized countries, had a per capita GNP of only $210 (tenth poorest in the World Bank ranking) and derived only 9 percent of its GDP from manufacturing in 1990. With 741 people per square kilometer in 1990, it was easily the most densely populated large country. Its population was still 84 percent rural in the late 1980s, despite 6 percent annual growth of the urban population. Fifty-six percent of the labor force worked in agriculture in 1985–1988. Population growth averaged 2.3 percent in 1980–1990 but was expected to fall to 1.8 percent in the 1990s (World Bank 1992). Severe poverty[6] and a large population (107 million in 1990) make Bangladesh an important setting in which to study industrial policy and the role of SMEs at an early stage of economic development.

Although few countries need economic growth more desperately, Bangladesh has found it hard to keep ahead of rising population. According to the World Bank, GNP per capita grew at only 0.7 percent a year in 1965–1990. Recurrent political disturbances, natural disasters, and misguided policies have combined to block sustained economic growth.

Bangladesh has massive underutilized labor resources. Most of the labor force does precarious, low-productivity agricultural work and the number of job seekers grows at about 2.5 percent per year. Female labor force participation has been low but is now rising, adding still more job seekers.

While employment growth probably accelerated in the late 1980s, growth rates of GDP and value added in agriculture and manufacturing (including both small and large firms) were lower than in the late 1970s.

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Average real wages thus declined significantly. Growth rates of GDP and total factor productivity (TFP) in Bangladesh industry are low compared with that of its neighbors, India and Pakistan (Sahota 1990). Industrialization has shown only a few glimmers of hope, notably the rise of garment exports since the early 1980s.

Industrial Structure and the Role of SMEs

Before the partition of India in 1947, East Bengal was Calcutta's agricultural hinterland. It specialized in growing jute, all of which was sent by rail to Calcutta for milling. The few large factories in East Bengal were owned and operated by businessmen from Calcutta, who returned there after partition. Small rural industries were also dominated by Hindus, many of whom followed traditional caste occupations. Partition thus cut off Muslim East Pakistan from its traditional trading, industrial, and shipping center and undermined its predominantly Hindu business and industrial class.

As East Pakistan in 1947–1971, the future Bangladesh took part in a process of state-led economic development initiated by a national government based in the country's western wing and run by West Pakistanis. Industrial investment was controlled by Pakistani nationals in the public and private sectors. The Pakistan Industrial Development Corporation (PIDC), established in 1952, was the main instrument of industrial promotion; a separate East Pakistan Industrial Development Corporation (EPIDC) was formed in 1962. Strategic and heavy industries such as steel and machine tools were assigned to government-owned corporations. In more traditional industries, joint ventures ("associateships") with private entrepreneurs were set up. Fifty-five joint venture jute mills and ten cotton textile mills were established in East Pakistan.

Because there were few East Pakistani businessmen, the public sector became more dominant than in the west, where private business was stronger and had more political influence. Many of the private industrialists who did appear in the eastern wing were of West Pakistani origin. Smaller enterprises were under indigenous (though still largely Hindu) control and were promoted by the Bangladesh Small and Cottage Industries Corporation (BSCIC), established in 1959.

The nationalist and socialist sentiments that accompanied the liberation of Bangladesh in 1971 led to nationalization of large firms and restrictions on private investment, including businesses owned by Bangladeshi citizens as well as Pakistanis.

Tables 20 and 21 summarize official statistics on the size structure of manufacturing industry. Cottage industries were defined as units with fewer than ten workers if mechanized, or twenty if not mechanized,

TABLE 20 Distribution of Manufacturing Employment by Enterprise Size, Bangladesh, 1986

Enterprise size (no. of workers)	Number of firms	% of total employment
1–19	121,636	40
20–49	4,509	10
50–99	1,490	8
100 or more	1,469	42

SOURCE: Economic Census, 1986.

whereas small firms were those that employed no more than twenty or thirty workers, respectively. Recently, however, small industry was redefined to include any manufacturing or service enterprise with a total investment up to Taka 15 million ($485,000 in 1986) and an investment in machinery and equipment not exceeding Taka 10 million ($324,000) exclusive of taxes and duties. Cottage industries appear to be grossly underenumerated in these statistics.

Many types of manufacturing occur in small enterprises located in rural areas. A sample survey taken in the late 1970s suggested that 25 percent of the rural labor force took part in industrial activities of various types. The average rural firm employed 3.8 workers, 70 percent of whom were family members. Sixty-three percent were male, 37 percent female. Rural industry was often a part-time or seasonal activity intended to supplement income from agriculture. It provided earning opportunities for women, who often were not permitted by local custom to work outside

TABLE 21 Output of Small and Large Manufacturing Firms, Bangladesh

	Percentage of GNP		
Year	Small firms	Large firms	Total firms
1972–75	2.47	4.00	6.47
1975–78	3.40	4.27	7.67
1978–81	3.83	5.10	8.93
1981–84	4.10	5.30	9.40
1984–87	3.65	4.55	8.20

SOURCE: National Accounts.

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the home. The survey found that the Hindu minority was still overrepresented in rural industry, particularly in the more traditional activities. But the number of Muslim entrepreneurs was rising, particularly in the more modern, higher-productivity lines of work.

Industrial Policies and Programs, with Special Reference to SMEs

This subsection traces industrial policy and programs from preliberation to the present, discusses the findings of EEPA, and finally summarizes the impact of policy on small enterprises.

Preliberation Period

The PIDC took over a number of large-scale industries that Pakistan had inherited from the British. After EPIDC was formed in 1962, it encouraged joint ventures between West Pakistani industrialists and nascent Bengali entrepreneurs by allowing investors to start businesses with equity contributions as small as 7.5 percent. It also devolved some of the enterprises it had established to private entrepreneurs as conditions were perceived to be ripe. On the whole, free enterprise flourished. Large private enterprises developed in jute, sugar, and textiles. Small firms also grew. However, incentives were strongly slanted in the direction of import substitution.

Industrial Investment Policy, 1972

When Bangladesh was liberated from Pakistan in December 1971, 34 percent of fixed assets in the modern industrial sector were controlled by EPIDC. Nearly half the remainder belonged to non-Bangladeshi entrepreneurs who fled or were expelled after independence. Following the new constitution's call for "socialism, secularism, and democracy," many businesses were nationalized. These included all abandoned properties worth Taka 1.5 million ($193,000) or more; the entire jute, textile, and sugar mill industries (the three largest in the country), irrespective of who owned them; banking and insurance; and the important export trade in jute. Private entrepreneurs were thus restricted to small investments in relatively unimportant sectors.

Pakistan's ISI policy was pursued with even greater enthusiasm by Bangladesh. Nationalization and high tariff walls enhanced the market power of the large firms. Nominal import duties ranged from 50 to 100 percent. Export promotion measures introduced in the late 1970s led to some duty reductions, but the ISI policy continued with little change for several years.

From time to time, constraints on the private sector were relaxed. The ceiling on private investments was raised several times in the mid-1970s

and finally abandoned in 1978. The number of industries reserved for the public sector was reduced to eight, while ten sectors were put on the concurrent list (industries where both public and private enterprises were permitted). By 1982, 375 of the 725 nationalized units had been privatized. Foreign investors were promised equal treatment with national investors.

New Industrial Policy, 1982 (NIP82)

The early 1980s saw more violent political changes, culminating in a military takeover in March 1982. The new government tried to break with the past by speeding up privatization, liberalization, and the regional dispersal of industry. Its NIP82 included efforts to accelerate privatization and the role of the private sector generally, and to tilt marginally from ISI to EOI, from restrictions on private investment to investment incentives, from a positive to a negative list of imports, and from public ownership to privatization of public enterprise. Fifty-seven jute and textile enterprises were sold off in 1982–83. Soon after, a few banks were denationalized. The new government also tried to encourage investment by simplifying the complex administrative formalities and initiating a "one-stop" investor service.

Revised Industrial Policy, 1986 (RIP86)

A further attempt to boost private investment promotion was made by RIP86, which augmented fiscal, credit, and other incentives, as well as policies to favor small and cottage industries (SCIs).

Export incentives (higher export bonus for using domestic raw materials, letters of credit that could be used back to back to import materials, and bonded warehouse facilities) were granted to producers of ready-made garments, specialized textiles, hosiery, and leather goods. Bonded warehouses, duty drawback benefits, a 9 percent concessional interest rate (against prevailing market rates of 14–16 percent), and tax rebates were made somewhat more widely available. Despite the announced EOI policy, however, effective rates of assistance[7] generally remained high for import substitution products and low or even negative for export goods (Trade and Industry Project [TIP] 1987).

SCIs were declared a priority sector for the first time in the Third Five Year Plan (1985–1990). Incentives included the following:

- tax holidays and favorable import duties on machinery and equipment; extra incentives were offered to investors in less developed regions and in industrial estates sponsored by BSCIC
- subsidized 10 percent interest rate, irrespective of debt-equity ratio and location of investment

- exemption from income tax on all income arising from export of handicrafts
- enhanced role for BSCIC in skill and management training for SCIs, research aimed at improving productivity, product quality and design, the supply of raw materials, and marketing
- requirement that commercial banks and other financial institutions open separate windows to finance SCIs and set aside a fixed percentage of their resources for such loans; SCIs were required to maintain a debt-equity ratio of only 80:20
- requiring banks also to arrange necessary funds for "sick" SCIs and for subcontracting
- development of a small entrepreneur credit guarantee scheme under the joint sponsorship of BSCIC and Sadharan Bima (Insurance) Corporation

Just as these policy statements were formulated, the pace of privatization slowed down and an attempt was made to turn denationalized firms into public limited companies owned in part by their workers. Nevertheless, privatization reduced the public sector's share of fixed assets in the modern manufacturing sector from 90 percent in 1972 to 40 percent and cut the number of publicly owned industrial units from 720 to 160. In line with the privatization policy, the stock exchange was reactivated and nonindustrial activities such as fertilizer marketing were deregulated.

Bangladesh thus has experienced privatization and increasing emphasis on export promotion. Yet available evidence suggests that private investors have not responded strongly to the more favorable industrial policies, and also that privatized firms have not performed significantly better than publicly owned firms (Sahota 1990). An important exception is the garment industry, whose rapid growth in recent years suggests that Bangladeshi entrepreneurs do have the capacity to respond effectively when presented with favorable incentives. "Export catalysts" such as the Korean Daewoo Company in the garment industry have been shown to be effective ways of teaching Bangladeshi entrepreneurs how to export (Rhee and Belot 1989). Key government actions included liberalization of the relevant trade channels, particularly those that helped exporters obtain inputs at world prices, and more favorable treatment of inward remittances from migrants to the Middle East, which helped to finance many new SMEs.

Many observers believe that Bangladesh has still not gone far enough toward developing a liberal policy framework that will permit entrepre-

neurs to function effectively. Since large firms continue to be heavily protected, it is not surprising that they are inefficient. Are small firms any more so?

NIP82 supposedly introduced preferences for small industrial firms. As in other developing countries, preferential treatment of small enterprises was justified by claims of greater efficiency and labor intensity. Advocates of small-firm preferences argued that the rural agricultural labor market and migration of surplus rural labor to create a sector of productive urban labor could not be relied upon to raise the incomes of the poor because of seasonally varying demands, oversupply of labor, and many market imperfections. It would be better, they argued, to help the poor become producers of commodities rather than suppliers of labor. The image of the poor as producers in small enterprises, rather than as vulnerable laborers, is more compatible also with a political vision of democratic and relatively autonomous self-governing systems (Sanyal 1987).

EEPA Research

EEPA in Bangladesh (also known as the Employment and Small Enterprise Policy Project, or ESEPP) examined industrial performance before and after NIP82 to see whether its policy objectives were achieved. Data from the Census of Manufacturing Industries (CMI) were collected and checked for consistency. Industrial enterprises for which data were adequate were grouped by size and type, and their performance on various criteria was measured.

The research found that approximately 40 percent of manufacturing establishments, accounting for about two-thirds of total output, experienced declining TFP between 1974–75 and 1983–84. In other words, there was little sign of dynamism in manufacturing over this period. The positive impact of NIP82 on TFP growth, if any, was not yet evident in 1983–84. A closer exploration of the possible differential impact of NIP82 suggests that only the large establishments at best had benefited. Employment expansion over the period came predominantly from large enterprises.

Evidence on capital intensity and enterprise size is mixed. Among enterprises established during the decade under study, for which the measures of capital stock are likely to be most accurate, large firms (100 workers or more) are three times as capital-intensive as the smaller ones. For size classes up to 100 workers, the K/L ratio was found to be relatively uniform. Value added per worker increased sharply with size. The wage bill/output ratio was found to be similar in old and new firms but moderately higher in "moribund" firms. In general, the study fails to support the contention that small enterprises are labor intensive.

Large firms show higher TFP growth (or less decline) than SMEs, although growth in the number of firms is highest in the smallest size class.

The growth of large enterprises in terms of value added per worker, value added per unit of output, and value added per unit of capital clearly surpasses that of small ones.

Manufacturing employment rose at a higher rate (8.1 percent) in the 1980s than in the 1970s (4.7 percent). But the growth rate of manufacturing output slowed (from 5.6 percent in the 1970s to 2.4 percent in the 1980s), causing output per worker to drop. Firms with 1–4 workers experienced the highest rate of establishment expansion after 1982, except in the textile industry, where the size class with 10–19 workers expanded at a higher rate. These results should be tempered by noting that (1) most establishments started at low sizes; (2) net mobility among establishments with fewer than ten workers was upwards and that for most larger ones downwards; (3) some establishments may have appeared as replacements for erstwhile household/cottage shops; and (4) in the overall intersize class mobility, the size class with fewer than five workers was generally the net gainer.

The promulgation of NIP82 and RIP86 and concomitant incentives to the private sector created expectations of a big increase in private investment and industrial production. This has not occurred.[8]

EEPA research indicates that production efficiency was positively related to firm size and negatively related or unrelated to effective rates of assistance (ERAs).[9] Capital intensity was directly related to efficiency but not significantly, and capital intensity showed little correlation with firm size. More important when considering their impact on investment, employment, and TFP growth rates, the coefficients of ERAs were found to be negative or zero across almost all size classes and industries, suggesting that the policies of the 1980s probably reduced the efficiency of Bangladesh's industries. The coefficient of firm size was positive and significant. Since scale economies were already accounted for in the analysis, a possible reason for the relative inefficiency of small firms is inferior technology. That small firms were generally inefficient is further indicated by the lower-value marginal product in small-size classes. Not all small enterprises were inefficient, however; in some industries small units were as efficient as large ones. Nevertheless, in most industries the large enterprises were clearly the most efficient of all. Most important, changes in GDP (a proxy for domestic demand) appeared to have more effect on TFP and employment in small firms than in large ones, suggesting that an effective stimulus for small enterprises is perhaps a high rate of economic growth, at least at Bangladesh's low level of economic development.

Impact of Policy on Small Enterprises

In strongly interventionist policy regimes like that of Bangladesh up to 1982 (and to some extent later), many kinds of assistance obtainable

by large firms are likely to be unavailable or less available to SMEs. Nuimuddin Chowdhury concludes his careful comparative study of small and large firms in the cotton weaving industry up to 1977 with the observation that

> The real driving force . . . remained . . . the bestowal of massive financial and other assistance on the large-scale textile industry, from which a fractional and largely circumstantial fall-out was provided to the mainstream of small producers in hand-weaving. The explanation of that real driving force lay in the web of social and political factors that have interacted with, sometimes overridden, economic arguments concerning the objectives, nature and ramifications of industrial policies in pre-liberation Bangladesh. (1985: 21)

The large cotton weaving mills that Chowdhury studied were public enterprises. More recently, an EEPA (ESEPP) study assessed the problems of large and small firms in Bangladesh (Harvard Institute for International Development [HIID]/ESEPP 1990). It found that export firms of all sizes deplored procedural difficulties, while the most common complaint among enterprises that produce for the domestic market concerned difficulty in obtaining inputs at reasonable prices. Thus export firms, which have to meet high quality standards and tight delivery schedules, often find themselves most constrained by government policies and procedures. Small producers serving the domestic market are less affected by government policies and more bothered by what might be called the problems of underdevelopment.

The study also examined the extent to which small, medium, and large firms avail themselves of the incentives and facilities offered by the government. While differences were observed among industries, there were no sharp differences among firm size groups within particular industries. Entrepreneurs in all size classes commented that the incentives offered by the government were of little value because of delays in obtaining them and the need to make illegal payments. BSCIC assistance programs for small firms were found to have severely limited coverage. Only 4 percent of respondents in the 4–99 worker size class reported receiving assistance from BSCIC. Most of the assistance took the form of credit.

Sources of capital for enterprise finance varied by industry, size class, and the gender of the entrepreneur. As in other countries, small firms rely primarily on internally generated funds. When they need credit, they turn most often to moneylenders and other informal sources. Female entrepreneurs in the sample made no use at all of external funding, and even medium and large firms frequently borrowed from moneylenders.

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Additional Considerations and Policy Recommendations

It can be argued that a neglect of economic theory and analysis by policy makers led to the poor performance of Bangladeshi industry. The desire of the newly formed military government to eliminate public enterprise deficits caused the privatization aspect of NIP82 to be implemented too hastily. Markets responded poorly because of uncompetitive environments. Nationalization, protected public sector monopolies, private investment ceilings, and restrictions on entry to reserved sectors all undermined incentives and increased bureaucratic interference in day-to-day business affairs.

The history of investment and credit in the manufacturing sector helps explain the unsatisfactory performance. Although many SMEs, particularly in the garment and textile export sector, financed investments through small working capital loans and remittances, development finance institutions (DFIs) have always been seen as the major instruments for promoting economic development. They have experienced many difficulties. In the 1970s DFIs lent to public enterprises that ran heavy losses. The debt-equity ratio of these firms rose, on average, to 85:15 and they could not meet their debt obligations. Things got even worse after many of these firms were privatized in the early 1980s; DFI loan recovery rates plummeted to less than 10 percent by 1986. Recovery rates on commercial bank loans to small firms were reported to be in the 15–20 percent range around 1990. Foreign donors who financed the DFIs were often not repaid.

The main reason for low loan recovery from public enterprises has been the heavy losses run by these enterprises. Defaults by private enterprises are attributable largely to the speed, scale, and terms of denationalization. The original owners of firms nationalized in 1971–72 were reluctant to take them back, since they were required to assume the heavy liabilities accumulated by public managements. But they did so, allegedly under persuasion by the president and with the encouragement of easy credit (they could borrow 92.5 percent of their capital). These powerful families then found pretexts for not meeting their loan obligations. Sources suggest that low recoveries by banks from SMEs in the 1980s resulted also from a perception that defaults would be tolerated. Debt defaults of up to 90 percent caused donors, whose money formed the base for the DFIs' industrial loans, to cut back on future loans. The IMF imposed its conditions in the early 1980s. The resulting credit crunch was one cause of the slump of the early 1980s, from which industry was slow to recover.

Small firms benefited little from the reservation of credit for them or from training and technical assistance, which were poorly or hardly implemented and regarded as of limited value by owners of SMEs.

The virtual lack of economic growth has been a major problem for all types of enterprise. SMEs in rural and less developed regions depend on demand from agriculture, while small service and engineering firms in the urban areas rely on overall, especially industrial, growth. The growth of SMEs in Bangladesh depends mainly on the growth of the economy. When demand is strong, they can perhaps take care of themselves. When the economy slumps, supply factors (credit, raw materials) become important, but not so much as for large enterprises. Small enterprises shrink less than large enterprises during recessions and seem to be only mildly impacted by government policies.

Although less efficient than large industry, small industry in Bangladesh has grown faster over the past two decades. Slow expansion of large-firm employment seems to have pushed people into self-employment or starting their own small businesses. Remittances from Bangladeshi workers in the Middle East and elsewhere, which ran at almost $0.5 billion annually for several years, financed much of this activity by increasing the liquidity of those who can only invest in small businesses.

Overregulation of the economy through labor laws enforced only on large firms and excessive administrative procedures also created opportunities for the growth of small enterprises. The economy is heavily regulated through reliance on procedures, sanctions, and approvals. As measured by ERAs, fiscal and financial subsidization increased by roughly 30 percent in the 1980s. Yet domestic manufacturing industry did well neither in investment, output expansion, efficiency, nor TFP growth. The large price distortions created by government intervention failed to increase investment or output growth. The ineffectiveness of policy is further indicated by the growth of exports from SMEs that receive low rates of government assistance. Except for finished leather, effective assistance to export industries is either negative or very slightly positive, whereas for import substitution products ERAs of 100 percent or more are the rule and rates exceeding 200 percent are common.[10]

EEPA interviews suggest additional reasons for the lack of entrepreneurial response to industrial policies. Recurrent natural disasters and the sharp fall in the world jute price have hurt the economy, and well-publicized incidents of violence against managers spurred by labor-management disputes have further damaged the investment climate. But these obstacles can be overcome by Bangladeshi entrepreneurs, as shown by the case of the garment industry and by the export performance of sectors such as rubber, metal manufacture, shrimp and frog legs, and carpet backing. As the experience of the garment industry reveals, small firms can take part in this growth.

Deregulation of industry and reduction of ERAs and implicit subsidies

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appear obvious, if politically difficult, ways to accelerate industrial development. Although firm size does not seem a reliable criterion for policy design, it is clear that small enterprises play a positive role in adjusting to economic shocks and meeting local demands, particularly in less developed regions. As many seemingly efficient small enterprises operate with inferior, perhaps improvised technology, one could consider ways to incorporate a technology improvement component in policies designed to increase productivity. The size distribution of firms is probably a secondary issue compared to policies aimed at greater market integration and broad-based productivity growth. Such a structural transformation will require a far more liberal policy framework than the one currently in place.

SUB-SAHARAN AFRICA

The thirty-seven low- and middle-income economies of Sub-Saharan Africa[11] share a number of characteristics that affect policy toward SMEs.[12] While there is considerable diversity in Africa, there are also many common features which are important for our purposes:

- Low per capita incomes; eighteen of the world's poorest twenty-five countries are in Africa. Since most countries also have small populations (only Nigeria, Ethiopia, and Zaire were over 30 million in 1990), national markets are generally very small.
- Predominantly rural populations. In twenty-nine African countries 60 percent or more of the people live in rural areas. While much nonagricultural activity takes place in rural areas, the main source of income for rural Africans is farming.
- Slow growth of agricultural output, even stagnation or decline in a few countries. Farmers' incomes and demand for nonfarm products have grown slowly if at all.
- Low levels of human and physical capital. Many adults are illiterate and the physical infrastructure (transport, communications, and utilities) is limited and typically in a poor state, particularly in rural areas.
- Low population density. With few exceptions, the rural population is widely dispersed.
- Heavy reliance on foreign trade. Exports and imports are higher relative to GDP on average in Africa than in other developing regions.

- Limited institutional infrastructure. Marketing, finance, technical and market information, quality control, and legal systems are all limited and enforcement is spotty.
- Distorted policies. The magnitude of policy distortions is reported to be higher in Africa than elsewhere (Meier and Steel 1989).
- Soft states. The political and administrative structures of many African countries are vulnerable to socially costly rent-seeking behavior by government officials or powerful private individuals (Biggs and Levy 1988).

The central challenge facing African policy makers is to find ways to encourage productivity growth and increase specialization in economies dominated by poverty-level, subsistence-based production. The factors just listed combine to make this a difficult task.

A basic problem in most of Sub-Saharan Africa is the weakness or absence of economic growth and structural change. In many of the region's low-income economies the growth rate is so low that structural transformation simply is not occurring. In a few, it is actually operating in reverse.

Table 22 shows that the eleven poorest countries, with GNP per capita of $250 or less in 1990, experienced a small decline in average income in 1965–1990. Manufacturing value added in these countries grew at only 2 percent a year during the 1980s and contributed only 15 percent to GDP on average in 1990. The fourteen nations in the upper part of the low-income

TABLE 22 Economic Growth and the Manufacturing Sector in Low- and Middle-Income African Countries

GDP/capita, 1990 ($)	No. of countries	Annual real growth rates[a] (% per year): Mfg. value added, 1980–90	Mfg. value added, 1965–90	GDP/capita, 1965–90	Share of mfg. value added in GDP, 1990 (%)
Low-income countries					
250 or less	11	2.7	2.0	−0.4	15
270–530	14	—	3.9	0.3	12
Middle-income countries					
640–3,330	10	—	4.7	2.4	13

NOTES: Dash = not available.
a. Growth rates given in unweighted averages.
SOURCE: World Bank, *World Development Report*, 1992.

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group fared only slightly better. Finally, the few African nations that are classified as middle-income countries owe that position primarily to natural resource exploitation. Even they have experienced only very limited industrialization and structural transformation.[13]

Of the eight countries below $250 per capita in 1990 for which data exist, agriculture's contribution to GDP fell between 1965 and 1989 in only four. In Tanzania, Zaire, Uganda, and Madagascar—all countries where per capita income declined—it rose. Conversely, agriculture's share fell in eighteen of the twenty-one countries above the $250 line for which comparison is possible. The two countries in which it increased—Ghana and Zambia—experienced declining per capita income.[14] Industry's GDP share rose in sixteen of these countries, but the bulk of the increase was often in mining or construction, not in manufacturing.[15]

Industrial productivity growth in Sub-Saharan Africa appears to have been weak or absent. While the data leave much to be desired, we can compare the growth of employment in the industrial sector (including mining, construction, electricity, water, and gas, as well as manufacturing) with growth in real value added for number of countries in 1965–1983. Such data are available for eight of the countries that were still below $250 in GNP per capita in 1990. In six of these cases (Ethiopia, Tanzania, Somalia, Malawi, Sierra Leone, and Uganda), employment grew faster than value added, signaling a decline in labor productivity. Only in Burundi and Nigeria did industrial labor productivity rise. Among the somewhat more developed countries in the $270–$530 per capita income class in 1990, the productivity growth record was only slightly better. Six of these countries raised industrial labor productivity in 1965–1983, but eight others experienced declines. Only among the middle-income countries was there clear-cut evidence of productivity growth; four of the five countries for which data are available experienced growth of industrial value added in excess of employment growth. The countries with the most favorable records were Niger, Kenya, Benin, and Guinea in the low-income group and Congo and Cameroon in the middle-income group.

Data on industrial structure are also incomplete and often exclude many of the smaller enterprises. Table 23, which presents unweighted averages based on official estimates, shows that food, beverages, and tobacco constitute nearly one-half of manufacturing value added in low-income Africa. This share is much higher than in Asian low-income countries, where comparable figures in the late 1980s are 32 percent in 1970 and 27 percent. The textile and garment industries, while important in low-income Africa, are somewhat less so than in low-income Asia (28 percent in 1970; 20 percent in the late 1980s). Except for Mauritius, no African country has yet emerged as a major textile and garment exporter, as several Asian countries did in the early stages of their industrialization.

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TABLE 23 Shares of Key Industries in Manufacturing Value Added, Low- and Middle-Income African Countries, 1970 and 1989

GDP per capita, 1990 ($)	Food, drink, and tobacco 1970 (%)	Food, drink, and tobacco 1989 (%)	Clothing and textiles 1970 (%)	Clothing and textiles 1989 (%)	All others 1970 (%)	All others 1989 (%)
Low-income countries						
250 or less	49	46	20	18	32	36
270–530	48	—	18	—	34	—
Middle-income countries						
530–3,300	47	42	12	19	41	39

NOTES: Dash = not available. Terminal figures vary from 1987 to 1990, depending on data availability.
SOURCE: World Bank, *World Development Report*, 1990, 1991, 1992, 1993.

Although it does not show in Table 23, metal and metal product industries are far less important in low-income Africa than in low-income Asia and have declined in relative importance. Yet in middle-income Africa these industries show considerable dynamism.

There are few signs of industrial diversification or structural transformation among low-income African countries. Manufacturing activity (at least among the firms covered by the official statistics) remains concentrated in food processing and the production of beverages and tobacco.

Small Industrial Enterprises

Small firms form an important part of the industrial sector in most African countries. Not only is the overwhelming majority of industrial establishments small, but small firms account for the vast bulk of industrial employment. In the few countries for which data on establishment size are available, their employment share is at least 59 percent (Table 24).

Most of this employment is generated by microenterprises with fewer than ten workers. Indeed, the great majority of firms employ fewer than five persons and many are simply one-person enterprises. There are relatively few firms in the 10–50 worker category and they generate comparatively little employment. The paucity of firms in this size category (the "missing middle") is acute in Africa, with the possible exception of Nigeria.

TABLE 24 Distribution of Employment in Manufacturing in Five African Countries

Country and survey date	Size of firm (% of total employment): Medium and large (50 or more workers)	Small (10–49 workers)	Micro (fewer than 10 workers)
Sierra Leone, 1974	5	5	90
Nigeria, 1972	15	26	59[a]
Ghana, 1970	15	1	84[a]
Zambia, 1985	16	1	83
Kenya, 1969	41	10	49[a]

NOTE:
a. Computed as a residual, which is the difference between employment recorded in labor force or population surveys (includes all sources and establishment surveys).
SOURCES: Computed from Chuta and Liedholm (1976); Page (1979); and Milimo and Fisseha (1986).

Small firms also generate a significant portion of manufacturing value added, ranging from 26 to 64 percent. The GDP share of small firms in all sectors varies from 2.9 to 8.3 percent (Liedholm and Mead 1987).

As Table 25 shows, clothing production, primarily tailoring, is the most important small-scale manufacturing activity in most African countries. This is particularly so in West Africa, where clothing accounts for approximately one-half of all small enterprise employment. Wood products, primarily charcoal preparation and furniture making, generally follow, while metal working (usually blacksmithing), food production (primarily baking and brewing), and vehicle, shoe, electrical, and bicycle repairs are also common. In general, small firms concentrate on the production of light consumer goods such as clothing, furniture, food, and drink.

In most African countries, the vast majority of small manufacturing enterprises is located in rural areas.[16] Employment in small-scale rural manufacturing often exceeds that generated by urban manufacturing firms. In Sierra Leone, for example, 86 percent of industrial sector employment and 95 percent of industrial establishments were located in rural areas (Chuta and Liedholm 1985).

In Zambia, 64 percent of industrial employment was estimated to be rural (Milimo and Fisseha 1986). Official figures often understate the true magnitude of rural industry because national censuses and surveys of industry miss the smallest rural firms.

TABLE 25 Employment Shares of Small-Scale Manufacturing Establishments for African Countries

Country and coverage	% of total employment (by industry)				
	Clothing products	Wood products	Metal products	Food/ag. processing	Other
Sierra Leone (entire country, 1976)	51	20	18	5	6
Nigeria (four states,[a] 1972)	56	11	4	2	27
Ghana (Accra, 1972)	46	12	2	5	35
Cameroon (Yaounde, 1978)	48	16	5	1	30
Burkina Faso[b] (Eastern ORD, 1980)	25	1	8	55	21
Tanzania (Dar + 20 major townships, 1966–67)	26	19	5	9	41
Kenya (Central Province village centers, 1977)	22	43	6	22	7
Zambia,[c] 1985	6	32	4	55	3
Egypt (2 rural governorates, 1982)	38	24	5	12	20

NOTES:
a. Mid-Western, Kwara, Western, and Lagos States.
b. Discrepancy in original.
c. All except Copperbelt provinces and Lusaka.
SOURCES: Sierra Leone: Chuta and Liedholm (1976); firms below 50 persons.
Nigeria: Aluko, Oguntoye, and Afonja 1972 and 1973; firms below 50 persons; enterprise, not employment shares.
Ghana: Steel 1979; firms below 5 full-time wage employees.
Cameroon: Steel 1979; firms below 5 full-time wage employees.
Burkina Faso: Chuta and Wilcox 1982; firms below 50 persons.
Tanzania: Schadler 1968; firms below 10 persons; enterprise, not employment shares.
Kenya: Norcliffe, Freeman, and Miles 1984; firms below 50 persons.
Zambia: Milimo and Fisseha 1986.
Egypt: Davies et al. 1986.

Research on SME dynamics in Africa initiated under EEPA and continued under USAID's GEMINI project[17] shows that both the number of SMEs in Africa and their total employment are increasing.[18] The most rapidly growing firm size categories appear to be those with 2–9 and 10–49 workers. The number of one-person enterprises is generally growing slowly; in some countries it is declining. In over half the countries for which data are available, employment in small and micro firms is rising more slowly than that in medium and large firms. There is a secular shift

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toward somewhat larger firms based in larger localities and producing more modern products.

Investigations of the birth, growth, and death of individual small firms provide insights into the changes that are taking place. The greatest number of new firms are microenterprises. In countries with higher per capita incomes, new enterprises are appearing increasingly in larger localities. As in other parts of the world, turnover in small-firms is high. Disappearance (death) rates are highest for microenterprises. They peak in the first three years of a firm's life, during which about half the new firms disappear; firms that last beyond that initial period have a much higher chance of long-term survival.[19]

Employment growth rates for surviving microenterprises range from zero to very high. A relatively high average growth rate masks the fact that half or more of all SMEs do not grow at all.[20] Urban enterprises are more likely to grow than those located in rural areas.

Few African microenterprises "graduate" to become more complex SMEs; most remain very small. Most larger SMEs, therefore, do not emerge from the huge pool of microenterprises but originate as larger firms. The percentage of larger SMEs that began as micro firms is higher, however, in West than in East or Central Africa.

In interviews, small producers in Africa say that lack of demand is one of the most important constraints they face. Most of their products are simple consumer goods used mainly by relatively poor urban and rural households. Empirical studies indicate that the income elasticity of demand for these products is just under one. In Sierra Leone, for example, Robert King and Derek Byerlee (1978) report than an income increase of 10 percent would raise the demand for the products of small firms by almost 9 percent. A study in the Gusau region of Nigeria reports similar results (Hazell and Roell 1983). Steven Haggblade, Hazell, and James Brown (1989) estimated that these consumption linkages account for approximately 80 percent of the total agricultural growth multipliers in Africa. Consequently, the growth of demand for the products of small enterprises appears closely linked to corresponding increases in household incomes, particularly among the rural and low-income segments of the population.

A second source of demand for small industry products stems from their backward and forward production linkages with other segments of the economy. These linkages appear weaker in Africa than in other parts of the developing world. Backward linkages from agriculture are stronger in Asia, primarily because of higher levels of mechanization and irrigation (Haggblade, Hazell, and Brown 1989). Forward production linkages, however, can be important in some parts of Africa, as with rice and oil palm processing in West Africa (Liedholm and Kilby 1989). Little demand for small-firm products is generated by orders from large-scale industry; very

few subcontracting relationships appear to have developed between large and small industrial firms. Work done under EEPA suggests that this may be attributable to small markets and the tendency of foreign-owned import substitution firms to import a large share of their inputs, as well as to the rudimentary development of legal systems, which makes contract enforcement uncertain and costly (Mead 1989).

Government and foreign customers are minor sources of demand for small-scale industries. Only for a few specialty products such as gara-dyed cloth from Sierra Leone (Chuta and Liedholm 1985) and baskets from Botswana (Haggblade 1982) are exports from SMEs significant (Liedholm and Mead 1987).

A key issue is whether small-scale manufacturing firms in Africa are efficient users of economic resources, particularly when compared with their larger scale counterparts. Both partial and comprehensive measures of economic efficiency have been used to explore this question.

Aggregate data consistently show that small firms in Africa are more labor-intensive than large firms. However, large and small firms tend to make different products (Page and Steel 1984: 16–18) and differences in labor intensity are less evident within narrowly defined branches of industry in which various scales of production exist. Page and Steel (1984) speculate that the most important determinant of labor intensity may be access to institutional credit and incentives. "Informal," mostly small, enterprises face high prices for capital because they lack such access. They may also be able to hire workers (especially apprentices) at less than the minimum wage.

Some studies indicate that capital productivity is higher in small firms than in large ones, but evidence on this point is limited and more mixed. That capital productivity is higher in large enterprises in some countries and product categories is indicated by research done both by the World Bank (Page and Steel 1984) and under EEPA (Liedholm and Mead 1987).

Only a few studies have used one of the analytically more correct comprehensive economic efficiency measures, in which all scarce resources are included in the analysis and valued at "shadow" (social) prices that reflect their scarcity values in the economy. Liedholm and Mead (1987) undertook a social benefit-cost analysis to compare the relative efficiency of small and large industrial enterprises in Sierra Leone. They found that in all the individual industrial groups examined the social benefit-cost ratios of the small firms not only exceeded 1, but also were greater than comparable ratios for large-scale firms. This suggests that African SMEs can at least be more efficient than large-scale enterprises in the same country. Given the notorious inefficiency of the state-owned enterprises that dominate large-scale manufacturing in many African countries, however, this is not necessarily a ringing endorsement of SMEs.

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The efficiency of individual African firms also varies by characteristics other than size. A review of industry surveys (Liedholm and Mead 1987) indicates that the most efficient firms tend to hire labor, operate in workshops outside the home, be located in places with more than 2,000 inhabitants, and be involved in product lines with relatively elastic demand, such as tiles, furniture, baking, and repair activities. One-person firms are frequently on or below the margin of economic viability. Judiciously applied, such indicators can provide the analyst or project planner with useful insights into those types of industries most likely to be economically viable in Africa.

SME Development and Policy: Two Case Studies

To add concreteness to the discussion of SME development in Africa, we now turn to a closer examination of the situation in two low-income African countries in which substantial work was conducted under EEPA: Malawi and Rwanda.

Malawi

A densely populated Central African country, Malawi[21] is poorer even than Bangladesh, with a GNP per capita of only $200 in 1990. Although Malawi has had one of Africa's better growth records—real GDP grew at 5.5 percent in 1965–1980 and at 2.9 percent in 1980–1990 (World Bank 1992)—its growth was concentrated in estate agriculture and modern, larger scale urban enterprises. Over 80 percent of the population lives on small farms whose aggregate real output in 1987 is reported to have been the same as in 1979, even though the number of people living on them probably increased by over 25 percent, implying a decline in real income per capita. In 1980–1981, average cash expenditures for nonfood purchases by 1.1 million smallholder households amounted to only some $25–$30 per household per year. Since then, as just suggested, nonfood cash purchases per household almost certainly fell in real terms.

Malawi faces ominous population and labor force growth trends. Population growth averaged 3.4 percent a year in 1980–1990 and is expected to continue at that rate at least until the year 2000. The combination of rising population with slow employment growth in modern industry, services, and estates has led smallholder agriculture to expand at a pace that is surely not sustainable, in view of the scarcity of uncultivated land and small size of existing farms.

Statistics on the size and structure of SMEs in Malawi are thin and based on questionable concepts (Mead, Bolnick, and Young 1989: 7). A 1987 study that tried to update estimates from the 1977 population census

sorted small nonagricultural producers into three categories (Mead, Bolnick, and Young 1989: 7–10). The first is small enterprises with hired labor, which number between 30,000 and 35,000. Three-fourths of these operate outside the major urban centers and more than half are in retail trade. Second, some 120,000 self-employed individuals engage in nonfarm activities as their primary occupation. They hire no paid labor, but unpaid family members may work with them. Perhaps 80 percent work outside the major urban centers. Finally, large but unmeasured numbers of people (probably in the hundreds of thousands) are part-time participants in nonfarm activities. A recent detailed study of 210 smallholder families in a poor region of Malawi (Peters 1989) found that every single household had some source of income other than farming. The smallness of individual farm holdings (about 55 percent are currently less than one hectare) forces people to arrange supplementary income sources.

Small nonagricultural enterprises clearly play a central role in this economy, even though many of them offer only the barest of income supplements, with little prospect for significant increases. The fact is that people currently have no alternative. It seems likely that the number engaged in SMEs will continue to rise in the foreseeable future.

What is the appropriate policy response to such a situation?

First, one must recognize that, despite its extent and growth, employment in SMEs is not a primary solution to Malawi's development needs. At best, it is a stopgap response by the population to a deteriorating situation, a way to stave off further deterioration until a more fundamental and comprehensive development process gets under way. The latter must include increased production of both food and cash crops among smallholder farmers, an improved domestic distribution system (particularly in rural areas), and increased competition and efficiency in the production of manufactured goods.

Second, some types of small enterprise do use resources efficiently and provide reasonable incomes for those engaged in them. Policy change and project-level interventions should focus on identifying such enterprises and facilitating their growth. As suggested above, the enterprises most likely to succeed are existing firms (not new start-ups) with at least some hired workers (not self-employed people working alone) in urban or small-town locations (not dispersed rural producers). The EEPA mission identified three types of small producer with particularly good growth prospects:

- those that are or can be tied to growing segments of the economy, through consumption linkages or backward and forward production linkages

- those that can capture a larger share of existing markets through competitive pricing and improved marketing arrangements
- those built around more active and effective participation by small enterprises in the distribution system

Among the policies and programs needed to promote economic growth with stronger SME participation are

- promoting agricultural growth, particularly expansion of cash cropping among smallholders as well as increased productivity on estates
- increasing the capacity of small producers to sell in the larger and more dynamic national markets by improving their access to information about markets, products, and technology
- improving access to imported and domestically produced inputs. Prior to 1989, Malawi maintained an overvalued exchange rate and licensed foreign exchange, which was legally available only to registered enterprises. Although the system was partially deregulated in 1989, it continued to protect large enterprises and make it hard for SMEs to acquire imported inputs
- improving SME access to credit. The banking system was relatively well developed, but it did not meet the needs of SMEs. Credit was tight, in part because negative real interest rates since 1983 had reduced deposits; bank lending policies favored larger customers. Alternative approaches for increasing the flow of credit, especially to SMEs, were explored in the EEPA report
- reducing the cost of the internal distribution system and improving its responsiveness, thus opening new possibilities for small producers to participate as traders and transporters while expanding markets for all types of producers. Extensive and strictly enforced government regulations made Malawi a clean and well-ordered society, but they often impinged on small business profitability.[22] The EEPA report suggested a review of regulations covering transportation and the location and hours of business activity.[23]

To effect these changes, modifications were needed in foreign exchange release procedures (particularly to increase the availability to

SMEs of imported inputs), in the financial system (to ensure that convenient deposit facilities earn positive rates of return and increase the flow of credit to small borrowers), in the regulatory environment (to encourage competition in production and liberalization of controls on transport and trade), and in the tax system (which made it hard for small firms to sell to large, registered enterprises). There was also an urgent need for improved information on the current enterprise structure and potential areas of growth, to provide a basis for improved policy making and programming.

Rwanda

Although Rwanda[24] resembles Malawi in many ways, there are important differences between the two countries. First, Rwanda's per capita GNP ($310 in 1990) is substantially higher. Second, while reported GDP growth rates are lower (4.9 percent and 1.0 percent per annum over the 1965–1980 and 1980–1990 periods, respectively, compared with 5.5 percent and 2.9 percent for Malawi), the benefits of growth have been shared more widely. For example, 41 percent of all smallholder farms are reported to earn income from the sale of coffee, tea, or tobacco, the three main "industrial crops." While the average Malawian smallholder farmer spends only $25–$30 per year on cash purchases of nonfood items, the comparable figure for Rwanda is about $150. Although this is still a small sum, the difference is large enough to make the rural market for small enterprise products substantially larger in Rwanda than in Malawi.

Like Malawi, Rwanda is a densely populated yet predominantly rural and agricultural country. In 1990 only 8 percent of the population lived in urban areas, an unusually low figure even for Africa. Similarly, 93 percent of the labor force was listed as agricultural in 1980. Although urban population is estimated to be growing at 8.0 percent, the urban base is so small that for many years to come the great majority of Rwandans will continue to live on dispersed rural smallholdings. Average farm size was only 1.21 hectares in 1985; 57 percent of holdings were smaller than one hectare.

By far the most common small-scale manufacturing activity is the brewing of traditional beverages (banana wine and sorghum beer). Other small, unregistered enterprises are devoted to bricks, tiles, and pottery and to tailoring and embroidery, basketry, carpentry, and a variety of other activities, all predominantly rural. Whereas medium- and larger scale manufacturing enterprises employed just over 10,000 people in 1985[25] in a total population of more than six million, 55,000 to 70,000 engaged in the production and distribution of traditional beverages while 47,000 worked in other types of SMEs (Khiem 1987).

Rwanda's household budget and expenditure survey, based on detailed information from a nationwide random sample of 270 households

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and analyzed with EEPA assistance, showed that over 40 percent of rural families engage in artisan production other than traditional beverages. In most cases, this was a relatively minor income supplement. For only 8 percent of households did artisan activities provide as much as 50 percent of income; on average, they supplied 13 percent of rural household net cash income (Republique Rwandaise 1988: 43). One-fourth of the households in the sample engaged in some form of commerce, while half received income from wages. Only 27 percent of rural cash income came from the sale of agricultural and livestock products, underlining the importance of rural nonfarm income sources, particularly for those households with the smallest holdings. With high population growth rates and low absorptive capacity elsewhere in the economy, pressures to find such alternative income sources will surely intensify.

The policy and regulatory environment in Rwanda has recently become more supportive of small enterprise growth (Ngirabatware, Murembya, and Mead 1988). Major changes include

- improved administration of the government's special credit guarantee scheme to increase the access of small enterprises to bank lending
- a new investment code, removing minimum capital investment requirements and thus opening the possibility for small enterprises to benefit from tax holidays
- simplified registration procedures for newly established small enterprises
- an improved institutional framework for promoting small enterprises

Although a number of policies and regulations still hinder the development of SMEs, Rwanda does not discriminate sharply between large and small enterprises. The major challenge facing policy makers is to promote efficient growth throughout the economy, in which SMEs can participate. Needed reforms include the following:

- *Protection.* Reorient policy so that protection is provided on a more uniform basis through a less highly differentiated tariff structure, rather than by discretionary interventions based primarily on licensing; to the extent that discretionary protection policies remain, establish criteria for types of activities to be protected, levels of protection to be offered, and their duration; reduce the level of

protection offered to existing inefficient producers; promote internal competition to counter the effects of monopolies that result from high levels of protection from imports.

- *Taxation.* Strengthen the capacity of the tax department to assess and collect taxes due; review and revise the tax structure to reduce cyclical fluctuations in receipts and the heavy reliance on taxes on external trade; review and tighten procedures for tax exemptions through the investment code as well as by other means; simplify procedures for obtaining investment code benefits, especially for small producers; reduce the importance of "categorical taxes,"[26] which place particular burdens on small enterprises just getting established in the formal sector, in favor of those that vary with taxable capacity.
- *Regulation.* Simplify the procedure for obtaining permission to establish new enterprises, especially small ones; simplify and expedite customs, foreign exchange, import, and tax procedures.
- *Finance.* The financial system serves larger enterprises reasonably well, but the flow of credit to small producers is still quite limited. While further improvement in the operation of credit guarantee schemes may help, the most important changes needed concern procedures for loan processing and monitoring as well as in the preparation of bankable projects for submission to the financial institutions.

These proposed policy changes do not focus exclusively, or even primarily, on SMEs. Rather, they aim to establish conditions for dynamic growth in the economy as a whole. SMEs have an important role to play in that process, and it is necessary to ensure that discrimination against them is not introduced into the policy environment. But if the promotion of SMEs is seen as the central policy response to Rwanda's development needs (or those of other low-income African countries), then policy makers are likely to be disappointed. Considerable resources may also be wasted in pursuit of something that can only be a partial solution to their development needs, perhaps in the meantime helping to create conditions that retard the structural transformation that ultimately must be at the heart of the development process.

At the same time, it is important to reemphasize that certain categories of SMEs, in Rwanda as in other low-income African countries, can make important contributions to economic development and structural transformation. Eliminating policy discrimination against SMEs is important for achieving a process of efficient growth and structural transformation.

Beyond this, changes in economic policy, important as they may be, are not enough to enable these small producers to play their full and appropriate role in the development process. There is also a need for well-designed direct assistance that will facilitate such a full participation by efficient small producers. This will mean primarily

- the provision of information about new products, new markets, and new technologies
- the teaching of improved skills in management, production technology, and marketing
- improved access to raw materials, intermediate products, machinery and equipment, and credit

SME POLICIES AND PROGRAMS IN LOW-INCOME ECONOMIES

In this section we first discuss policies in relation to demand- and supply-side priorities. Then we discuss the role of programs that promote SMEs.

Policies

In low income economies, as elsewhere, government policies play a key role in either facilitating or impeding the expansion of efficient SMEs. No one set of policies or industrial strategies can be mechanically fitted to all developing countries. Rather, the policy mix must reflect the economic and social characteristics of the country as well as its ability to administer these policies. In particular, the policy array most appropriate for stimulating small enterprise growth in low-income countries such as Bangladesh and the countries of Sub-Saharan Africa differs from that relevant to more developed regions, particularly countries characterized as semiindustrialized. Policy priorities for SMEs in low-income countries can be grouped into those that operate on the demand side (usually by means of the product market) and those that affect the supply side (usually by means of resource markets).

Demand-Side Priorities

Because demand constraints are severe in low-income countries, a key role must be assigned to policies that stimulate the demand for the products of efficient SMEs. SMEs will develop if they are linked to "growth engines," particularly agriculture and foreign trade.

Agricultural policies must play a relatively larger role in the overall policy mix in low-income countries than in middle-income countries. Agriculture is the largest employer, a major source of income, and the primary source of demand for SME products, particularly for rural SMEs. SMEs are closely linked to agriculture through consumption impacts, but production linkages can be important as well. Efforts to promote structural transformation in the manufacturing sector without corresponding attention to increases in agricultural productivity may lead instead to slower overall growth and a rising share of agriculture in GDP (Mellor 1986; Timmer 1988). Although efforts to increase agricultural production are crucial in general, the nature and composition of these policies must also be considered, since their effects on the demand for SME products can vary substantially. For example, nonfarm SMEs probably benefit less from the growth of large estates than from that of small- and medium-scale farmers (Haggblade and Hazell 1989).

Trade policies are also important, especially in smaller countries such as those in Sub-Saharan Africa. Small national markets require these countries to participate in international trade, but many of their governments intervene extensively in trade, replacing market forces with administrative decision making. Growing exports are important for overcoming market constraints, but progressive SMEs are frequently thwarted by overvalued exchange rates, exchange control systems, and export incentives biased towards larger firms (Haggblade, Liedholm, and Mead 1986). Moreover, tariff protection tends to be highest in product lines dominated by the larger (and often less efficient) enterprises (Liedholm and Mead 1987). A refocused trade policy could lead to a pattern of improved import substitution through an expansion of dynamically efficient SMEs. The possibility that SMEs can gain customers by displacing inefficient and import-dependent larger enterprises (that is, by increasing the SME share in existing markets) deserves serious consideration in countries where overall domestic demand is growing slowly.

Supply-Side Priorities

Policies to strengthen the responsiveness of productive SMEs to respond to demand growth are also important in low-income economies. To policies that work directly through labor, capital, and other input markets should be added those that relate to infrastructure, education, and the regulatory and institutional environment.

Many policies contribute to distortions in the capital and labor markets and affect firms differentially by size. The net effect of these factor price distortions has been measured for several low-income African countries (Haggblade, Hazel, and Brown 1989). Subsidized credit, interest rate ceilings, import duties, quotas, exchange rates, and tax incentives have, on balance, made capital substantially cheaper for larger producers than for

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their smaller competitors. Conversely, minimum wage legislation, mandated fringe benefits, and public sector wage policies have made labor relatively more expensive for larger producers. Although the net effect of these policy distortions on the competitiveness of small firms compared with their larger scale counterparts is not always clear, in most instances it has been to subsidize the large and penalize the small (Liedholm and Mead 1987). Since the magnitude of policy distortions in most African countries is probably greater than elsewhere (Meier and Steel 1989), attempts to introduce a more neutral policy environment may have more impact on SMEs here than in other regions.

Expansion of infrastructure, particularly in rural towns, is another potent government function that may be relatively more important in low-income countries, especially those with dispersed populations and low-quality infrastructure at present. Given the dispersed settlement patterns in many parts of Africa, the emergence of rural towns as focal points enables policy makers to provide infrastructure needed by productive SMEs at lower cost. In addition to physical infrastructure (roads or railroads, electricity, and water), improvement is also needed in institutional infrastructure such as legal and information systems. Such "market-completing" reforms to reduce transaction costs are particularly important in soft states that lack the capacity to devise, implement, and sustain selective direct interventions such as those practiced by Korea. A related need is for collateral investments in human capital, which are of crucial importance in facilitating the development of efficient enterprises. These infrastructure-type improvements are, of course, most important in low-income countries where human capital is highly underdeveloped at present. They are therefore likely to be more important in most countries of Sub-Saharan Africa than, say, in South Asia.

Finally, there is evidence that regulatory policies constrain the expansion of existing micro and small enterprises in most low-income countries. In Northern Nigeria, for example, policies and regulations were the most frequently cited category of constraints during small firms' growth spurts, and the perceived importance of these policy bottlenecks increased with firm size (Chuta 1989). The individual policies and regulations did not all appear at the same time, but rather were introduced at different points in the firm's life cycle. It is important to avoid sharply negative policy discontinuities that act as disincentives to firm expansion.

SME Promotion Programs

In addition to maintaining a relatively neutral policy environment, there is also a need for direct assistance to increase the access of small producers to information, inputs, and management and technical skills that will enable them to play their full role in the development process. Any thoughtful

observer will recognize that there has been much waste of resources in programs offering these types of interventions in many countries of the third world; such programs have a particularly low success rate in Sub-Saharan Africa, as we saw in Chapter 4. This situation creates a dilemma of intervention. On the one hand, SME proprietors in countries like Bangladesh, Malawi, and Rwanda are among the poorest in the world and thus, in some sense, the most in need of assistance. At the same time, conditions in their countries, particularly the low capacity of their governments to intervene effectively, make it least likely that credit and technical assistance programs will be significantly helpful, let alone effective enough to represent a good use of scarce local and donor resources.

These harsh facts should not lead us to reject all such interventions as complements to the policy changes discussed earlier, but they should prompt great caution and a healthy awareness of the need to improve the design of these interventions and be selective about types of enterprises to be helped and forms of assistance to be offered. In a recent study of the responses of small firms in Ghana to structural adjustment, William F. Steel and Leila Webster (1990) found that some small businesses were adapting successfully to the changes in markets and prices that were occurring and appeared to have good growth prospects, while others were unable to master the new business environment and seemed unable to modify their products in the face of mounting competition. The distinction was unrelated to the subsector in which the entrepreneurs operated and was only loosely related to scale, although somewhat larger SMEs were a bit more likely to be doing well than microenterprises. Assistance provided to the stagnant group would probably be wasted.

> [T]here are many microenterprises in traditional activities such as sewing and carpentry. Because of public sector employment cutbacks under the adjustment program, an increasing number of workers have no alternative to self employment. At the same time, weak purchasing power among the lower-income population constrains the prospects for individual microenterprises. Although some microenterprises will succeed and grow, most are likely to continue hand-to-mouth as increases in demand are quickly competed away. (Steel and Webster 1990: ii)

Fortunately, prospects for assisting the more dynamic group of small-scale entrepreneurs are better:

> For potentially dynamic small firms, an important constraint is their lack of access to finance for working capital and new investment. Some are ready to grow beyond the limits of self-finance, but they remain unable to

> obtain the necessary funds from formal financial institutions. Entrepreneurs who established SSEs after the Economic Recovery Program of 1983 tend to be better educated, more responsive to demand and more able to seize opportunities than owners of older businesses. These new entrepreneurs offer substantial hope of the emergence of a strong entrepreneurial class under policies that reduce the political and economic uncertainties associated with long-term fixed investment. Growth of the private industrial sector in the medium term will depend in large part on whether these dynamic entrepreneurs are encouraged by an improving macroeconomic environment and increasing access to finance for expansion. A strong technical education system would contribute importantly to the long-run supply of capable, adaptive entrepreneurs. (Steel and Webster 1990: ii)

Again we see, as Staley and Morse noted many years ago, that any direct supply-side assistance should be focused on the more promising, "modern" SMEs. Even so, there is little basis for optimism that such targeting will succeed in the conditions of most low-income countries. In most cases, the severely limited resources available to these countries can probably be spent more beneficially on agricultural intensification, rural road construction, or improvement of primary school quality than on most types of SME promotion programs. This applies particularly to government-run programs. Encouraging private sector intervention, as in the case of Daewoo and the Bangladesh textile industry, may be more promising.

CONCLUSIONS

Several conclusions emerge from this discussion of small enterprise development in low-income countries.

- Small enterprises, including SMEs in manufacturing, are widespread in all these countries and serve as important supplementary income sources for rural producers who cannot earn a satisfactory income from agriculture because of small farms, poor soils, declining soil fertility, or unfavorable climate. This is true both in densely populated countries, where there is heavy pressure on arable land, and in more sparsely populated countries when the quality of transportation infrastructure is low. Medium-sized enterprises are scarce in these countries.
- While the importance of small nonfarm enterprises (in many cases microenterprises) is increasing in many low-income countries, primarily because the economy has been unable to provide adequate

numbers of productive jobs, there are also some SMEs that use resources relatively efficiently and create significant amounts of productive employment.

- Fundamental long-term development in low-income economies cannot rest primarily on the promotion of SMEs but must come about through a broader process of growth and structural change. Rising agricultural output is a critical part of this process.
- As development takes place, some types of small producers will expand and develop, while others will be replaced by competing products and more efficient producers. Macro and regulatory policies as well as project-level interventions should be designed to facilitate these longer term patterns of transformation, not to block or retard them.
- Government policies must start from a recognition that small and slowly growing national markets impose demand constraints that limit the potential for small producers to expand output. Dealing with this problem requires that priority be given to the encouragement of potential growth sectors, primarily agriculture and exports. Small enterprise policy must build from such growth points, seeking to create an environment in which small enterprises can participate in that growth, either directly by producing themselves for export or indirectly through linkages with other growing sectors. Key policy issues include the avoidance of factor price distortions arising from trade, credit, and labor market policies; minimization of discretionary regulatory interventions, particularly authorizations and permissions; and the development of, and equal access to, physical, human, and institutional infrastructure. Such nondiscriminatory policies are particularly important in relatively soft states where the potential for misuse of discretionary policy interventions is high.
- Although SMEs in low-income countries can be seen as needy, the ability of the government to carry out supply-side interventions in a cost-effective manner is particularly suspect in such settings. We believe that governments and donors should emphasize infrastructural investment, both physical and human, along with efforts to improve the integration of markets for goods, productive factors, and finance.

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Chapter 6

Middle-Income Countries: Problems with the Transition to Industrialization

It is a disturbing fact that since the World Bank started classifying nations into per capita income level groupings in 1978 only five nonoil producing countries have successfully made the transition from middle-income to high-income status: Hong Kong, Israel, Singapore, Spain, and finally Taiwan, which is omitted from World Bank statistical publications for political reasons. Obviously many middle-income countries have found it hard to complete the transition to industrialization, even though they have approached developed country levels of literacy and life expectancy and created physical, institutional, and intellectual infrastructure vastly superior to that found in low-income countries. One cause of this difficulty is the lingering effects of macroeconomic, trade, industrial, financial, and labor market policies adopted in past decades, usually in conjunction with ISI drives. These obstructive policies are easy to identify but hard to change, since reform efforts are often blocked by powerful elites who benefit from the status quo.

People from Africa and Latin American must be getting tired of hearing economic development success stories drawn from Asian experience. Chapter 7, which deals with successful transitions to an industrial economy, may add to their distress by reexamining two of the most important Asian success stories. The present chapter, on the other hand, looks at a less successful Asian nation, the Philippines, whose once-bright prospects

for industrialization remain unrealized, in large part because of inappropriate policy choices. In a subsequent section, the chapter then examines transitional difficulties in Latin America, a region composed mainly of middle-income countries that have found it hard to break through to full industrialization.

THE PHILIPPINES

In 1950 the Philippines[1] ranked among the richer Asian countries and was widely considered to have excellent prospects for economic development. Despite extensive damage suffered during World War II, the island nation enjoyed a decent per capita income and possessed a well-educated population, fairly good physical infrastructure, and considerable experience with democratic institutions and internal self-government. These legacies of nearly five decades of American colonial rule appeared to give the Philippines an edge over neighboring countries that had been treated less benignly as colonies of France, the Netherlands, Portugal, or Britain. Private capital was available both from a wealthy domestic elite and from U.S. investors, who received preferential treatment in the Philippines. Access to the American market on favorable terms was assured. For all these reasons, development prospects seemed bright.

Through the 1950s, things appeared to go well. Following a balance of payments crisis in 1949, initial measures to encourage industrialization were enacted. Economic growth averaged nearly 4 percent per annum during the 1950s, led by a manufacturing sector that grew at 12 percent a year. This bettered growth rates in neighboring countries such as Thailand, Malaysia, Singapore, and Indonesia. It turned out, however, that the Philippines' gains in the 1950s resulted from early-round, "easy" ISI, which proved incapable of sustaining economic growth in the longer run, yet difficult to change in the sociopolitical context of the Philippines.

In retrospect, the fundamental problem was not that Filipino efforts to industrialize began with import substitution but that the country somehow became stuck at that stage. As Bernardo Villegas (1986) has pointed out, Hong Kong, Taiwan, South Korea, and Singapore also went through import substitution phases. The critical difference is that in less than a decade these countries were able to dismantle their protective barriers and aggressively launch export-oriented industries, even as they retained some elements of ISI policy. This policy shift appears to have enabled them to accelerate their economic growth in the 1960s. The Philippines was unable to make the shift, and its per capita income growth fell off in the 1960s; by 1970 it was the slowest growing economy in the Asia Pacific region.

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As happened elsewhere, early industrial progress in the Philippines faltered because ISI ran into a dead end (Oshima 1987). The newly created industrial sector was highly protected, capital-intensive, and heavily dependent on imported inputs and equipment. The capacity built exceeded the needs of the domestic market, in which incomes rose slowly after 1960, and the sector was too inefficient to export. Sporadic efforts to cut back on protection were either defeated or subverted in the political arena. Instead, protection levels on politically favored activities actually rose further after the imposition of martial law in 1972 gave the Marcos administration more freedom to grant special favors to its "cronies." Despite abundant and relatively well-educated labor prepared to work at wage rates that became increasingly competitive with those paid in other Southeast Asian countries, the Philippines was unable to attract much investment in labor-intensive, export-oriented industries. Although the costs of ISI were probably defined and measured more thoroughly for the Philippines than for any other Asian country (for example, by John Power, Gerardo Sicat, and Mo-Han Hsing [1971]; George Hicks and Geoffrey McNicoll [1971]; and Robert Baldwin [1975]), policy makers seemed incapable of applying the lessons of this research.

A second important reason for the Philippines' inferior performance was weak agricultural growth. Output per agricultural worker rose only half as fast in the Philippines during the 1960s and 1970s as in Thailand. During the twentieth century, Thailand successfully moved away from a feudal system toward freer rural markets, in which ambitious peasants could acquire additional land for cultivation and market their produce freely for their own benefit. Meanwhile in the Philippines the indigenous land-owning elite that had emerged to fill the vacuum created by a lack of commercial and agricultural interests among the nineteenth-century Spanish colonialists progressively tightened its grip during the twentieth century. Widespread sharecropping and tenancy blunted producer incentives. Although significant agricultural development did occur in later decades, it was not enough to lay the strong base for industrialization that Thailand created with its vigorous agricultural growth in the 1960s and 1970s.

In Villegas's opinion, neglect of agricultural development was the fatal flaw in the development strategy of the fifties.

> The emphasis on import substitution distracted national leaders from the urgent task of improving agricultural productivity, especially in such food crops as rice and corn. Even traditional export crops such as sugar and coconut suffered a continuous decline in farm productivity. Export volume was increased primarily through the expansion of acreage rather than through improvements in yield. Whereas the present-day strength of the economies of Taiwan, Thailand, and Malaysia can be attributed

> largely to their having laid a solid foundation in rural and agricultural development early in the years following the Second World War, Philippine leaders waited for more than a quarter of a century after the war before taking serious measures to improve agricultural productivity. (1986: 151–152)

The Philippines has so far been unable to recapture the growth momentum that it lost in the 1960s. GNP per capita rose at only 1.3 percent a year on average from 1965 to 1990. The Philippines slipped far behind Thailand, which had a similar income level in 1950 but had nearly doubled its GNP per capita by 1990 ($1,420 versus $730 for the Philippines). It remained far behind richer and faster growing Malaysia ($2,320 in 1990) and by 1990 held a narrowing lead over previously much poorer Indonesia ($570). While the Philippines economy did not stagnate, as did many in Africa, its growth was slow, particularly by regional standards.

Development problems in the Philippines are often attributed to the power of its Latin American–style elite, which manifests itself in highly unequal distributions of income and wealth. As Oshima (1987: 214–215) notes, the problem is not the existence of an elite as such, but rather its behavior. In Japan, he reminds us, the oligarchy spearheaded modernization and development before 1940; although Japan suffered disaster in World War II, enough constructive elements survived for Japan to recover and eventually become an economic superpower. The efforts of the Japanese oligarchy, Oshima argues, were in large measure directed toward national development, as distinct from their own vested interests. Similarly, the Thai oligarchy, although it neglected agricultural development, enlarged the nation's physical infrastructure and allowed peasant agriculture to expand. The oligarchy in the Philippines, perhaps because it originated under rapacious Spanish rule, proved far less nationalistically motivated.

SMEs in the Industrialization Process

The protective system of the 1950s featured a cascaded duty structure, an overvalued peso, and administered interest rates. It strongly penalized imports of consumption goods, encouraged imports of capital equipment, and stimulated the building of plants that assembled or lightly processed imported goods and materials. Many of the early investments, spurred by high rates of effective protection, were made by American companies that had previously supplied the Philippines market from plants in the United States. Consumer goods fell from 28 percent of imports in 1950 to 17 percent in 1957, but the share of imports in GDP was not reduced. The

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industrial sector became unduly import- and capital-intensive (ILO 1974: 14).

Attempts to devalue the currency and reduce controls made in the early 1960s and again in the early 1970s enjoyed only temporary success. The ILO mission led by Gustav Ranis (ILO 1974) judged protection to be greater in 1973 than in the mid-1960s.

> Two decades of import substitution in manufacturing behind heavy protection have left the Philippines with not only a badly distorted industrial structure in terms of output mix and a lagging rate of growth (certainly at international prices), but also an increasingly capital-intensive set of technology choices. The continued emphasis on import substitution, first of the primary, then of the secondary or backward linkage variety, led to a continued relative de-emphasis on manufactured exports and over-emphasis on large-scale capital-intensive manufacturing at the expense of the development of more labor-intensive or medium- and small-scale enterprises. In addition, the system has accentuated existing biases in favor of the concentration of industrial activity in Manila and the surrounding region at the expense of the rest of the country. (ILO 1974: 15)

This pattern of industrialization limited direct labor absorption in the new plants, while the lack of attention to agriculture pushed people out of the countryside and into urban centers.

As in other Asian countries, household and cottage establishments had long accounted for the bulk of manufacturing employment. In 1955, establishments with 1–4 workers (called "unorganized manufacturing" in the Philippines) represented 75 percent of manufacturing employment. Although their share had fallen to 55 percent by 1980, they still employed 900,000 people and seemed likely to remain a significant part of the scene for many years to come (Anderson and Khambata 1981: 77–82). A decade later, Albert Berry and Dipak Mazumdar (1991: 46) speculated that household and cottage manufacturing employment had actually risen sharply in the 1980s. These figures are not indicative of a healthy industrial transition of the sort outlined in Chapter 2.

At the other end of the enterprise size range, employment growth in large-scale manufacturing has been fairly rapid since the 1950s. Berry and Mazumdar (1991: 46) characterize as "striking" the 91 percent employment increase among firms employing 100 or more workers between 1967 and 1983, which pushed their share of total manufacturing employment up from 22 to 31 percent of the total. In fact, however, this growth, which translates to an average annual growth rate of 4.1 percent, is not particularly impressive. Large firms would surely have absorbed far more labor

under a different policy regime, especially if labor-intensive manufacturing for export had developed in the Philippines as it did in neighboring countries (Bautista 1981).

SMEs employing 5–99 workers have had a hard time in the Philippines. Employment in this size group fell absolutely during the 1950s, probably in response to the difficulties they encountered in penetrating the control system and obtaining some of the benefits that larger firms enjoyed. Although SME employment revived in the more liberal 1962–1968 period, SMEs above the microenterprise scale remained far less prevalent in the Philippines than in more rapidly growing regional economies such as Malaysia and Singapore (Bruch and Hiemenz 1984: 119). According to Berry and Mazumdar (1991: 46), firms with 20–99 workers suffered a sharp employment decline and falling wages in the 1980s.

The growth of large-scale manufacturing under the protection regime, along with the failure of SMEs to develop, created a highly dualistic size distribution of firms in the industrial sector. This dualism was recognized by the Ranis mission (ILO 1974) and analyzed intensively by Tyler Biggs et al. (1986), who called it "the missing middle."[2]

As Berry and Mazumdar observed in their 1991 review article, the weak performance of the Philippines manufacturing sector can be seen both in the composition of manufacturing employment and in its overall growth.

> Total manufacturing employment grew at about 2.1% per year between 1956 and 1985, compared with a rate of 3.0% for total employment; by the latter year the manufacturing share had fallen to 9.7%. As of 1967 most manufacturing workers were still in the household sector, and only about a quarter were in establishments of 20 or more workers; over half were located in rural areas. . . . Employment in middle-sized establishments of 10–99 workers remained small compared to other countries of the region and to countries at the Philippines stage of development, accounting for just 6.3% of manufacturing employment in 1967 and 6.1% in 1983. (1991: 46)

Labor productivity in manufacturing has been characterized by wide gaps among scales of operation and an overall declining trend. In 1986–1987, output per worker was five times as high in enterprises with 200 or more workers as in firms with 10–19 workers (Berry and Mazumdar 1991: 46). The large firms paid wages 2.5 to 3 times as high as the small firms and were able to maintain their wage levels while those of the small firms declined.

The strongest indictment of Philippines industrial policy is a startling decline of both real wages and productivity that has continued over an

extended period. According to Biggs et al. (1986: 27), real wages in Manila fell steadily from 1960 on, reaching an index value of 62 in 1985, with 1960 equal to 100.

In his exhaustive analysis of productivity trends from 1956 to 1980, Richard W. Hooley (1985) found that total factor productivity (TFP) grew slowly up to 1970, then fell at an accelerating pace, ending up lower in 1980 than it had been in 1956. TFP declined also in many individual industries but rose in the food, beverages, tobacco, apparel, and wood products industries. Its fall after 1970 was attributable in large measure to policies that shifted resources to particularly inefficient heavy import substitution industries such as petroleum, iron and steel, and transportation equipment (Hooley 1985: 28). Another factor was the rising importance of public enterprise in the late 1960s and 1970s.

Mismanagement, plus a tendency to emphasize service to the public and employment expansion over profits and efficiency, made public enterprises less efficient than private firms by a margin that grew over time (Hooley 1985: 29). As one would expect, industries with low levels of protection, high export orientation, low dependence on imported energy, significant improvements in labor quality, and large expenditures on research and development had better productivity growth records than industries with the opposite characteristics (Hooley 1985: 60). Although Hooley did not examine productivity trends by scale of operation, it appears likely from his analysis and discussion that SMEs did better, on the whole, than large-scale manufacturing enterprises.

Policy Framework

Enough has already been said to indicate that Philippines macroeconomic, trade, and investment policies have been strongly biased against labor-intensive and small-scale establishments almost since independence. Noting this, the Ranis mission recommended a far-ranging policy package that included infrastructure construction at the barrio and block levels, land reform, improvement in irrigation, promotion of small- and medium-scale industry, measures to decentralize industry, maintenance of a realistic or somewhat undervalued exchange rate, reform of interest rates, liberalization of import restrictions, tariff reform, promotion of adaptive technology, reduced use of fiscal investment incentives, and a wages policy (ILO 1974: 25–51). Yet when Biggs et al. (1986) investigated the situation in the mid-1980s, they found that the policy framework was if anything more strongly biased against SMEs than it had been a decade earlier.

The industrial census of 1983 revealed that 21 percent of employment in "organized" manufacturing enterprises was in establishments with 1–10 workers, while 57 percent was in establishments with 200 or more

workers (Biggs et al. 1986: 2). Between the twin peaks of this bimodal size distribution of manufacturing employment was a deep valley of establishments employing 10–200 workers, a "missing middle." This structure contrasted with the size distribution of manufacturing enterprise in other Asian countries (except South Korea) and closely resembled that of the East European socialist countries, where very large industrial enterprises were strongly favored.

Biggs and his coauthors argued that the economic policies adopted by the Philippines government were mainly responsible for the "premature" domination of the industrial structure by large enterprises and the paucity of dynamic SMEs of the kind that were critical for Taiwan's development and important also in the industrialization of Japan, Hong Kong, Singapore, Malaysia, and Thailand. The report argued that the "missing middle" harmed the economy's competitiveness, adaptability to shocks, flexibility to adjust to capricious international markets, employment creation, income distribution, and entrepreneurial development (Biggs et al. 1986: 7–18). The damage was done by the government's investment, trade, wage, and financial policies, and abetted by its small-industry promotion policies, which encouraged firms to remain small. Although output per worker was much higher in large than in small enterprises, the falling wage level (which was, of course, opposite the trend that one would expect to see in a successful industrial transition) helped small firms survive and even multiply. In 1972, average compensation was 5.3 times as great in large firms (100+ workers) as in very small firms (fewer than 20); by 1983, this ratio had risen to 5.9:1 (Biggs et al. 1986: 29).

Perhaps the most important contribution of the EEPA team was to analyze the workings of the "small firm growth trap." As firms grow, it noted, they lose their eligibility for the benefits of government programs targeted at the smallest firms. Moreover, and equally important, they become subject to a far more comprehensive set of regulations and tax codes. The combined result of this simultaneous withdrawal of implicit subsidies and intensification of administrative and tax requirements is a very high marginal tax rate on small firm growth. The effect is so stifling that the EEPA report calls it the "small firm growth trap."

The trap has two main aspects. First, as firms grow, they graduate to higher tax and tax law brackets. Second, growth results in entry into a more formal business world. Rules and tax obligations that can safely be ignored (or "negotiated") by small firms become more firmly binding. These two aspects combine to produce a sharp increase in the effective tax burden of the enterprise.

In the past in the Philippines, the existence of incentives offered specifically to small firms and a graduated system of minimum wage regulations created a particularly extreme version of this growth trap. Firms that

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left the league of cottage producers faced sudden increases in sales taxes, import duties, and minimum wage requirements. Recent system reforms (the abolition of small-firm tax preferences and unification of the wage legislation) have, in principle, eased the transition from cottage industry to SME status.

What counts, however, is how the system works in practice. The EEPA team's interviews with a stratified sample of entrepreneurs suggested that (1) most cottage firms are able to evade the sales tax; (2) labor code regulations are systematically enforced only after firms grow beyond the twenty–employee level; and (3) BOI (Board of Investment) incentives are not immediately available in practice to firms that grow out of the cottage/small categories; only the larger and better-established firms seek them because the smaller firms are uncertain about the benefits and find the initial and ongoing costs of participation too high, despite some recent reduction in red tape. Applying these findings, the team concluded that there is a size threshold below which firms can evade the 10 percent sales tax and pay less than the minimum wage; above the threshold enforcement is relatively strong. Once such a firm crosses that threshold, assuming that it had been paying wages 20 percent below the legal minimum wage, it becomes liable to a punitive marginal tax rate on its additional earnings of 85 percent or more. (Biggs et al. 1986. 34–35).

To learn how SME policies and programs impacted in specific circumstances faced by SMEs, the EEPA team examined five industries (furniture, garments, electronics, metalworking, and jewelry) that represented situations in which SMEs produced either for domestic or foreign markets and did so either directly or as subcontractors. Exposure to international competition forced garment and rattan furniture makers to engage in a continuous search for ways to reduce production costs, improve their products, and penetrate new markets. In both industries, this intense competitive pressure had favorable effects on SMEs. To cut costs, larger firms extended their subcontracting networks, opening up opportunities for small firms.

In contrast, the impetus for growth in the electronics and metalworking industries came not from the lure of export markets but from local content policies designed to shelter infant local producers from import competition and promote the development of subcontractor networks by product assemblers. While this did create opportunities for SMEs, it lured firms down what eventually proved to be a dead-end road. When domestic demand and import protection declined in the 1980s, many of the firms established in the 1970s were forced to close down.

Based on this kind of comparison, the EEPA team's policy recommendations supported a more liberal industrial policy, which it thought would favor the more dynamic SMEs. It further urged that incentives should be provided for the growth of progressive SMEs, not for smallness per se.

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While conceding that protection might occasionally be imposed as a stimulus to learning, it urged that any protection offered should be highly selective and conditional on enterprise performance.

Although the policy and program[3] recommendations of the EEPA team were received enthusiastically by the deputy minister of trade and industry at the time and by many officials, they were criticized and opposed by other officials and rejected outright by the minister of trade and industry, himself a large-scale industrialist.

SME Development Programs

Prior to publication of the Ranis mission report in 1974, efforts to promote SME development in the Philippines had been limited (Yonzon 1991). In addition to the many policy reform proposals mentioned earlier, the ILO mission recommended that the financial and fiscal systems be modified to reduce the bias against SMEs and that technical assistance programs be launched to improve market information, skills, and technology. The mission argued that the potential for the rapid development of small- and medium-scale manufacturing industry was substantial.

> This view stems partly from the underdeveloped state of manufacturing at this scale in comparison with that in other countries with similar levels of income per head. It depends partly also on the belief that at least some of the constraints on the growth of smaller-scale manufacturing are artificial rather than natural. But it depends further on the judgment that, even in the face of natural handicaps, benefit will be derived from promoting its growth because of its labor intensity and efficiency in the use of capital. The need to create productive jobs in manufacturing at a much more rapid rate, given the limitations on the supply of new capital, means that priority must be given to investments which have relatively high coefficients of employment and output per unit of capital. Moreover, the need to achieve a wider participation in economic development, both by income classes and by regions, points also to the advantage to be gained from more rapid growth of firms in the range between cottage and large scale. This will not only help to fill the vacuum between large-scale industry and its supporting services, dominated by a relatively few wealthy families, and the masses of the poor at the bottom of the income scale, but will also greatly increase the upward mobility of the poor.
>
> Finally, successful rural mobilization will require, as well as make possible, a diversification of economic activities in the rural sector. Small-scale manufacturing can play an important role here in the processing of agricultural products, in the production of machines, tools, parts, and their repair, and in producing a variety of consumer goods for relatively small and remote markets. (ILO 1974: 158–159)

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For all these reasons, the ILO mission recommended not only the removal of artificial biases against SMEs but also programs to promote SMEs *whenever economical means could be found* [emphasis added]. Even if the optimal size of firms in many industries might eventually be medium or large, they observed, the most efficient route to such a goal might well be successful growth from a small start.

The late 1970s and the 1980s were a period of active SME promotion in the Philippines. Many new programs emerged, particularly in the field of credit. The Medium and Small Industries Coordinated Action Program (MASICAP), which was intended to help SMEs outside Manila obtain credit, was launched in 1973 and in 1980 was merged with the small business advisory centers (SBAC, established in 1974), which were supposed to help them use the credit effectively. Ernesto and Joseph Pernia formally assessed these programs in 1986:[4]

> Since 1973, MASICAP teams had assisted many and varied enterprises, new as well as old, for a cumulative total of 7,403 projects. Of this total, however, only 2,944 projects had been processed as of 30 June 1980, with a large backlog in financial institutions, reflecting an inability to deal with the small industry sub-sector and confirming the initial assumption of the program. Industrial activities spanned a wide range, from noodle processing to guitar and furniture making, to machine shops, to mining and quarrying. (Pernia and Pernia 1986: 639)

The Pernias tried to measure the effects of MASICAP/SBAC on employment, investment, and productivity in assisted enterprises. Their study was conducted in a region regarded as a good one for the program, with a high rate of loan repayment. Comparing MASICAP/SBAC clients with unassisted enterprises as well as with those helped by earlier government programs, they found that MASICAP's impact was favorable and the cost apparently modest. They did not, however, attempt to compare the program's benefits with its costs.

Biggs et al. (1986: 120–152) critically reviewed the many SME promotion programs in operation in the mid-1980s. They found, first, that the impact of all such programs was severely constrained by the unfavorable policy environment. Further, they argued that existing programs were spread too thin and neglected the growth problems of progressive firms. The report went to some length to spell out a technical assistance program that could better meet these needs. In the critical area of SME finance, the Biggs mission urged that assistance be concentrated more on growing, progressive firms. To encourage commercial bank learning about how to lend successfully to small enterprises, the team endorsed Anderson and

Khambata's earlier (1985) recommendation that the government subsidize industry-specific training programs in project feasibility analysis for staff members of private banks. A number of other recommendations were made, including a novel proposal for the government to help finance traders, whose capacity to help SMEs produce for domestic and international markets would thereby be enhanced.

As with policies affecting SMEs, SME promotion programs in the Philippines have yet to undergo significant reform. In a recent review of the government's SMEs promotion efforts since the mid-1970s, Maria Fina C. Yonzon (1991: 136–148) identified five problem areas: (1) insufficient coordination among the numerous government programs; (2) a large gap between policy formulation and implementation; (3) excessive attention to financial assistance and relative neglect of other forms of aid; (4) insufficient private sector participation in both policy making and project implementation; and (5) too little exchange of information and learning from the experience of other countries, especially those in Asia. Thus, proliferation in the number of SME promotion programs undertaken since the mid-1970s does not seem to have been accompanied by greater success. Neither benefit-cost analysis of the programs themselves nor reports from small-scale entrepreneurs suggests that this was the case.

Conclusions

The following points summarize our findings in regard to SME development in the Philippines.

- Despite a host of analyses over the years that highlighted the pernicious effects of existing policies and proposed numerous policy and program reforms, the Philippines remains notable primarily as a country where the potentials of small and medium industrial enterprises are largely unexploited. In general, this was as true under Corazon Aquino's administration in 1986–1992 as it had been under her notorious predecessor, Ferdinand Marcos.
- Although no formal quantification has been undertaken, it seems likely that the negative effects of policies on SME development outweigh any positive effects of SME promotion programs. Despite some limited reform, industrial, trade, and financial policies continue to favor large enterprises and impede the growth of productive SMEs.

LATIN AMERICA

From the end of World War II through the 1970s, Latin America[5] experienced accelerated structural transformation with deep economic and social consequences. Although averages can be very misleading in so heterogenous a region—one ends up adding together (or, worse yet, averaging) Brazil and El Salvador—some general traits are evident. A period of slow growth through the 1960s was followed by rapid growth in the 1970s. During the latter decade, economic growth came to be regarded not as an anomaly, but rather as the natural result of a successful industrial transformation accompanied by rapid urbanization, increases in the share of manufacturing in GDP and improvements in social welfare indicators such as life expectancy at birth, literacy rates, and infant death rates. Together these measures appeared to indicate that an important and generally successful process of structural transformation was taking place.

Toward the end of the 1970s, however, economic growth began to slow down. Gradually the perception of reality changed. It began to appear that the structural transformation that had occurred, far from ensuring continued growth, might instead be responsible for a slowdown in the growth rate of GNP. Although manufacturing output continued to rise, its growth was accompanied by rising unemployment and an increasingly bipolar size distribution of firms dominated by very large and very small firms and containing few firms of intermediate size. Worse, industrialization oriented overwhelmingly toward domestic markets proved incapable of either saving or earning the foreign exchange needed to continue servicing external debt once inflows of new capital began to shrink. The debt crisis and near cessation of economic growth that occurred in the early 1980s were the culmination of this process, along with the export market fluctuations that exposed the underlying structural rigidity.

During the 1960s and 1970s, most Latin American governments and the general public perceived the secret of their success to be a broad package of ISI policies, based on the infant industry argument. These policies had complex effects on aggregate growth, the sectoral composition of output, and employment generation. They introduced distortions in capital, labor, and goods markets that were intended to draw resources into the large-scale industrial enterprises viewed as essential for development. Without intending to do so, they hampered the development of SMEs by obstructing their access to capital, increasing their input costs, and enhancing the monopoly power of larger enterprises.

This bias of the ISI policy package in favor of large firms and against small ones is paradoxically the clue to both its successes and its failures. On the one hand, a bias favoring large firms, justified on the grounds that

only they could realize economies of scale, was crucial for generating fast growth of the manufacturing sector. On the other hand, the bias against smaller firms hampered the development of competition and higher productivity in the industrial sector, thus reducing the ability of the economic structure to respond to adverse shocks. When adverse shocks did hit the Latin American economies in the form of export market fluctuations and difficulties in servicing the mounting burden of external debt, the virtues of ISI policies became vices that posed enormous obstacles to policy reform.

Even during the 1970s, when ISI was still generally regarded as successful, voices were raised to warn about some disturbing traits of the industrialization process. Although the share of manufacturing in total GDP was rising, employment generation in the manufacturing sector was weak. Only a small fraction of the total workforce was able to obtain jobs in manufacturing. These high-income, high-productivity jobs coexisted side by side with low-income, low-productivity jobs, a phenomenon observed in many countries where factor markets are not yet well developed. This permitted wide variations in the marginal productivity of labor among similar uses.

Despite the rapid industrialization that took place in Latin America during the 1970s, exports of manufactures did not rise significantly. Manufacturing's share in total exports grew little if at all. Because the newly created industries depended heavily on imported inputs and capital goods, the stagnating participation of manufacturing in exports contributed to recurrent balance of trade deficits and a chronic imbalance of external payments.

The large subsidies that industry received, both explicitly and through the provision of public services and utilities at prices below cost, were often financed by taxes on traditional exports. Falling prices in markets for traditional exports thus contributed to the fiscal deficits. The political clout of industry-related interests, representing both labor and management (united for once in this situation), made it hard to effect the needed adjustment, which would necessarily challenge the subsidies that the industrial sector was receiving. Bulging fiscal deficits were financed either by printing money (Argentina is the extreme case) or, more commonly, by borrowing abroad. In either case, the outcome was an external debt burden that grew out of all relation to the country's ability to pay.

Macroeconomic aspects of ISI-associated distortions have been abundantly treated in the large and growing literature on structural adjustment. The biases of ISI against small enterprises, which have important consequences for the sectoral pattern of development and employment generation, have received less attention. To sharpen our understanding of the particular effects of ISI policies on capital, labor, and goods markets, we

focus our discussion of this issue on Ecuador and Honduras, two countries that were studied intensively under EEPA. The first subsection describes these country cases. The second subsection then addresses the regulatory framework that affects the development of industrial enterprises in Ecuador, Honduras, and Latin America generally, with emphasis on size-related aspects. In the next subsection we briefly examine the best-documented case of industrial SME growth in Latin America—that of Colombia, where rapid SME development in the 1970s was intensively studied by a group sponsored by the World Bank (Cortes, Berry, and Ishaq 1987). Finally, prospects and policy recommendations are presented.

Country Cases

Ecuador and Honduras are two countries studied intensively under EEPA, and they will figure prominently in our discussion of SME development in Latin America.

Ecuador

Ecuador[6] is a medium-sized Andean country with a land area of 284,000 square kilometers and a population of 10.3 million in 1990. Although its GNP per capita of $980 classifies Ecuador as a middle-income country, it is one of the poorer nations in Latin America.[7] Per capita income growth averaged 2.2 percent annually during the 1960s, then accelerated rapidly during the 1970s, when it averaged 6.2 percent a year. The acceleration resulted largely from a rapid rise in the value of petroleum exports and associated growth in the services sector. Nevertheless, in the period between 1965 and 1980 manufacturing value added grew at an average annual rate of 11.5 percent (and industry as a whole at 13.7 percent), compared to 7.6 percent for services and only 3.4 percent for agriculture. The slow growth of income from agriculture compared to manufacturing and services contributed to a process of urbanization that raised the urban share of total population from 37 percent in 1965 to 56 percent in 1990. Yet during this same period industrial employment barely kept pace with the growth of labor force, rising only from 19 to 20 percent of total employment. Nearly all of the 16-point drop in agriculture's employment share (from 55 to 39 percent of the total) thus had to be absorbed by services, mainly of a low-productivity nature. Nevertheless, this was a period of rapid economic growth for Ecuador, in which GNP per capita—no doubt very unequally distributed—rose at 3.5–4.0 percent through 1980 and by 2.8 percent a year in the entire 1965–1990 period.

Several policy mistakes prevented Ecuador's 1970s oil boom from creating much high-productivity employment or stimulating sustained economic growth. First, much of the economic rent earned was used to

finance consumption subsidies on food and fuel. Second, the real exchange rate was allowed to appreciate strongly, creating disincentives for tradable goods production (agricultural and industrial exports as well as import substitutes). Third, the manufacturing sector was overprotected, given the small domestic market. Fourth, financial market policies including controlled low interest rates and selective credit allocations reduced the cost of capital to those who could obtain loans and encouraged them to use capital-intensive production methods. Fifth, minimum wages and other labor protection policies benefited workers with formal sector jobs but discouraged job creation. Finally, government regulations created an anti-export bias and blocked growth along a path that would have shifted workers into higher productivity jobs (Fletcher, Marquez, and Sarfaty 1988: 67).

During the 1980s, recurrent fiscal and balance of payments deficits had strong adverse consequences for the Ecuadorian economy. GNP per capita peaked in 1981, stagnated in 1982 and then fell steadily, reaching 70 percent of its 1981–82 level by 1987. Meanwhile, as a result of stagnating domestic demand and the inability of an inefficient manufacturing sector to export competitively, manufacturing's GDP share failed to rise. Production grew very little in both industry and services, while agriculture, previously the lagging sector, took the lead simply by continuing to grow at 3–4 percent a year.

The period of rapid growth in manufacturing value added (1965–1980) was marked by substantial expansion of the dominant large establishments, a burgeoning of the numbers of microenterprises and self-employed craftsmen, and a sharp decline in the number of middle-sized firms as well as their employment (see Table 26).

Data on production and employment structure (see Table 27) suggest that the primary sector achieved modest but steady growth in output per worker but failed to absorb additional labor. From the onset of the crisis in 1982, however, output per worker in the primary sector declined constantly in relation to the economy-wide average. The rapid industrial growth that occurred between 1974 and 1982 was relatively capital-intensive and created comparatively few jobs; conversely, output per worker grew faster in industry than anywhere else in the economy during this period. After 1984, most urban labor absorption took place in the service sector, where productivity levels were stagnant or falling. Many of the workers in this sector were migrants from rural areas who found whatever self-employment or low-productivity jobs were available. The large pool of underemployed urban labor so created has become a critical problem for economic policy.

Given this situation, the EEPA team found that the urban informal sector had grown to encompass 37 percent of total employment in Ecuador's

TABLE 26 Size Distribution of Establishments, Employment, and Value Added in Manufacturing, Ecuador, 1965 and 1980 (percentage of total)

	Establishments		Employment		Value added	
Establishment size	1965	1980	1965	1980	1965	1980
Large establishments[a]	6.5	1.4	55.6	45.3	75.9	70.7
Small establishments[b]	24.6	4.2	26.1	15.0	18.8	14.2
Microenterprises and self-employed[c]	68.9	94.4	18.3	39.7	5.3	15.1

NOTES:
a. Large establishments have 50 or more employees.
b. Small establishments have 10 to 49 employees.
c. Microenterprises have fewer than 10 employees.
SOURCE: Instituto Nacional de Estadistica y Censos, Economic Censuses of 1965 and 1980.

three leading towns by 1987.[8] More than half of these people worked in retail trade. Within the urban informal sector, at least three different small business situations could be distinguished: (1) a promising but small group that needed only credit or some other complementary input to evolve into self-sustained enterprises (in a few cases, only a better regulatory environment was needed); (2) a larger group that lacked the capacity to evolve but did provide stable, although poorly paid, jobs for their workers; and (3) poorer units at the bottom that at best barely eke out a living for their members and could benefit only from alternative employment opportunities and short-term transfers (Fletcher, Marquez, and Sarfaty 1988: 36–37).

TABLE 27 Structure of Real GDP in Ecuador, 1970, 1982, and 1987

	% of total at 1980 prices		
Sector	1970	1982	1987
Agriculture	21.9	12.6	15.2
Manufacturing	17.3	18.5	17.3
Other industry (petroleum, mining, utilities, and construction)	6.6	20.3	17.8
Services	54.2	48.6	49.7

SOURCE: World Bank, *World Development Report*, various issues.

Honduras

Honduras[9] is a small Central American country with an area of 112,000 square kilometers and a population of 5.1 million. At $590 in 1990, its per capita income is the second lowest in the hemisphere. The rate of economic growth reached 7 percent per annum during the 1970s, thanks to high coffee prices and the emergence of a highly protected manufacturing sector, but falling coffee prices and slower growth of manufacturing caused it to drop sharply in the 1980s. The Honduran economy remained in a state of recession into the 1990s.

By 1990, underemployment and unemployment were estimated to involve around one-quarter of the economically active population, twice the 1974 rate. The problem was aggravated by the large number of refugees entering Honduras from neighboring countries.

Agriculture is still the dominant sector in the Honduran economy, contributing more than one-quarter of GDP (Table 28) and employing about one-half of the work force according to official statistics. Local studies, however, show that 90 percent of agricultural workers are employed on a seasonal basis and earn yearly wages from agriculture that are insufficient to cover basic living expenses. The balance of their income appears to derive from the production of goods or services for the unrecorded informal economy. The sector that experienced the most rapid growth during the period has been public administration and defense. The service sector as a whole grew at a real rate of 5.4 percent from 1970 to 1980, then slowed to a growth rate of 2.4 percent from 1980 to 1990. Much

TABLE 28 Structure of Real GDP in Honduras, 1970, 1980, and 1985

	% of total at constant 1966 prices		
Sector	1970	1980	1985
Agriculture	31.4	26.1	27.7
Mining	2.0	1.8	1.9
Manufacturing	13.1	14.3	12.4
Construction	3.2	3.6	3.6
Public utilities	1.1	1.7	1.8
Transport	6.3	5.8	6.0
Commerce	10.8	11.1	11.0
Housing and enterprise services	9.2	10.5	10.1
Public administration & defense	3.1	4.2	4.4
Personal services	10.3	10.0	9.5
Indirect taxes	9.6	10.9	11.6

SOURCE: Central Bank of Honduras.

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faster growth would clearly be required to absorb the underemployed workers.

The contribution of manufacturing to GDP rose during the 1970s, only to stagnate after 1980. Local analysts cite the smallness of the local market as an important constraint on growth, given the inability of protected manufacturing firms to export competitively.

Almost half of total manufacturing value added consists of food processing, beverages, tobacco, and textiles. Industrial production in all subsectors declined in 1984–85, and the recovery since then has not been impressive. Entrepreneurs in the clothing and footwear sectors reported a 30–50 percent drop in sales in 1987, which they attributed to a flood of less expensive items imported illegally from neighboring countries.

Census data for 1975 (Table 29) show that microenterprises dominated the enterprise size structure in the manufacturing sector in Honduras, when measured in terms of either number of establishments or employment. Value added by microenterprises is unknown; 60 percent of the sector's value added, excluding that of microenterprises, was produced by large firms. One-third derived from medium-sized firms with 20–99 workers. In Honduras, it is the somewhat smaller group of enterprises with 5–19 workers that is most conspicuously "missing" (Table 29).

Large firms are the main beneficiaries of government policies designed to promote industrial development and exports. Data analyzed by EEPA suggest strongly that these policies favor inefficient larger enterprises and, as in Ecuador, discriminate against the smaller firms. The ways in which they do so are by now largely familiar. Financial market policies cap the maximum lending rate, providing a disincentive for banks to make smaller loans. Exchange rate policy supports an overvalued lempira, and larger enterprises enjoy preferred access to foreign exchange at the official rate. Smaller firms must often buy imported equipment and supplies

TABLE 29 Size Distribution of Industrial Firms, Honduras, 1975

	Percentage of total		
Establishment size	Establishments	Employment	Gross value added[a]
Artisan (1–4 employees)	97.8	57.1	N.A.
Small (5–19)	1.3	5.3	7.1
Medium (20–99)	0.8	14.8	33.2
Large (100 and over)	0.2	22.8	59.7

NOTES: N.A. = not applicable.
a. Not calculated for artisan firms (microenterprises); percentages for other size classes relate to the total excluding microenterprises.
SOURCE: Stallman and Pease n.d.

through local dealers who apply high markups. Extensive red tape, locally known as *tramites*, saps the resources of all firms but especially hinders SMEs, which are technically illegal in most cases but face prohibitive costs if they seek to legalize themselves.[10] Replacing existing policies with policies more neutral with respect to firm size could greatly improve the impact of policy and overall economic performance.

Existing Policy Framework

As we saw in Chapter 3, ISI policies create distortions in principle by encouraging a pattern of resource allocation that is based not on social opportunity costs but rather on a price structure distorted by massive government intervention in the form of subsidies, taxes, and a variety of rationing systems (including pure quantitative restrictions). These distort the capital, labor, and goods markets and reduce the competitiveness of SMEs. The cases of Ecuador and Honduras illustrate some of the problems created by such policies.

Labor Laws

"Protective" labor laws that mandate high fringe benefits and impose a variety of special-purpose taxes are widespread features of government intervention in Latin American labor markets. Generally, labor regulations contain highly detailed prescriptions and prohibitions deduced from axiomatic legal and social principles and relating to all firms. They have little to do with agreements at the firm level between workers and management. These labor laws were generally enacted by populist governments early in the industrialization process and borrowed heavily from the labor legislation of European countries. Given the difference in factor endowments and level of development between the two continents, however, these imposed labor costs are much harder for Latin American firms to pay.

Many Latin American governments also promoted the development of labor unions to provide countervailing power against large and monopolistic, often multinational, companies. Regardless of the effect of unions on income distribution, resource allocation, and equity, early unionization and capital subsidies (to be treated later under "Policies That Affect Product Markets") strengthened the monopoly power of traditional industries (food products and textiles, for example) by increasing incentives to introduce larger scale, more capital-intensive technologies.

In most Latin American countries, labor law establishes binding and stringent regulations over all employees except those who work for the

government or for enterprises with fewer than a specified minimum number of workers (ten in Honduras, fifteen in Ecuador). These regulations cover everything from the timing of work shifts to the form of labor contracts. Mandatory minimum wages formally apply to all employees, including those in small firms, and may not be abrogated by worker/employer contracts.

In Ecuador, Nicaragua, and most other Latin American countries, workers are legally entitled to more than twelve monthly payments per year. Usually they receive year-end bonuses (*aquinaldos*) and often a mandatory minimum share of firm profits. If their employment is terminated, even through just-cause firing, workers are entitled to severance pay calculated on a sliding scale based on both last wage and seniority. Since every firm must make a financial provision for the eventual cost of dismissing workers, which rises with the wage levels and seniority of its workers, these regulations make firms overly cautious about expanding employment, even when market demand is increasing.

Uneven enforcement of labor law regulations by the authorities introduces a progressive but unpredictable element into these laws. The regulations are much easier to enforce on the larger, more visible firms of the modern sector than on the SMEs and informal sector units. Since large firms, however, actually pay wages well above the mandatory minimum wage and offer working conditions well within the law, in practice conflict is more likely to arise in SMEs and informal sector firms, whose workers receive wages below the minimum and toil in unhealthy and unsanitary conditions. These enforcement difficulties, plus the fact that legal labor costs are higher for large firms than for small firms, enormously increase the cost of growth for SMEs. Expansion of an SME requires hiring more workers and, as each benefits threshold is passed, paying *all* higher compensation, including wages and associated fringe benefits, as well as taxes. This phenomenon, which causes the per-worker cost of creating additional jobs to be higher in a small firm than in a large one, is an important explanation for the paucity of medium-sized firms in Latin America.[11]

Because the big modern sector firms generate too little employment to absorb the available labor, and given the lack of unemployment insurance systems, workers who cannot find a modern sector job are reduced to inventing one, either through self-employment or by accepting employment in an unregulated informal sector enterprise. As a consequence, the labor market exhibits a duality in which high- and low-wage jobs are occupied by similar types of workers. However, one should not conclude that this feature of the labor market stems exclusively from labor regulations. Many other factors, particularly capital market distortions, contribute to this outcome.

Policies That Affect Access to Capital by SMEs

Latin American governments have long intervened in capital markets, both through direct lending by public sector financial institutions and through regulation of interest rates charged by private lenders, which may be combined with efforts to influence the allocation of credit. Such intervention became a tradition in the early stages of industrialization, when the virtual absence of capital markets justified government intervention to provide the short- and long-term financing needed to develop new industrial activities. Later on, as the private banking system developed, intervention was still deemed necessary to oversee banking practices and reduce the inherent instability of a highly concentrated financial market.

Interest rate ceilings, sometimes embedded in multitiered systems that fix both the fraction of total credit to be received by each class of borrower and the interest rate that each class will pay, are a nearly universal feature of financial market regulation in Latin America. The rationale is to stimulate certain sectors through the provision of financing at below-market interest rates, while at the same time forcing lending institutions to provide credit to less profitable borrowers who offer contributions not measured by profitability to the economy or the polity.

Any system that fixes prices below market levels affects efficiency and equity. The one just described encourages an inefficient allocation of resources, particularly in terms of capital/labor ratios in the affected activities. New firms tend to select more capital-intensive techniques, and therefore generate less employment, than they would if they faced market prices for capital and labor. Equity effects arise because there is excess demand for credit at the preferential rates; influence and contacts become more important determinants of credit allocation than profitability. These two effects have reinforced each other in many Latin American countries, helping to create an industrial sector dominated by large firms that develop monopolistic power in the product markets in which they operate, further reinforcing the distortions generated by public regulations.[12]

In Latin America, commercial banks have little incentive to lend to small firms because of the high cost of administering a portfolio composed of many small loans and the inability of asset-poor SMEs to benefit from asset-based lending. In both Ecuador and Honduras, lack of access to capital was the most frequently mentioned problem when EEPA researchers asked small-scale industrial entrepreneurs about the factors that hampered their firms' growth.

Problems in the capital market have led to the development of extensive informal credit systems in both countries. These provide short-term financing to SMEs, often at rates well above those of the formal banking system but sometimes (as in suppliers' credit) at lower cost. Informal lending is often inventory based and thus better suited to the SMEs' ability

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to provide collateral. Many of the small-scale businessmen interviewed in Honduras reported having used informal credit, mainly to even out fluctuations in sales and in some cases for inventory building.

In both Ecuador and Honduras, a variety of SME-targeted credit lines arose in the 1980s to fill the vacuum left by traditional financial institutions. In some instances, special lending institutions were created to cater to SMEs' financing needs. These institutions usually channel funds provided by bilateral or multilateral donors. In some cases, they provide collateral to approved applicants for special commercial bank credit lines. These credit lines are often subsidized through special discounting procedures provided by the monetary authority, or are required as a given percentage of the total lending activity of any commercial banks.

The performance of these special public institutions has been uneven. In Ecuador, UNEPROM (a public specialized agency) reports delinquency rates on its lending operations well below those incurred by the commercial banking system. On the basis of this experience, a larger fund administered by the Ministry of Social Welfare is being developed. On the other hand, the Honduras experience (in which USAID funding was involved) shows high delinquency rates relative to normal bank system lending. This has been attributed to inadequate loan review and approval procedures.

A number of NGOs, often funded by international donor agencies, have developed what appear to be efficient systems of lending to microenterprises and SMEs. In Honduras, USAID reports a high success rate with this type of lending operation. Yet the coverage of these private funding operations is extremely limited. For example, the Honduras program covered an estimated 5 percent of microenterprises.

In general, it can be concluded that distortions in the capital market act directly and indirectly to reduce access to credit for SMEs and hamper the growth possibilities even of efficient activities. Enterprise size–based discrimination in financial markets is a crucial part of the explanation for the "missing middle" in the size distribution of industrial enterprises. Large firms have sufficient contacts and collateral to obtain privileged access to capital markets, which in turn reinforces their market power; SMEs lack access to the financial flows that would enable them to expand their activities and move up rapidly in the size distribution.

Policies That Affect Product Markets

Two types of policy have important effects on SME participation in product markets in Latin America: trade policy and subsidies. Trade policy is influential because its design and implementation lowers ERPs for SMEs relative to those faced by larger firms. A price system that is highly distorted by subsidies to officially registered firms reduces the ability of

many SMEs to obtain permits and licenses and meet other official requirements.

Tariff protection has long been the main pillar of ISI policies. According to the infant industry argument, new industries pass through a learning process and in the early stages of growth need to be protected from competitors that have already experienced the decline in average costs associated with learning. In Latin American countries, this argument was used to justify not only tariff protection but also licensing practices. As tariff protection and capital-associated subsidies were allocated by government on a discretionary basis, it was seen as a logical next step that additional protective measures should be adopted to increase the probability that the investments so encouraged would succeed. Licensing was preferred to tariff protection because it was believed that restrictions on the number of firms operating in an industry would accelerate realization of the scale economies needed to bring unit costs closer to those in the world market.

As a result of these policies, few firms were able to enter each sector. Once entry was restricted by policies, licensing, and related policies, as well as by learning on the part of firms already in the industry, new institutional barriers to entry were created. Oligopolistic firms tended to acquire political influence and the ability to resist any attempt to relax the regulations that gave rise to their monopoly power.

Even where licensing is not used, tariff protection is neither evenly nor equitably distributed across different types of goods and production methods. Consumer goods imports are usually taxed more heavily than imports of intermediate goods, while imported capital goods are often not taxed at all. Moreover, particular goods within any of these broad groups may be much more heavily protected than others; often, imports of specific items are prohibited outright. The result is a complex and often capricious tariff structure that substantially distorts resource allocation. Worse, tariff exemptions are frequently awarded to specific importers at the discretion of the fiscal authorities. These exemptions usually result from political influence and can involve corruption.

In the early 1980s, when the burden of external debt on the foreign exchange accounts became unbearable, generalized quantitative restrictions and exchange rate controls were imposed on top of this already complicated structure. Under the controlled regime, importers must obtain government permits to qualify for foreign exchange at the official rate. As this rate is below the market price of foreign exchange and excess demand for imports therefore appears, government discretion becomes the rule and those with more political influence become the first, and frequently the only ones, to be served. While details differ, trade regimes and regulations imposed in the 1980s are broadly similar in Honduras and Ecuador.

SMEs are strongly affected by the trade regime. Their usual lack of influence and "connections" makes for delays in obtaining import permits and access to foreign exchange. The need for such permits in itself discriminates in favor of large firms employing the legal staff and having the connections to receive permits with little delay. In Honduras, the EEPA study (Goldmark et al. 1987) shows that most SMEs were experiencing difficulties in obtaining imported inputs, a factor cited as a serious constraint on small-firm growth. The alternative was to obtain these inputs in the local market, where SMEs were often further disadvantaged by having to pay retail prices. Discrimination against SMEs is most important with respect to machinery imports. Many SMEs use unsophisticated types of equipment that are classified as consumer goods in the tariff regime and are therefore subject to import restrictions. They are often forced to buy this equipment on the local market, paying not only the import tax but also the local retailer's margin. This makes the effective price of capital higher for small than for large firms and lowers the ERP for SMEs compared to their larger counterparts.

Red tape is another factor that weakens the competitive position of SMEs. The costs of dealing with the government are a form of invisible taxation in all Latin American countries. *Tramitadores* and *gestores* (middlemen; agents), and a variety of lawyers and accountants are needed to obtain licenses, permits, and other official perquisites. The cost of all this paperwork (in cash and in time that otherwise could be spent on productive activities) is extraordinarily high.[13] Both cash and time are exceedingly scarce commodities for small-scale entrepreneurs. Yet without the licenses, permits, and other official paperwork no official subsidies can be obtained. Thus, the competitive position of SMEs relative to larger firms is harmed. However difficult to measure these costs and disadvantages may be, they are frequently cited by owners of SMEs as important obstacles to their survival and growth.

Colombia's Experience

In sharp contrast to the experiences of Ecuador and Honduras is that of Colombia in the 1970s, as described and analyzed by Cortes, Berry, and Ishaq in the World Bank study *Success in Small and Medium Enterprises: The Evidence from Colombia*. The "success" referred to in the title is the fact that small and medium industrial enterprise in Colombia "was a dynamic, growing, profitable and innovative sector during most of the 1970s" (Cortes, Berry, and Ishaq 1987: 208). In this subsection, we examine the roots and extent of this success and ask what implications it may have for other Latin American countries.

Up to the late 1960s, the share of large enterprises in Colombian manufacturing output and value added was rising, that of cottage shops

was falling, and the share of noncottage shop SMEs was roughly constant. Labor productivity in the SMEs was far below that of the large enterprises and was rising more slowly. In the 1970s, however, growth of SMEs accelerated to about 9 percent per annum in terms of both output and employment (that is, labor productivity was constant). SMEs made a significant contribution to total job creation in the economy during this period. Most SMEs seem to have been profitable in both private and social terms and many were able to grow and improve technically over time. Firms in the metalworking sector, which was studied intensively as an outstanding example of rapid growth, were able to design their own products and adapt existing designs to the needs of their clients.

What caused the improved performance of Colombian SMEs in the 1970s? One important factor was rapid overall economic growth during the decade, in which per capita income rose at about 5 percent a year. This increased the demand for manufactured goods. Prices of such goods rose, yet large firms were somewhat reluctant to expand; this opened up opportunities for SMEs.

On the supply side, there were important changes in both labor and capital markets. Real wages fell during the 1970s. This made it more attractive for people to go into business for themselves and made it easier for those who began or expanded SMEs to hire additional labor. Tax reforms in the late 1960s and early 1970s may also have encouraged the shift by making it harder for salaried personnel to avoid income taxes. Both capital and foreign exchange became more readily available after the late 1960s. The market for second-hand machinery broadened.

Aggregate savings soared in the early 1970s, fueled by large receipts from coffee and illegal drug sales (Cortes, Berry, and Ishaq 1987: 216). Inflation accelerated, yet rates of return on financial instruments were slow to adjust and in many cases turned negative in real terms. This made investment in real assets such as small businesses and real estate more attractive. The law gave skilled workers the right to collect substantial severance pay (*cesantia*) if they quit their jobs and went into business for themselves; many chose to exercise this option.

The growth of savings also accelerated the development of the informal credit market. The significance of this development for SMEs is somewhat unclear because small-scale entrepreneurs relied mainly on their own savings to finance both the establishment of new businesses and the expansion of existing ones. There also seem to have been increases in lending to SMEs by both official lending institutions and the informal market.

Finally, SMEs were able to import equipment (most of which was available only from abroad) more easily in the 1970s than before. Buoyancy in Colombia's balance of payments in those years permitted the foreign exchange regime to be liberalized and the exchange rate kept close to equilibrium.

The rapid growth of SMEs that Colombia experienced in the 1970s did not, unfortunately, continue into the 1980s. Like other Latin American countries (although to a lesser degree than most), Colombia suffered a sharp downturn in growth rates after 1980. The manufacturing sector was particularly hard-hit. The research of Cortes and coauthors did not extend long enough to provide detailed analysis of the effects of this slump on SMEs, but the authors suggest that large, medium, and small firms were all seriously affected (Cortes, Berry, and Ishaq 1987: 220).

With respect to the role of government policy on SME development in Colombia in the 1970s, Cortes, Berry, and Ishaq comment that, "on balance [it] appears to have been neither a major support for SMI nor a strong deterrent" (1987: 220). As in other Latin American countries, trade policy has been protective, and this is believed to favor large firms. Similarly, access to credit from the formal financial sector remains much easier for large enterprises, although the growth of an informal financial sector has helped SMEs to some extent (exactly how much is unclear, as noted earlier). Official regulations dealing with minimum wages, labor unions, fringe benefits, and taxes have been enforced more rigorously on large firms, increasing the competitiveness of SMEs. The greater flexibility that SMEs enjoy in hiring and firing labor is a major competitive advantage conferred (apparently inadvertently) by government policy (Cortes, Berry, and Ishaq 1987: 221).

Like other countries, Colombia has a number of institutions intended to promote SME development through the provision of technical assistance. SENA, the national vocational training institute, is widely admired. Cortes and coauthors note that few of the firms they surveyed benefited from these programs; they are agnostic on the question of whether expansion of their coverage would repay its cost.

The study is nearly as skeptical about the impact of policy on SME development. Its final paragraph reads:

> An interesting hypothesis for further research would be the notion that public policies that encourage entrepreneurship, improve access to capital, provide more information on technology, and so on are of limited importance to the success of SMI when demand is healthy but that they become *more* important when demand is sluggish. The most pessimistic hypothesis, in some sense, is that policy can never have much effect. At present, neither of these views can be dismissed. (Cortes, Berry, and Ishaq 1987: 225)

This conclusion, while literally true, could be read to suggest what it does not say—that policy does not matter. In our view, the World Bank's Colombia study provides no basis for drawing such an inference. What

Cortes, Berry, and Ishaq have done is to provide the most detailed, solid description and analysis yet of what happened in the SME sector of a particular country in a particular decade. Although their study provides some basis for commenting on likely causal factors, including the possible role of policy, it is not designed to test the effect of different policies and does not in fact do so. For this reason, the concluding observation that policy (including measures not introduced or poorly implemented) *may* have no effect [emphasis added] seems a bit gratuitous.

Broadly speaking, what the Colombian experience analyzed by Cortes, Berry, and Ishaq seems to indicate is that Latin American countries with policy frameworks typical of those in the region—or, preferably, at least partially liberalized—can achieve growth in the output, employment, and productivity of industrial SMEs *as long as national economic growth is rapid*. While the evidence on the effect of particular policy regimes when demand is sluggish is unclear, the Colombian situation is quite different from that in Peru, where a protectionist policy framework was stubbornly maintained in the face of alarming national economic decline. This stimulated the emergence of a massive informal sector (usually but not always small scale) as a counsel of despair (de Soto 1989).

Prospects and Policy Recommendations

Prospects for economic growth are now beginning to brighten in Latin America after the "lost decade" of the 1980s. The debt crisis showed clearly that without major policy reforms growth is impossible. To varying degrees, Latin American countries have accepted that lesson and are beginning to apply it. Without growth, durable improvements in income distribution and social welfare are simply not attainable. Nevertheless, vested interests, often accompanied by government unawareness of the need for reform or inability to bring it about, continue to make reform an unpopular recommendation in many instances.

The debt crisis should be understood as both a symptom and a result of misguided economic policy, which generated an immense misallocation of resources. International financial institutions, mainly the World Bank and IMF, have taken the lead in a dialogue with governments in the region about needed reforms in monetary and fiscal policy and about restructuring trade, industrial, and agricultural policies. The main thrust of policy reform is towards expansion of export-oriented industrial and agricultural production, concentrated in products and industries in which the country has an international comparative advantage. This strategy directs insufficient attention to the relationship between SME growth and the overall economic environment.

A modern, less doctrinaire, more market-based approach to growth policy could be a successful recipe for the future. When combined with the promotion of more efficient (and more labor-intensive) techniques, it should produce more rapid employment generation. However, even if policy reform efforts are concentrated on changes in macroeconomic policy, it should not be forgotten that the rate of growth will depend in part on the product composition of output and the size structure of industry. Policies in most Latin American countries continue to discriminate against SMEs. Yet, microenterprises and SMEs frequently represent the only employment opportunities for the poorer group of workers. Since the adverse short-term effects of macroeconomic policy reform hit this group especially hard, special attention should be given to policies that could enhance chances for the survival and growth of efficient SMEs. At the same time, it should be kept in mind that there is nothing inherently efficient in being small. A policy that indiscriminately favored SMEs with no concern for efficiency and competitiveness could well be even more wasteful than the present policy regime.

The wide disparities in the marginal productivity of particular resources between large and small firms points to the existence of static economic inefficiency behind high protective walls. Policy reform will eliminate many of the less productive jobs by creating conditions in which the less efficient firms are put out of business. Socially costly as this process may be, postponing the adjustment will only deepen the crisis, which in turn will require still harsher and costlier economic reforms.

On the other hand, SMEs are important not solely because they provide employment to large numbers of people. In a better regulatory environment they could play a crucial role in accelerating the growth of productivity and employment. If policy discrimination against SMEs could be reduced, the more efficient ones could grow to fill the "missing middle" in the size distribution of firms. In doing so, and given the fact that they can more effectively dissipate specific market shocks, they could have an important stabilizing effect on employment and income. The increase in domestic market competition that a growing segment of SMEs will generate is sure to have a positive effect on productivity and employment growth.

To attain this goal, policy reform is a necessary, albeit insufficient, condition. Beyond setting "the right macroeconomic prices"—interest rates, exchange rates, minimum wages—and reducing bulging fiscal deficits, a reform of the regulatory environment is sorely needed to achieve growth and a more internally and externally competitive economy. Labor law modification, changes in the operations of the capital market, and reduction of bureaucratic red tape are as necessary as exchange rate unification to induce growth.

Donor agencies such as USAID can play a useful role in policy dialogue by using their experience to help governments focus on complementary policies and supporting services to encourage employment-intensive private sector responses to the production incentives created by policy reform. Policies and programs directed to the SMEs and microenterprises should be oriented to removing specific capital-market distortions and helping to solve entrepreneurial and technical difficulties that constrain output and productivity growth.

Past experience in Ecuador, Honduras, and other Latin American countries indicates that these types of programs should be kept small as a means of preserving reasonable levels of operational efficiency. Institutional development of NGOs should be another focus of donor agency activity, to the extent that they could foster new and innovative programs to help in the productive development of SMEs.

Finally, human resource development is a crucial need for Latin American countries. These countries embarked on industrial development at a time when they could not draw on adequate human resources provided by a developed educational system and complementary health and environmental protection institutions. Instead, they had to obtain their labor force from a population with low levels of education and with inadequate health systems. Increases in educational quality (particularly of basic schooling) and extension and improvement of health and environmental services are needed not just for equity but also for growth. Without a healthier, better educated labor force, prospects for development of a modern industrial sector in Latin America are bleak.

CONCLUSIONS

The following conclusions summarize our discussion of SMEs in middle-income countries.

- Many middle-income countries have found it extraordinarily difficult to complete the transition that could in due course make them high-income economies. To overcome this difficulty, they must adopt policy regimes that are far more open and competitive than most of those currently in place.
- In contrast to the situation in low-income countries, where large numbers of people work in low-productivity SMEs primarily because there is surplus labor and agricultural land is in limited supply or hard to gain access to, SMEs and the informal sector in middle-income countries are in large part a result of restrictive and

protective policies that bias resource allocation in favor of high capital intensity and large industrial enterprises. These are the same policies that impede the next stage of economic transformation.

- In many cases, countries stalled at the middle-income level have also neglected agriculture and adopted policies biased against that sector. An important lesson of development is that transition in the agricultural sector must accompany transition in the industrial and service sectors.
- In political economy terms, the characteristic problem of middle-income countries is that while they have registered limited economic gains, their policies have failed to provide work for a large share of the growing work force and can no longer do much to raise the wages or productivity even of the relatively small number able to find employment in protected large-scale enterprises. Policy reform is needed, but established interests often block it.
- Accelerated economic growth in middle-income countries will lead to the elimination of many existing SMEs while providing opportunities for some of the more progressive ones to grow and transform themselves. In the following chapter, we look at how this was done in two of the most successful developing countries.

Chapter 7

Newly Industrializing Economies: An East Asian Model of Development?

This chapter examines the role of SMEs in the industrialization of two of the East Asian countries that are variously known as NICs (newly industrializing countries), NIEs (newly industrializing economies), Little Tigers, or Dragons. These countries have become a popular source of lessons for development thinkers and policy makers in other Asian countries as well as Africa, Latin America, and, most recently, Central and Eastern Europe and the former Soviet Union. Since the city states of Hong Kong and Singapore are less likely to yield lessons applicable to larger countries, our investigation is limited to the remaining NIEs, South Korea and Taiwan.

Colin Bradford (1986), Lawrence Lau (1986), Paul Kuznets (1988), and most recently the World Bank (1993) have spoken of an "East Asian model of economic development," which is usually said to have been pioneered by Japan and successfully copied by the NIEs. For Kuznets, the critical features of this model are high rates of domestic saving and investment in both physical and human capital, small public sectors, competitive labor markets, and successful export expansion based mainly on manufactures. (The NIEs all lack natural resources, so they have had to rely heavily on imported raw materials.) The obvious appeal of this approach to development is that it produced record rates of economic growth and most of the cases of successful transition from developing to developed country status recorded since World War II.

Although the East Asian NIEs began to grow rapidly in the early 1960s, economists started to pay serious attention to them only in the late 1970s. Explanations of their economic success have changed in interesting ways over the years (Hicks 1990). Early interpreters[1] frequently attributed high East Asian growth rates to conversion to market-based economic policies (especially trade, exchange rate, and financial policies) in the early 1960s, as well as to the vigorous responses that these policy reforms invoked from the populace. According to Little,

> Starting in the years around 1960 . . . Korea, Taiwan and Singapore . . . made policy changes that by the middle 1970s combined selective protection for certain import competing sectors with a virtual free-trade regime for exporters—by which we mean that exporters could obtain inputs . . . at world market prices, while the effective exchange rate for exporters was close to that which would have ruled under free trade. Overall effective protection for industry was zero for Korea, and of course for Hong Kong, and low for Taiwan and Singapore. The consequential growth of exports was phenomenal, far exceeding what anyone could have predicted or did predict. (Little 1981: 141; quoted by Hicks)

Little adds that land reform in both countries in the early postwar period (which helped ensure unusually egalitarian development outcomes), government attention to agriculture in Taiwan (but not Korea) and high levels of investment in human capital encouraged by centuries of high regard for education all provided important complements to the market-based policies that he emphasizes. But he rejects other possible explanations:

> Nothing else can account for [their success]. Their tax systems are not very good—perhaps the best thing about them is that taxes are low. Planning (except for agriculture in Taiwan) and the public sector have not, in my opinion, played key roles. Moreover, the non-human resources are notably unfavorable to high income or growth. The prior conditions for growth were very unfavorable in Korea. Luck has played little or no part in their development. Aid was certainly important in the early stages . . . but not important during the high growth period. Private foreign investment . . . has played a useful but only a minor role. Since the ability to borrow heavily itself depends on success, and since the attraction of foreign investment and its social value is also primarily a matter of public policy, I think it can be concluded that everything can be attributed to good policies and the people. (Little 1981: 42)

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Later, as knowledge of how these economies actually work became more widespread, their governments' extensive interventions in many aspects of their economies became better known and were increasingly cited as disproof of the notion that reliance on unfettered markets was the key to NIE success.[2] Leroy Jones and Il Sakong (1980) emphasized the importance of government-business cooperation for Korean economic achievements. Later treatments extended and eventually strained this argument. Alice Amsden (1989) attached so much importance to the government's role in South Korean industrialization that she characterized the entire process as "state-sponsored learning." Robert Wade (1990) vigorously rejected the neoclassical explanation for both Korea and Taiwan (and, by extension, all developing countries) in favor of his own "governed market" interpretation.

If one attributes East Asian success in any significant measure to intelligent and determined state intervention, rather than to reliance on markets, it becomes important to ask whether other governments can intervene as effectively as those of Korea and Taiwan (allegedly) did, and if so in what circumstances. To what extent did the success of these two countries depend on cultural characteristics unique to East Asia, such as the oft-mentioned influence of the Confucian tradition? Tyler Biggs and Brian Levy (1991) argue that successful state intervention in the industrialization process requires the existence of a "hard state" that can offer performance-based incentives to producers yet withdraw those rewards with impunity when the desired performance is not forthcoming. This suggests that "hard states" would be well advised to provide performance-based incentives, for example to firms that attain certain standards of export performance, while "soft states," which would be unable to forestall or limit the corruption and other forms of rent-seeking behavior likely to arise in a controlled system, would do better to limit government intervention and adopt policy frameworks that give freer play to market forces and thus provide fewer opportunities for rent seeking. Yet Wade disagrees, asserting that successful industrialization *requires* a hard state; countries that do not have such a government must set about building one if they wish to industrialize (Wade 1990: 370–81).

Critics have pointed to oversimplification in the dichotomy between "hard" and "soft" states, which was originally suggested by Gunnar Myrdal (1968). Another basis for criticism of the "governed markets" thesis is the accumulating evidence that government intervention in the East Asian economies, far from being infallibly wise, was frequently misguided, with costly results. Tony Michell (1988), Joseph Stern (1990a, 1990b), and others cite failures of industrial targeting as practiced in Korea. What seems clear, therefore, is not that government intervention in "hard

states" invariably produces higher rates of economic growth, but rather that by concentrating decision-making authority in the hands of a powerful few it raises the stakes and increases the chance that either glittering success or costly failure will result.

Is it really useful, moreover, to think in terms of a single East Asian model of development? Although the NIEs in many ways resemble Japan in both their settings and their approaches to policy, there are also important differences among these countries. Here we are most concerned with contrasts between South Korea and Taiwan, especially those related to industrial structure and employment and enterprise policy. Many analysts have remarked on these differences and have tried to characterize them. For example, Biggs and Levy (1991) accept Amsden's (1989) description of Korean industrialization as government-directed learning and see Taiwan's approach as much less directed. Similarly, Yung Chul Park (1990) distinguishes the leading role of government in the economic development of South Korea from the supportive role that it played in Taiwan. Earlier, Ronald Dore contrasted small-scale, individualistic elements in development with large-scale, bureaucratic ones, then predicted that "a corporate bureaucratic future awaits Korea whether there is unification, or the Republic of Korea and the Democratic Peoples Republic of Korea continue to survive independently" (Dore 1977: 198). Pricing strategies in both Korea and Taiwan involved frequent intervention to boost export incentives, but the nonprice mechanisms of governmental intervention and associated mechanisms of industrial expansion were quite different in the two countries (Biggs and Levy 1991).

In large measure because of these differences in policy, the industrial and enterprise structures of the two countries differ dramatically.

> Taiwanese firms tend to be smaller than their Korean counterparts and to depend more heavily on market transactions. Manufacturing establishments tend to be larger, individual product markets more concentrated, and the extent of conglomerate control greater in Korea than in Taiwan. The five largest Korean conglomerates accounted in 1982 for 22.6% of that nation's manufacturing shipments; the corresponding figure for Taiwan was only 4.7% . . . the fifty largest firms (not conglomerates) accounted in the most recent estimate for 37.5% of Korean, but only 16.4% of Taiwanese, manufacturing sales . . . establishments with 500 or more workers accounted in 1981 for 41% of Korean but only 16.4% of Taiwanese, manufacturing sales. Indeed over that decade the number of manufacturing firms in Taiwan increased by 150%, while the average enterprise size, measured by number of employees, increased by only 29%. By contrast, in Korea the number of manufacturing firms increased by only 10%, and the number of employees per enterprise by 176%. (Biggs and Levy 1991: 379)

In what follows, we explore some of the causes and consequences of these differences.

SOUTH KOREA

Decades of painful colonization by Japan ending with World War II, partition into two nations after that War, and another bitter war within just a few years gave South Korea a poor start on developing one of the poorest nations on earth. The slow and difficult process of national reconstruction that followed the Korean War was financed mainly by U.S. foreign aid, since the Republic of Korea had little capital or ability to earn foreign exchange.

Economic Growth and Industrialization

As late as 1960, South Korea's per capita income was still only $80, equivalent to Japan's in 1868, whereas its economic structure resembled that of Japan in 1900 or England around 1700 (Michell 1988: 11). Yet a relatively effective national government had been created and steps taken that later could be seen as important preconditions for rapid economic growth (Whang 1989). A land reform enacted in the late 1940s successfully redistributed substantial amounts of land to small-scale operators and reduced tenancy, unlike similar legislation enacted in many other developing countries (Mason et al. 1980: 237–40). Free and compulsory primary schooling was introduced in the late 1940s, launching a strong commitment to education by both the citizens and their government that eradicated illiteracy and in time raised educational achievements to a level known in few developing countries (Mason et al. 1980: 342–78).

Following protests against the administration of President Syngman Rhee, a new government led by General Park Chung Hee came to power in 1961 and soon instituted a series of economic reforms widely regarded as the turning point in Korea's economic development. Interest rates were lifted above the rate of inflation, the won was devalued, import controls were cut, and the national budget was brought under control (Mason et al. 1980: 94–97). Following these reforms, economic growth accelerated sharply. Per capita income growth averaged 7 percent during the 1960s, permitting a figure of $240 to be reached by 1970.

Poor in capital and natural resources, South Korea proved rich in human resources. Its people were prepared to work hard and make major sacrifices for the education of their children (McGinn et al. 1980). A system of free and compulsory primary education was instituted, and adult literacy reached 80 percent in the early 1960s. The harsh climate and rugged

landscape limited the potential of agriculture, which received little official promotion in any case. Together, the spread of education and lack of farming opportunities pushed labor force entrants to seek urban jobs. For a time unemployment was high, even among the educated, but labor-intensive, export-oriented industrialization in the 1960s did much to solve this problem. At least half of the vigorous growth of manufacturing employment during the 1960s is attributable to export expansion (Watanabe 1972). Labor absorption in manufacturing was complemented by growth in the construction industry, which increasingly undertook large international projects in addition to domestic ones. By the mid-1970s, surplus labor had been absorbed and wages began to rise. In 1977 the first balance of payments surplus was achieved.

> For a country located close to Japan there can have been no more favorable time to enter the world market than the early 1960s. Japan had passed the 'turning point' in the labor market and companies were seeking to export labor-intensive manufacturing processes. In 1960 the various indirect barriers to trade with Japan were removed. These barriers had been chiefly on imports, but a considerable amount of two-way trade, which had previously been difficult or impossible, was sponsored by *sogo shosha* (Japanese general trading companies). A full accord permitting direct Japanese investment was signed in 1965. (Michell 1988: 14)

Beginning in the early 1960s, the Korean government provided incentives to exporters. There were many different incentives, which had a powerful combined magnitude. They included

> a preferential tax system, a preferential loan system and various administrative support systems. More specifically, the preferential tax system included tariff exemptions on imported raw materials, intermediate and capital goods for export production; exemptions from indirect taxes on intermediate goods and export sales; a reduction in direct taxes on profits made through export activities; reserve funds created from taxable income to develop new foreign markets and to defray export losses; and an accelerated depreciation allowance for fixed capital used directly in export production. The preferential loan system provided exporters with access to subsidized short and long-term credits for their purchase of inputs and for the financing of their fixed investments. Furthermore, generous wastage allowances were granted on imported duty-free raw materials, over and above the requirements of actual export production. An export-import linkage system permitting access to otherwise prohibited imports was in operation, and preferential rates on several overhead

> inputs such as electricity and railroad transportation were made available. (Nam 1989: 68–69)

These incentives permitted exporters to function in something like a world price regime. They were virtually exempted from the protective measures that sheltered production for the domestic market while simultaneously raising the cost of the inputs and capital goods that they had to buy.

The incentive structure installed in the 1960s was strongly biased in favor of larger enterprises, particularly in its less formal aspects:

> In discussing the important factors underlying the successful export expansion in Korea since the early 1960s, one should not fail to recognize the significant role of the informal incentives which the government provided to exporters, namely, the administrative support. These included special attention from senior officials to any difficulties met by exporters; the somewhat more lenient tax treatment to exporters; rapid processing of the government's paperwork; the promise of government support in the future; etc. Though no one can estimate the value of such informal incentives, the extent to which this administrative effort was geared towards encouraging exports is well known. (Nam 1989: 69–70)

The degree of export subsidization was reduced somewhat in the mid-1970s. A provision that had cut income tax by 50 percent for profits earned from exports was eliminated in 1973; the system of prior tariff exemption on imported inputs used in export production was replaced by a duty drawback system in 1975; the preferential electricity tariff was abolished in 1976; and "wastage allowances" (which permitted exporters some extra imports that they could sell at a high profit on the local market) were progressively reduced throughout the 1970s. This left subsidized "policy loans" as the principal remaining instrument of export promotion (Nam 1989: 69).

In the early 1970s the government decided that the time had come to reduce national dependence on low-skill, labor-intensive industries like textiles, garments, and footwear, which employed mostly unskilled female workers, and build up capital-intensive heavy industries. The heavy and chemical industries (HCI) drive, launched in 1972, emphasized six industries: steel, chemicals, nonferrous metals, machinery, shipbuilding, and electrical equipment. These industries were to be developed so as to provide 65 percent of national export earnings by 1981. Korea's nascent business groups (*chaebol*) were urged to invest in the six HCIs; the flow of credit was redirected into them. Subsidized "policy loans," already 30

percent of total credit in the late 1960s, rose to 43 percent by the mid-1970s (Michell 1988: 53).

Results of the HCI drive were mixed. The machinery industry, which had appeared promising, failed to develop satisfactorily, but against many predictions the steel industry became highly efficient and began to export successfully (Michell 1988: 53). By the end of the decade, heavy and chemical industries furnished 50 percent of Korea's exports, far more than before if still well short of the 65 percent target. Although economic growth slowed only slightly during the 1970s, heavy borrowing to finance HCI expansion caused foreign debt to balloon. Since the government opposed foreign (particularly Japanese) ownership, the overseas capital required was obtained through loans rather than direct foreign investment.

By the late 1970s problems caused or exacerbated by the pattern of economic growth during that decade were claiming increasing attention. Employment creation in manufacturing, which had been substantial in the 1960s, slowed markedly during the HCI drive of the 1970s. As the neglected agricultural sector continued to shed labor, service activities had to pick up the slack. Inequality in the size distribution of income, which had been low in the early phase of economic development, increased sharply and became a concern. The high regional concentration of industry around Seoul also worried officials, especially since the capital was close to the cease-fire line dividing North and South Korea. Government efforts to promote industrial dispersion proved ineffective (Murray 1988). Finally, the Korean government began for the first time to take a serious interest in the fate of industrial SMEs.

In 1979 a stabilization program was enacted and the policy framework began to shift toward neutrality. In pursuit of market liberalization, the Anti-Monopoly and Fair Trade Act was passed in 1981. The following year, the interest rate subsidy on policy loans was eliminated and the five major government-owned commercial banks were privatized. Perhaps most important, imports were gradually liberalized as a means of increasing competitive pressures on domestic producers, thereby enhancing both productivity and quality. In general, government intervention in the economy was reduced and market forces were permitted to exercise greater influence over the pattern of economic activity. According to one commentator, "this shift . . . reflect[ed] the reality that the subsidized loan policy in the 1960s and 1970s had resulted in over-investment in some industries, unbalanced industrial development and an underdeveloped financial sector." (Whang 1989: 54).

After 1970, South Korean manufacturing workers enjoyed perhaps the largest sustained increases in wages and productivity ever experienced. Average real wages in the sector more than doubled in the 1970s, then doubled again in the 1980s (Galenson 1992: 79). It is therefore fascinating

and somewhat puzzling that beginning in 1987 South Korea was swept by widespread, deeply felt, and sometimes violent labor discontent (David L. Lindauer et al. forthcoming).

SMEs in the Industrialization Process

Although South Korea still ranks as an upper-middle-income country (per capita income was $5,400 in 1990), its industrial structure already closely resembles that of most high-income countries. Albert Berry and Dipak Mazumdar comment that

> rather like Japan, Korea pursued its industrialization through a policy of selective support, leading to the expansion of large firms. But, unlike in Japan (and in Taiwan) SMI did not play a major role in its plans, or, it seems, in the event, though the small-scale sector remains significant in Korean manufacturing employment. Lindauer (1984) estimated 1981 employment in the small sector (including household establishments) of nearly one million out of 3.1 million, a striking share in view of the pronounced shift and policy bias in favor of large units in the two previous decades. (1991: 41–42)

The average size of manufacturing firms and establishments increased steadily and significantly throughout the 1950s, 1960s, and 1970s. This rising average was the combined effect of a sharp decline in the importance of very small firms from the 1950s on (Ho 1980) and the rapid growth of large firms, particularly in the 1970s. The employment share of establishments with 200 or more workers nearly doubled between 1963, when it was 33.6 percent, and 1986, when it reached 62.4 percent (Berry and Mazumdar 1991: 42). The employment share of establishments with 10–200 workers declined slowly until the 1980s, when it rebounded from 18 to 21 percent of total employment (Berry and Mazumdar 1991: 49).

Jeffrey Nugent (1989) analyzed data for a number of industries in search of explanations for these changes in industrial concentration. He found that while the shifts in industrial structure related first to the HCI drive of the 1970s and then to the shift to a more neutral policy framework in the 1980s had some influence, the pattern of first increasing and later decreasing concentration occurred within many individual industries as well. According to Nugent, the most important causes of increased concentration were (1) the scale economies found in many industries; (2) the superior access to finance enjoyed by large enterprises, which was only marginally offset by government-sponsored credit for SMEs; (3) the importance of import licensing and its bias in favor of large firms; (4) large-firm advantages in the export market, which were only partially offset by

various measures of export mediation; and finally (5) the increasing importance of skill levels, advertising and research and development (R&D) expenditures, which favored large enterprises (Nugent 1989, quoted in Berry and Mazumdar 1991: 42).

Subcontracting has been far less common in Korea than in Japan and thus has done little to pull SMEs along with the growth of the large firms. A 1975 survey found that less than 20 percent of SME sales were made under contracts with other firms; the share of contract sales rose with firm size. Very few Korean SMEs were tied to one customer in the manner of Japanese SMEs. Seiji Naya (1985: 158) argues that a large domestic market for the poorer quality goods produced by SMEs blunted the incentive to bring about the improvements in quality that would have been required to meet the needs of larger firms.

In his comprehensive analysis of the role of SMEs in the industrialization of Korea and Taiwan through 1975, Samuel P. S. Ho (1980) examined the influence of location, production, and market factors on the development of SMEs in the two countries. He found that Korean and Taiwanese SMEs benefited from location advantages early in the development process but gradually lost this advantage as transport costs declined and markets broadened. By 1975 SMEs were still dominant in industries engaged in simple assembly, mixing, or finishing processes, but Ho predicted that small-firm predominance in these activities would gradually disappear.

Ho also found that while Korean SMEs (excluding the declining household enterprises) were generally both labor-intensive and efficient, there were numerous exceptions. In many industries, neither efficiency or labor intensity was systematically related to establishment size. With regard to efficiency,

> The evidence strongly suggests that establishments in size categories below 100 workers are most productive in only a limited number of industries, and in half of these cases the most productive size is the "small-medium" size category of 50–99 workers. Furthermore, the employment impact of these industries, particularly those that are efficient for establishments with fewer than 50 workers, are limited. Employment in all industries where employment in size category 5–9 workers are most productive accounted for only 2% of factory employment in manufacturing; in size category 10–19 workers, 1.9%; in size category 20–49 workers, 13.2%, and in size category 50–99 workers, 17%. (1980: 66)

By the mid-1970s, large-scale, labor-intensive production for the export market had matured. This led Ho to conclude that

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> apparently, the success of Korea's and Taiwan's manufacturing sectors in absorbing labor is due, to a large part, to the development of industries that produce labor-intensive products rather than to any special attention to small-scale manufacturing. . . . Thus, if the objective is employment creation, the development of the small-enterprise sector may not be the most appropriate policy to pursue. (1980: 102)

The location pattern of industrial SMEs in Korea is nearly as highly concentrated as that of large enterprises. This contrasts sharply with the situation in Taiwan, where SMEs are widely dispersed and frequently operate in rural areas. This reflects faster rural and agricultural development in Taiwan, resulting both from its superior land endowment and from higher public investment in agriculture and rural infrastructure (Ho 1980 and 1982; see also Ranis and Stewart 1987, which contrasts Taiwan with the Philippines). Korean SMEs drew less impetus from agricultural development than those in Taiwan, both because agricultural development itself was slower in Korea and because linkages with agriculture were weaker.

In both Korea and Taiwan formal financial institutions did little to foster the formation and growth of SMEs. Both countries possessed illiberal, largely government-owned financial systems, which were often used to promote the growth of favored, invariably large-scale, enterprises, especially in Korea. As a result, SMEs in both countries were forced to rely heavily on family savings to finance enterprise creation and expansion and make extensive use of informal financial mechanisms such as postdated checks to raise needed working capital.

Because they were virtually excluded from formal financial markets and could not obtain the subsidized credit available to many large firms, Korean SMEs faced higher capital costs. Combined with the lower wages that they were able to pay, this created an incentive to be more labor-intensive. The wage differential between large and small firms has fluctuated and generally declined over the years but has not disappeared.

The Effect of Government Policies and Programs on SMEs

We have already seen that little attention was paid to SME promotion until the 1980s. Jae-Shik Woo (1986: 115) comments that although a number of laws to promote SMEs were passed in the 1960s, these had little effect. Attention focused instead on labor-intensive exporters, which were usually large, during the 1960s, then on very large enterprises in the heavy and chemical industries in the 1970s.

Since 1981, however, the government has taken an active interest in efforts to bolster the position of the SMEs. This has involved subsidizing the R&D, marketing, and capacity expansion activities of SMEs that want to expand or upgrade their enterprises. (Whang 1989: 56). There appears to be a tacit admission that SMEs have been neglected in the past, leaving an imbalance to be rectified. As Heon Deok Yoon comments,

> Small and medium enterprises would not need special consideration if our economy were basically competitive, but a large and growing segment of our economy has sufficient market and political power to make our economy basically noncompetitive. Government policy tends to create artificial economies of scale, giving an unwarranted advantage to the very large firms. It is unfortunate that promotion programs developed to benefit all businesses tend to benefit larger firms. (1991: 112)

The basic aim of the government promotional effort that emerged in the early 1980s has been to develop the kinds of high-tech SMEs that would be found in a developed country. Major initiatives include (1) a small and medium industry promotion corporation, which provides technical assistance and training and lends to SMEs on slightly more favorable terms than commercial banks; (2) the Korea Institute for Economics and Technology, which does economic and business studies; (3) encouragement of a rapidly growing number of private, industry-specific R&D institutes (455 by 1987, of which 201 were specifically for SMEs); (4) policy changes to promote SMEs, as noted earlier; and (5) development of venture capital financing (Yun 1988: 98–107). Other promotional institutions are (1) the Korea Federation of Small Businesses, an apex organization of cooperatives which provides technical assistance; (2) the Industrial Bank of Korea (formerly the Small and Medium Industry Bank) and the Citizens National Bank, both of which are specialized lenders; (3) the Korea Credit Guarantee Fund; and (4) the Korea Trade Promoting Corporation (Yoon 1991: 116–20). We are unaware of any systematic appraisal of this relatively recent effort.

TAIWAN

Like Korea, Taiwan was a Japanese colony through World War II. While Korea served as a source of labor and some industrial products, however, Taiwan was a more conventional primary producing colony that grew rice and sugar for export to Japan and imported manufactured goods in return. When the war ended, Taiwan reverted to China. In 1949 it gained new significance as the new home of the Chinese Nationalist regime following

its expulsion from the mainland. Thousands of government officials, businessmen, and other mainland Chinese joined the native Taiwanese who had previously inhabited the island.

Economic Growth and Industrialization

In the early years the economic policy framework applied to Taiwan was simply that which the Nationalist regime had devised for confronting its numerous economic problems on the mainland. In response to a perennial shortage of foreign exchange, the government had instituted a multiple exchange rate system, which it combined with strict import controls. These measures built a high, protective wall that strongly favored import-substituting investments. Although the area and nature of the territory controlled by the Nationalist regime had changed radically, its economic policies adjusted only gradually to the altered circumstances.

Meanwhile, a number of formerly Japanese-owned manufacturing facilities on Taiwan had been nationalized. These included sugar refineries, wineries, tobacco plants, fertilizer factories, and petroleum refineries. The industries in which these enterprises operated were closed to private investment. Most of the new public enterprises supplied the domestic market, but the Taiwan Sugar Corporation, which monopolized sugar refining, was the largest earner of foreign exchange at the time.

Substantial import-substituting investments took place in the 1950s, especially in the textile and fertilizer industries, which were given priority as producers of basic necessities for consumers and farmers. When the growth of these industries failed to relieve foreign exchange shortage, the government began in 1958 to introduce measures intended to make production for export more attractive. Steps taken included unification of the exchange rate, liberalization of the foreign exchange allocation system, gradual relaxation of quantitative restrictions on imports, and tariff reductions (Lin 1973).

Although many economists regard these moves toward a more balanced policy position as the major cause of the export boom that began in the mid-1960s (for example, Ranis 1979; Hsu 1984), the level of protection provided by tariffs and other measures remained high. To promote exports, it was necessary to implement what Tein-Chen Chou (1985b) calls an "offsetting policy package," which spared exporters some of the costs of protection. The package included duty rebates, which were complex and expensive to administer but returned tax payments worth an average of 13 percent of export value to exporters in the 1960s and early 1970s (Chou 1985b: 31). To help producers escape such red tape, bonded factories, bonded warehouses, and export processing zones were established. Finally, a system of subsidized short-term loans was initiated by the Bank of

Taiwan in 1957. As virtually the only institutional credit available to small firms, which otherwise had to rely mainly on high-priced credit from the curb market if they needed working capital, these loans created a strong incentive for SMEs to produce for export. With low labor costs and duties on imported inputs now approaching zero, would-be manufacturers found that a wide range of processing operations and other simple forms of manufacturing had become profitable.

The general level of protection declined gradually. The average tariff rate fell from 47 percent in 1955 to 39 percent in 1971 and then to 31 percent by 1980 (Wu 1986: 48). Effective protection remained much higher than in a truly open economy like Singapore and about the same as in South Korea, but it was much lower than in such countries as Israel, Colombia, and Argentina. Intersectoral dispersion in rates of effective protection was somewhat less than in either Korea or the latter group of countries, but it was much higher than in Singapore (Biggs and Levy 1991: 376). Although Bela Balassa et al. (1971) characterized Taiwan's level of protection as low, these numbers (which understate the true level of protection because they omit quantitative restrictions that were often disguised to avoid retaliation by importing countries) suggest that it was in fact moderate at best. Not until massive export surpluses began to be realized in the 1980s was protection eased significantly.

Probably the two most important export promotion measures were tariff rebates and low-interest export loans (Wu 1986: 48–50). In 1954, duties on imported inputs used in all forms of export production were made eligible for rebates. Later, other taxes and charges also became rebatable. Although it can be argued that these rebates were not really export subsidies because they only offset some of the costs of protection, the export loan program undeniably subsidized exports. The Bank of Taiwan authorized short-term working capital loans for export production at substantially lower interest rates than would otherwise have been paid. The volume of such loans trebled between 1971, the first year for which data are available, and 1981, despite gradual reductions in the degree of interest rate subsidization from 1977 on.

Export marketing in Taiwan depended heavily on foreign, especially Japanese, trading companies (Scitovsky 1985). These companies dealt directly with local manufacturers, including many small ones, providing them with precise specifications for products that were readily marketable abroad. The standard pattern, especially among smaller firms, was to produce items made to the buyer's specifications and sold under his brand name. Known as original equipment manufacturing (OEM), this pattern has long been regarded as a source of risk and instability by many in Taiwan. The government has encouraged export-oriented firms to sell

more under their own brand names, but the success of this effort has been limited (Hsueh 1990: 5–6).

During the early years of its export drive in the 1960s, Taiwan maintained a good balance between agriculture and industry. Some of its early export successes involved commodities such as mushrooms and asparagus, which yielded higher returns to agricultural land and labor than rice and sugar, the traditional agricultural exports. Agriculture generated more than 20 percent of GDP until the late 1960s and more than 10 percent until the late 1970s.

As S. C. Tsiang (1986) observes, Taiwan's success in expanding both manufactured and agricultural exports justifies neither old-fashioned elasticity pessimism nor the standard assumption in neoclassical economic theory that small countries can expand exports indefinitely without encountering constraints. Taiwan frequently increased its exports of particular commodities so fast that one or more of its overseas customers objected and took steps to limit imports, or at least threatened to do so. The secret of Taiwan's trade success is not, therefore, that it somehow managed to avoid barriers to export expansion, but rather that when such impediments arose in one line of merchandise Taiwan was able to maintain overall export growth by shifting to other commodities. This happened in the U.S. and European markets for textiles, shoes, umbrellas, television sets, mushrooms, and other items. Flexibility and responsiveness to changing market opportunities were important keys to Taiwan's export success.

Taiwan has consistently recorded one of the world's highest rates of economic growth, averaging nearly 9 percent a year in the aggregate and 6.5 percent per capita over nearly four decades from 1952 to 1990 (Wu 1986; Lee 1992). Behind these high growth rates lay a dizzying pace of change in product lines and technology. By the early 1980s, Taiwan was the world's leading producer of such traditional industrial goods as bicycles, tennis rackets, umbrellas, footwear, and electric fans. Before the same decade ended, it had taken the lead in such high-tech products as computer terminals, monitors, printed circuit boards, yachts, electronic calculators, and telephone sets (Lee 1992: I-25). Some entrepreneurs reported that they had to redesign their product lines as often as once a month. Taiwan became a developed country in the 1980s. By 1990 its GNP per capita was nearly $8,000.

While many factors accounted for this phenomenal rate of economic growth,[3] expansion of industrial output at more than 12 percent per annum was unquestionably a major factor. (Agriculture grew at only 4 percent a year on average and thus declined sharply in relative importance; the current official target for the agricultural sector is zero growth.) The performance of exports, which expanded at 15 percent a year on

average over more than three decades from 1952 to 1984 (valued in current U.S. dollars), was also outstanding. Indeed, industrial growth and export expansion increasingly coincided, as the share of industrial products in total exports climbed from 9.3 percent in the early 1950s to 92.6 percent in the early 1980s. By 1976 manufacturing generated more than 40 percent of GDP and employed more than 30 percent of the labor force.

An exceptionally high rate of domestic saving financed Taiwan's economic growth (Tsiang 1986: 10–17). As early as 1950, in defiance of the then prevailing orthodoxy that interest rates should be kept low in developing countries, Taiwan began to offer savers bank deposits that guaranteed a return at least equal to the rate of inflation. Thereafter interest rates were almost always positive in real terms. The thrifty populace responded by rapidly increasing savings deposits, and the domestic savings rate climbed from only 5.2 percent of national income in 1952 and 7.6 percent in 1960 to 23.8 percent by 1970 and 32.5 percent by 1980. During this period the national income base was of course rising rapidly, so enormous increases were recorded in the absolute amounts saved. Although Taiwan's financial markets and institutions developed slowly and intermediation between savers and investors therefore remained highly imperfect, this volume of savings provided ample funding for domestic investment. Toward the end of the period, it also permitted both an astounding accumulation of foreign exchange reserves and substantial direct investment overseas.

Another major distinction is that Taiwan's income distribution, unusually equal at the start of the development process, not only failed to worsen during the rapid growth and industrialization of the 1960s and 1970s but actually improved until about 1980, when it finally began to deteriorate slightly (Lee 1992: I-42). Since economic growth in many other developing economies was accompanied by growing inequality, this is a striking anomaly that requires explanation. Tsiang attributes Taiwan's divergent experience to two factors:

> First, the trade liberalization and export promotion policy after proper adjustment of the exchange rate . . . induced a vast shift of labor supply from land intensive agriculture, which inevitably suffered from diminishing returns due to the limitation of land, towards those labor intensive industries in which Taiwan obviously had superior comparative advantages, i.e., the new export industries. . . . Secondly, the abandonment of the artificial, government-enforced low interest rate policy in Taiwan from the early 1950s enabled it to avoid the selection of . . . excessively capital-intensive and labor-saving methods of production, or those industries using such methods of production, which many other developing countries have been tempted to adopt out of a false notion of the cheapness of capital and a consideration of national prestige. . . . By avoiding

> such common mistakes, Taiwan was able to provide rapidly increasing new employment opportunities for its labor force in its expanding export industries, which resulted in rapid increases in the real incomes of its working class. (1986: 18–19)

Li-min Hsueh notes that labor income increased from 48 percent of domestic factor income in 1964 to 61 percent in 1987, largely as a result of rapid growth of manufacturing employment. This impacted favorably on income distribution, as did the wide dispersal of entrepreneurial abilities reflected in the pattern of industrial operations, which helped to prevent the concentration of wealth in a few hands (Hsueh 1990: 4–5).

Labor market policies and trends are an important part of the Taiwan story. Beginning in 1966, export processing zones (EPZs) were developed to induce capital to combine with cheap labor. Plants that located in the EPZs were large relative to the national average (309 workers per plant in 1971 versus a national average of 28) and paid lower wages (Wu 1986: 53). Labor unions were virtually moribund until 1976, when they were reactivated but remained highly restricted (Galenson 1992). Not until martial law was lifted in 1987 did collective bargaining become common. Strikes became legal only in 1988, and even then the government retained the right to terminate specific strikes. In response to the ending of martial law and spread of democracy, unionization of the workforce accelerated rapidly after 1987; by the end of 1989, there were more than 2.5 million union members, equivalent to more than 30 percent of all employees (Galenson 1992: 60). So far, however, Taiwan has managed to escape the severe labor unrest that has plagued South Korea since 1987.

Productivity and real wages rose rapidly in Taiwanese manufacturing. Real wages nearly doubled from 1970 to 1980, then rose by a further 76 percent by 1989 (Galenson 1992: 79).

SMEs in the Industrialization Process

Samuel P. S. Ho (1980) reports that in the early twentieth century Taiwan had little factory-style manufacturing other than sugar refineries. In 1915, for example, household enterprises making items such as apparel, textiles, and wood and bamboo products accounted for 75 percent of manufacturing employment. By 1940, however, this share had fallen to 25 percent, reflecting a significant broadening of Taiwan's industrial base during the 1930s. In its postwar import substitution phase, Taiwan experienced rapid industrial growth, mainly of larger enterprises producing a range of consumer goods and some intermediate products for the domestic market. Average firm size rose during this period, largely because many very small

firms disappeared. By the 1960s, more than half the surviving one-to-three-person firms were involved in tailoring and repair activities (Ho 1980).

Numerous labor-intensive industries were established or expanded in response to the improved incentives to export manufactures that were introduced in the early 1960s. Although small, medium, and large firms all participated in this expansion, the net effect on industrial structure was to accelerate the rise in average firm size. The employment share of establishments with fewer than ten workers, which had fallen only slightly from 34 percent in 1954 to 31 percent in 1961, plummeted to 13 percent by 1971. Conversely, the share of establishments with 100 or more workers rose from 38 percent in 1954 to 42 percent in 1961 and 62 percent in 1971 (Ho 1980). Yet labor intensity rose steadily throughout the 1960s and began to fall only in the 1970s when more skill- and technology-intensive industries started to come in.

As these figures indicate, industrialization in Taiwan, as elsewhere, involved rising average firm size and a decline in the relative importance of establishments with fewer than 100 workers. Yet important differences in industrial organization did emerge between Taiwan and the other NIEs, particularly South Korea. These differences are brought into sharper focus when large enterprises are redefined as those with 500 workers or more. This is the criterion most commonly applied to developed countries—which Taiwan, after all, has become.

Table 30 compares Taiwan with Korea on this basis. It shows that in 1966, as the growth of manufactured exports was gathering momentum in both countries, large plants actually made up a larger share of manufacturing employment in Taiwan than in Korea (mainly, most likely, because Taiwan was a considerably richer country). By 1971 the large-plant share

TABLE 30 Total Manufacturing Employment in Establishments with 500 or More Workers, 1966–1981

Year	Korea (%)	Taiwan (%)
1966	25.7	34.7
1971	35.6	36.1
1976	45.1	26.0
1981	40.5	27.5

SOURCE: Biggs and Levy 1991: 379.

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had risen in both nations, significantly in Korea but only moderately in Taiwan. The experiences of the two countries diverged sharply in the early 1970s, when the large-plant share of manufacturing employment soared to 45 percent (by 1976) in Korea but actually fell in Taiwan. Even though the large-plant share fell somewhat in South Korea during the late 1970s while it rose slightly in Taiwan, the contrast by 1981 was striking: large plants accounted for 40.5 percent of manufacturing employment in Korea but only 27.5 percent in Taiwan. Both countries had successfully moved up to skill-intensive and high-tech export products during the 1970s and 1980s, but in Korea this involved shifting over 40 percent of manufacturing employment into large establishments while in Taiwan nearly three-fourths of the workforce remained in SMEs, according to the developed country standard.

Although average firm size rose in both Korea and Taiwan, the absolute number of firms grew much faster in the Taiwan case (although still at less than one-tenth the rate of production growth). Howard Pack argues that the small-firm pattern in Taiwan contributed to TFP growth because small firms are likely to have

> (1) exhibited great flexibility in movement among product lines; (2) managed employees more intensively to obtain high and growing productivity from a given set of factors; and (3) allowed the benefits of considerable subcontracting and the realization of economies of scope. While the average size of existing firms did increase given the slower growth of the number of firms compared to value added, the small average size and the limited size of even the largest one-fifth of firms relative to international competitors, suggests that scale economies were unlikely to have been a major source of growing total factor productivity. (1992: 105)

The contrast between Korea and Taiwan owes something to differences in the composition of their respective industrial sectors. Korea's large-plant share rose most sharply during the HCI drive of the 1970s, while Taiwan had no HCI drive. Yet the explanation runs deeper than that.

Brian Levy (1991) explored the reasons for the contrasting experience of the two NIEs through a comparative study of the footwear industry, important in both countries through the 1980s, export oriented, and almost entirely privately owned in both cases. In 1976, large enterprises accounted for 90 percent of value added in Korea but only 20 percent in Taiwan. Although there were some differences in product mix, Levy ascribes the sharply contrasting industrial structures to differing organizational responses to the export opportunities that were perceived in both countries.

> The initial impetus in Taiwan was the decision of Mitsubishi to relocate its sandal production there, reflecting the Japanese ability to identify a large number of reliable and ambitious people, already employed in footwear production, to establish independent firms. A second factor was the greater Taiwanese capacity to subcontract. Third, a large number of independent export traders were willing and able to follow up on the initial Japanese impetus, bringing in an increasing volume of export orders. By contrast, the Korean export surge, although initially spurred by Mitsubishi as in Taiwan, was accompanied not by the entry of new firms but by an expansion in the size of existing operations. (Berry and Mazumdar 1991: 43)

Levy believes that much of the contrast in responses to market opportunity reflects differences in transaction costs. When these are high, he argues, manufacturers and their customers both try to minimize them by dealing in large volumes and avoiding the use of subcontractors and dealers. Where they are low, markets work better and the most efficient units in terms of production cost, whether small or large, are best able to compete. Taiwan possessed a long tradition of interlinked family- and clan-oriented small businesses. This tradition was well established in the commercial sector and could fairly readily be adapted to manufacturing. The existence of these business networks lowered the costs and risks of contracting, marketing, and credit for SMEs in Taiwan.

Other relevant differences between the two countries include Taiwan's higher income level and better educated population. Finally, politics favored large firms in Korea but small firms in Taiwan. Korea's interlinked military and business elites were sympathetic to the emergence of giant conglomerates. In Taiwan, by contrast, there was some tension between government and business because most officials of the KMT regime had come to Taiwan only in 1949 while business was dominated by native Taiwanese. The government viewed the accumulation of economic power in private hands with suspicion (Levy 1990).

Yet another significant difference between the two countries concerns the prevalence and role of rural industry. As the pace of industrialization accelerated in both nations during the 1960s and 1970s, Korean industrial development occurred almost exclusively in urban areas, leaving the structure of rural employment essentially unchanged. Agriculture still accounted for 78 percent of rural employment in 1975, versus 81 percent in 1960 (Ho 1982: 975). Traditional rural manufacturing activities classified in the food, textiles and apparel, wood and wood products, and nonmetallic mineral product groups continued to make up nearly three-quarters of rural manufacturing. In Taiwan, by contrast, although rural employment

structure was already more diversified in the 1950s (73 percent of rural employment was in agriculture in 1956), it subsequently changed far more dramatically than in Korea, with agriculture's share of rural employment falling to 60 percent by 1966. Manufacturing's share of rural employment rose to 10 percent over the same period; many of the new jobs were in nontraditional activities and in larger establishments than had previously existed in rural areas. Samuel P. S. Ho explains this striking difference as follows:

> There are several factors that have influenced industry to develop in a more dispersed fashion in Taiwan, with a greater share of industrial employment in rural areas, than in Korea. Two of these factors are the early development of a highly productive and commercialized agriculture and the development of a diversified agro-industry in Taiwan. Together they represent a basic difference in the development strategy followed by the two countries. . . . [R]ural industry, to remain vigorous, cannot be dependent on small-scale industries alone. Much more important is to have both small and large establishments in the countryside, and this is possible only if industrialization is spatially decentralized . . . industrial growth has occurred in a much more dispersed fashion in Taiwan than in Korea. Perhaps, more than any other reason, this explains the greater vigor of rural industry and the continued increase in rural prosperity in Taiwan. (1982: 983, 987)

These differences gave Taiwan an early comparative advantage in the products of small firms.

Taiwan's SMEs are also notable for their active participation in exports. According to statistics based on the official definition in effect since 1982,[4] SMEs accounted for 40–50 percent of manufacturing sales and 60–65 percent of exports during the 1980s (Hsueh 1990: 2). SMEs in manufacturing exported 65–75 percent of their output during this period (Hsueh 1990: 3). Even allowing for the extreme inclusiveness of the official definition, which categorizes 98.6 percent of manufacturing enterprises as SMEs in 1988 (Chou 1992: III-6), this is a truly impressive performance, which contrasts dramatically with the usual pattern of large-firm dominance in the production of manufactured goods for export.

One important reason why Taiwan's SMEs participated actively in production for export is that they were able to overcome the usual marketing constraint by relying heavily on foreign trading companies and direct orders from overseas customers, as discussed earlier. When it comes to production for export, economies of scale in marketing may be more important than economies of scale in production, at least for the lines of

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production that Taiwan has chosen to emphasize (Chou 1992: III-15). EEPA studies by Brian Levy (1987) and Klaus Llorch (1988) highlight the key role played by trading companies in overriding cultural, linguistic, and knowledge barriers to connect small- and medium-scale producers with overseas buyers. In addition, participation in export marketing often provided businessmen with knowledge and contacts that enabled them to shift successfully to manufacturing. Taiwan had more than 50,000 registered trading companies in 1986. The government had little to do with the emergence of this sector; indeed, it tried unsuccessfully to regulate it. Nevertheless, Taiwan's experience suggests that official encouragement of trading companies might be an effective way to promote the development of SMEs (Levy 1987: 30). Large manufacturers in Taiwan are more domestic market oriented than the SMEs. The 500 largest manufacturing firms export smaller shares of their production than the SMEs, concentrating instead on producing consumer goods and industrial inputs for the domestic market (Chou 1985a: 68–69).

Effect of Government Policies and Programs on SMEs

Brian Levy (1986) showed in an EEPA study that the policy measures adopted to promote manufactured exports in both Korea and Taiwan were biased against SMEs, which found it harder and more expensive than did their larger competitors to participate in duty drawback schemes, export processing zones, and cross-subsidization schemes for exports. In Korea, this bias was consistent with both official intent to create more large-scale manufacturing and the dominant role that large enterprises did in fact assume. In Taiwan, the official intent was absent or at least much weaker, and the outcome, as we have seen, is that SMEs took a larger part in export production, despite the policy bias.

Although the principle that SMEs merit promotion was officially recognized as early as 1967, Taiwan's SMEs received relatively little special treatment from the government before the 1980s (Biggs and Llorch 1989a). In January, 1981 the Medium and Small Business Administration (MSBA) was established under the Ministry of Economic Affairs. It is charged with facilitating lending to small businesses and providing loan guarantees, managerial and technical assistance, management training, and aid in applying for benefits such as tax reduction or exemption, accelerated depreciation and tax credits (Tsai 1991: 43–45). In 1991 a still more comprehensive SME Development Act became law. Assessing the results of these efforts, C. J. Lee diplomatically concludes that

> Although guidance and assistance services given to business by the government are relatively successful, there are many deficiencies to be improved, which include the following:
> - Cooperation among government, banks, talents, and businesses are not fully in conformation.
> - Government budget is still not enough.
> - Banks cannot meet with what businesses need.
> - Shortage of guidance advisors.
> - Business's unsound financial structures.
>
> (1992: I-74)

Like their counterparts in other countries, small-scale manufacturers in Taiwan complain about inadequate access to institutional credit. The common response of bankers is that the accounts kept by many small businesses are too sketchy to permit sound evaluations of creditworthiness to be made. Attempts have been made to deal with this problem by establishing specialized lending and credit-facilitating institutions such as the Taiwan Medium and Small Business Bank (a government-owned institution that operates at the national level), seven smaller specialized banks that perform similar functions in various local areas, and a credit guarantee fund set up in 1974. Still, Ya-Hwei Yang agrees with C. J. Lee that the problem remains unsolved:

> A financial and management service for small and medium businesses was established. This system is composed of banks i.e. commercial banks and special banks (medium business banks), small and medium business credit guarantee funds and a small business integrated assistance center. It provides general and special loans, guarantees, and management and financial services.
>
> However, most small and medium businesses still can not obtain adequate funds from the financial system. In order to solve this problem, government, the financial system, and small and medium businesses should all make reforms. The small/medium businesses should improve their accounting systems to enhance their bargaining power among banks. Financial institutions should consider these potential customers and adjust their extending policy properly. Government should observe the appropriateness of related financial laws and make necessary modifications.
>
> In recent years, the government has abandoned the long-run strict regulations on the financial system, and has started to liberalize the banking sector. After privatization of the banks in 1989, it is expected that small and medium businesses will have more access to formal financial funds and services in the future. (Yang 1992: II-1–II-2)

Although intermediation between savers and small-industry investors thus remains inadequate, small-scale manufacturers have been able to tap into the massive domestic savings available since the early 1970s well enough to meet at least their most pressing financing needs. The informal financial sector has played the key role here. Tyler Biggs's research for EEPA (1988) describes the many ingenious informal credit mechanisms used to intermediate between savers and small- and medium-scale producers. These include postdated checks, car loans, fictitious partnerships, rotating credit societies, equipment leasing, and others. Biggs argues that curb lenders are better able to serve SME borrowers because they know their customers better, have lower operating costs, and are subject to less nonprice competition and government regulation (Biggs 1989: 21).[5] He believes that, given Taiwan's heterogeneous firm structure, even a well-ordered liberal financial system would be unable to meet the credit needs of all producers because many borrowers would be unable to satisfy the "full information" requirements imposed by formal lenders. Biggs thus disagrees with Ya-Hwei Yang, as quoted earlier.

As capital became increasingly plentiful and labor more scarce during the 1980s, the government lost whatever limited interest it had had in helping labor-intensive SMEs survive and shifted its attention to efforts to help them upgrade their technology, management, and R&D activities (Hsueh 1990: 5–11). Since SMEs in Taiwan, as elsewhere, in fact spend next to nothing on R&D, the government has established a large-scale industrial laboratory known as the Industrial Technology Research Institute (ITRI) and made its services available to SMEs. Despite the existence of such facilities, however, many factory owners have been loath to tackle the challenging problem of upgrading their operations to keep them viable in Taiwan's fast-changing environment, preferring to retain their familiar products and production methods by moving their plants to lower wage countries.

SIGNIFICANCE OF THE KOREAN AND TAIWANESE CASES

Tein-Chen Chou (1992: III-17–III-18) notes that despite the spectacular successes of Taiwan's SMEs, policy makers have long been concerned by a perceived failure of Taiwanese SMEs to "grow up" into large enterprises.[6] As major reasons for this putative failure, he cites the capital constraint discussed earlier and an alleged lack of expertise in technology and management.

Whatever the facts, it is notable that although Taiwan is as good an example of SME success as advocates of SMEs and labor-intensive

development can reasonably hope for, uneasiness and discontent over what the future may hold persist in Taiwan itself. While liberals have argued that continued reliance on the decisions of many small businessmen, bolstered by the ongoing deregulation of the financial system, can be counted on to see Taiwan through the next phase of development as successfully as it got through past phases, others favor adoption of a more active industrial policy along the lines of that pursued by South Korea.[7] Can Taiwan really continue to rely on OEM manufacturing, they ask, as the brand-name products of Korea's conglomerates (Hyundai, Samsung, Lucky Goldstar, and others) make ever-increasing inroads into world markets?

We saw in Chapter 2 that some countries, notably Japan and Italy, have been able to industrialize through greater reliance on a flexible specialization strategy than has been typical of most developed countries, which have depended heavily on traditional mass production methods. Their experiences provide grounds for confidence that Taiwan will be able to continue along the path that it has blazed so far, relying more on SMEs and the production and marketing strategies that they typically adopt than most other countries. While this approach seems better suited to Taiwan's specific assets than would be an attempt to force the creation of larger scale business organizations, SME adaptation to new technologies and market requirements is likely to be at least as difficult as in the past. As Howard Pack notes,

> Taiwanese firms will undoubtedly face an increasingly difficult world in the 1990s. New product areas will have to be identified, their characteristics and production technology understood, and become the basis for another set of exports . . . the very success of the East Asian model has led to exporting becoming the goal of many countries, not least in some of the Latin American NICs whose debt service problems have led to new government policies that make exporting a more profitable activity compared to domestic sales . . . it is fairly clear that product cycles have become increasingly short for many of the products in which Taiwanese firms are interested. . . . In view of this, the evolving comparative advantage of Taiwanese firms is likely to be in market niches that are being abandoned in the developed countries rather than in the newest consumer or producer products. In such markets, the relative smallness and the ability to act quickly of Taiwanese firms may confer an important advantage. (1992: 111)

Meanwhile, Korea has taken a higher-profile, higher-risk approach. It, too, has achieved stunning rates of industrial and economic growth, but it suffers from insecurity about its position in the world market and has recently experienced major labor disputes (Lindauer et al. forthcoming).

CONCLUSIONS

Taking the experience of these two NICs, South Korea and Taiwan, together, a number of important general conclusions stand out.

- Both countries experienced the two "stylized facts" brought out in Chapter 2: the rise in average firm size in manufacturing, especially through the disappearance of very small establishments, and the decline in productivity and wage differentials among firms of different sizes. The conclusion reached in Chapter 2, that these changes necessarily accompany industrialization, is supported by the experience of both Korea and Taiwan.
- Yet the industrialization experiences of these two countries diverged significantly. Through a military-style quick-march, South Korea moved with unusual rapidity to an enterprise size structure similar to that found in the United States and the majority of developed countries. Yet Taiwan grew just as fast by following the divergent path blazed by Japan and Italy, relying heavily on the niche and flexible specialization strategies devised by its small- and medium-scale industrialists.
- This difference in the path followed to industrialization resulted from contrasts both in the assets available within each country and in the policies followed by their governments. Inspired by nationalism and an all too credible external threat, the Park government in Korea successfully organized a disciplined, homogeneous population to make an extraordinary national development effort. Taiwan also faced an external threat, but its population was less united because of the split between the mainland Chinese and the indigenous Taiwanese. Fortunately, its strong tradition of family business proved to be transferable from commercial to manufacturing activities. Taiwan probably would have done less well if it had tried to follow Korea's approach.
- The vital common element in Korean and Taiwanese policy was outward orientation. Although both countries protected domestic industries, they realized early on that to develop they would have to export, and to export successfully they would have to free their export producers from both the benefits and the costs of protection and permit—if necessary, force—them to operate in something close to a world price regime. Although both countries subsidized exports to some extent (Korea more than Taiwan), their policies approximated a world–price regime for exporters.

- Finally, it is noteworthy that neither country gave much support to programs intended to promote small-scale industry before the 1980s. Only in the past decade and a half have concerns about industrial upgrading in both countries, as well as equity worries in the case of Korea, forced some belated consideration. Both Korea and Taiwan adopted policies that encouraged the establishment and growth of labor-intensive enterprises, but these included large firms as well as SMEs.

Chapter 8

Summary and Conclusions

The longstanding fascination of national governments and international assistance agencies with the promotion of SMEs in developing countries takes insufficient notice, we believe, of two important facts. The first is that SMEs play critically different roles in low-, middle-, and high-income countries. SMEs at these varying levels of economic development have different potentials and should therefore be approached differently in government policies and programs. The second fact is that many of the economic policies followed by national governments, usually justified by rationales unrelated to SMEs, have significant impacts on the development of SMEs; the effects are often negative and may offset and outweigh the positive effects of official SME promotional programs.

Low-Income Countries

At low levels of economic development, SMEs are the dominant mode of manufacturing production, often accounting for at least 90 percent of manufacturing enterprises and 75 percent or more of manufacturing employment. In such settings, most SMEs are microenterprises (cottage industries and tiny workshops) that employ fewer than ten workers (many of them members of the proprietor's family), possess very little capital, and use primitive technology. The great majority of these firms can be

regarded as "survival enterprises," whose main function is to provide employment in an environment in which decent jobs are extremely scarce. Typically, they produce simple consumer (or occasionally producer) goods for local markets, especially for sale to farmers and other members of the lower income groups.

The smaller SMEs in low-income countries are typically so labor-intensive and undercapitalized that they have low labor productivity and also, in most cases, low total factor productivity. In part because available financing is limited primarily or exclusively to the proprietor's own savings, they frequently fail in their early years. Although they make important contributions to the satisfaction of basic needs in low-income countries, very few of these microenterprises ever grow to be medium-sized firms with 20–99 workers.

Medium-sized firms in low-income countries are a more promising group. They can be efficient producers in environments where labor is plentiful and capital scarce. Along with somewhat larger firms in the 100–200 worker class, medium-sized firms often have higher capital and total factor productivity than either larger or smaller plants. Their advantage is particularly evident when the large firms are heavily protected or government owned. While our research thus confirms Staley and Morse's earlier conclusion that it is these more "modern" SMEs that possess development potential, we question their conclusion (which has been accepted so widely and so long) that wide-ranging assistance programs are therefore justified.

Many different government policies impinge on the operations of SMEs in low-income countries. Among the most important types are those affecting international trade and exchange rates, fiscal policies, financial policies, agricultural policies, labor market policies, and general business regulation. Most of these policies work through effects on markets for labor, capital, or manufactured products. Capital prices are typically more distorted than labor prices by policies that seek to keep capital cheap for favored users; policies that try to affect the price of labor are less extensive and usually less effective.

Most of the relevant policies are biased in favor of larger manufacturing firms and against SMEs. In some instances the bias is intended, either because government officials believe that industrialization through large plants is the best way to develop the country or because large firms have succeeded in manipulating policy making in their own interest. In other cases, an unintended bias against SMEs arises from the imperfect flow of information and the higher cost (as a percentage of the total transaction) that SMEs must usually bear to take advantage of benefits such as investment incentives and tariff concessions and rebates.

The general policy bias against SMEs is, however, mitigated in three ways. First, policy bias in the labor market, such as it is, generally raises

wages disproportionately for large employers. Second, in some cases policy intentionally favors SMEs over large enterprises, either by offering them benefits not available to large enterprises (for example, special subsidies, tax exemptions, or even market reservations) or by exempting them from taxes or other costly impositions levied on large firms (for example, sales taxation or minimum wage legislation). The third source of mitigation of general anti-SME policy bias lies not in government policy as such, but in its enforcement. In some countries, lax enforcement of provisions such as sales tax, minimum wage regulations, and business licensing on SMEs makes the de facto imposition on SMEs significantly lighter than the de jure burden.

The strength of the anti-SME policy bias differs considerably among countries. The import substituting industrialization strategies followed by many developing countries in the past and retained, to some extent, to the present day, are inherently interventionist and tend strongly to favor large enterprises. Countries that emphasize export promotion (while not, in most cases, entirely abandoning import substitution) may also intervene in ways that favor large firms, but they usually intervene less and their anti-SME bias tends to be less blatant. Also, recent World Bank research indicates that countries differ considerably in terms of the consistency with which they implement business regulations across firms of different sizes. Some regularly hold virtually all SMEs responsible for every applicable tax and government regulation, while others let many of them slip through the regulatory net. A third common pattern is sporadic enforcement, which may be less burdensome than consistent enforcement but can create serious recurrent problems for SMEs with thin cash flows. It goes without saying, finally, that SMEs have to contend with whatever charges government inspectors and tax collectors attempt to levy on them, including bribes demanded as the price of avoiding legally applicable taxes and fines.

To summarize, SMEs in low-income countries (which are primarily microenterprises) provide valuable income and employment to the poor and are relatively efficient in static terms but have limited enterprise growth potential. Policy or regulatory bias against them is clearly antisocial and should be reduced to create a more level playing field. Reduction of distortions that favor capital use and penalize labor use should contribute to this objective. An important part of the SME policy analysis needed in such countries is to identify the major sources of policy bias so that their elimination can be pursued.

It is extremely difficult to design and implement cost-effective programmatic interventions in low-income settings. Major barriers include the high cost of reaching many tiny producers, the wide cultural gap between clients and program administrators, and the limited development potentials of the client firms themselves. A critical review of evaluation

studies conducted on SME promotion programs, which corrected for bias on the part of the original evaluator in some cases, supports the general argument that the task is an very hard one.

This conclusion is likely to distress the large numbers of individuals, firms and organizations committed to finding cost-effective—or even merely effective—ways to assist SMEs (especially microenterprises) in low-income countries. Yet government-run programs that provide credit and technical assistance to SMEs in low-income countries have a poor track record. NGO approaches have proven more effective in a number of cases, but their coverage is typically quite limited and their cost is usually high relative to the benefits achieved.

Perhaps the brightest ray of hope in an otherwise dim scene is the development of small-scale credit (and, critically, savings) on a commercial basis by banks like the Indonesian People's Bank (BRI). This and a few other experiments suggest that by lending at commercial interest rates and taking the time to learn how to work effectively with small-scale clients, banks can extend their business profitably to small producers and rural areas, even in poor countries, thereby loosening the tight capital constraint faced by SMEs and permitting the most productive among them to expand their employment and production.

We take a dim view of the possibility of governments providing technical assistance cost-effectively to SMEs in low-income countries because of the large number of such firms, the wide range of technical and managerial problems that they face, and the low level of their business operations relative to the cost of advising them. It may, however, be possible in some cases to stimulate private provision of nonfinancial services normally included in official SME promotion programs (including nongovernment collectives such as NGOs and industry associations).

The policy-making process relating to the development of industrial SMEs is heavily influenced by political considerations. For reasons of nationalistic, class, or ethnic politics, developing country governments often seek to "buy off" SME interest groups through largely symbolic gestures such as establishing small business administrations or setting bank lending quotas that are relatively easily evaded. Policies with more significant impacts on SMEs usually stem from rationales that have little or nothing to do with SMEs. Many of these policies (affecting capital, labor, and product markets) cluster around the ISI and EOI approaches to industrialization.

It is hard for bilateral or multilateral assistance agencies to intervene effectively to make national policies more responsive to the needs of SMEs. During the long and uneven history of foreign aid leveraging, improvement of policy impact on SMEs has rarely been imposed as a condition of general economic support. Nevertheless, although improving the policy

environment for SMEs is almost never the *purpose* of loan conditioning, it is a not uncommon *effect* when policy conditioning goes beyond short-term stabilization issues. Policy reforms to reduce industrial protection, cut out controls, and increase competition can have large benefits for SMEs.

Efforts to attach policy conditions to SME project loans have seldom gone beyond policies with immediate relevance to the success of the project itself. Such efforts are impeded by the relatively small size of SME project loans and by the fact that the bureaucracies that control SME promotion programs and facilities seldom have much influence on broader policies.

Since real and lasting policy change requires that local policy makers and program implementers understand and accept the reforms involved, the strongest aid agency tools for influencing policy in the long run may be the persuasion that comes from long-term advisory, research, and educational work.

Most of the problems and characteristics of SMEs in low-income economies are basically attributable to underdevelopment and can be solved by indirect means as economic development is achieved with increasing success. For example, presently limited markets for SME outputs will expand as incomes rise—particularly, in most low-income countries, farm incomes. Greater export orientation, improved physical infrastructure, and investment in human capital are obvious needs for both economic development and improved SME performance in nearly all countries. And for SMEs to compete successfully (at least outside entrepreneurial ethnic groups that impose their own "law"), establishment of a rule of law is essential so that business transactions become more reliable and predictable.

MIDDLE-INCOME COUNTRIES

It is important to realize, however, that long-run economic development does not uniformly cause SMEs to prosper. On the contrary, it generates challenges that few of them are able to meet. As an economy progresses from the low- into the middle-income range, SMEs (especially cottage and household producers) face growing competition from larger firms as falling transportation costs, rising income, and deregulation cut into the "natural protection" of local markets. Later, as unskilled labor starts to become scarce, SMEs lose another source of competitive advantage, their ability to pay lower wages than their larger competitors. At the same time, their profits may be further squeezed by falling prices for their products as larger competitors adopt more capital-intensive technologies imported from abroad.

Countries that successfully negotiate the middle-income range on their way to reaching a high level of development typically see a sharp reduction in the importance of SMEs as a share of manufacturing value added and employment. At the same time, differentials in wage rates, productivity, and profits between large and small manufacturers decline sharply. The rise in average firm size occurs not only in the economy as a whole (spurred in part by structural change that boosts the importance of industries with strong economies of scale) but also within most branches of manufacturing. About 80 percent of the change occurs within particular industries; only 20 percent or so is attributable to changing industrial structure.

Numerically, a decline (precipitous when development is rapid) in the number of small firms makes an important contribution to the rising average. A few small firms grow to be medium sized, and a few medium-sized ones become large firms, but most of the smaller firms simply go out of business. The "double development squeeze" (of rising wages and falling product prices) on small firms forces most of them to close. To overcome these pressures, SMEs must increase their capitalization and upgrade their technology, and thus come to look increasingly like the larger firms in all respects except scale. To offset the competitive advantage that large firms gain from economies of scale and scope, smaller survivors must adopt "niche strategies" that emphasize product quality, flexibility, and responsiveness to customer needs.

We have found that while patterns of decline in scale-related differentials in wages, productivity, and profits are similar across all countries that have industrialized successfully, there is more intercountry variation in the extent to which average firm size increases. In most industrialized countries, the SME share in total manufacturing employment has fallen to about 25 percent. This represents what we have called the "convergent path" to industrialization, which was followed by most presently industrialized countries and represents the aspirations of most developing nations. A few countries, however, have followed a "divergent path," which affords a larger role to SMEs at high levels of per capita income (perhaps 40–50 percent of manufacturing employment in SMEs). Common elements in the experiences of these "divergent" countries are factor market imperfections that raise either the cost of labor to large firms or the cost of capital to SMEs; export orientation; particular national institutions and contracting modes; and government intervention. In Japan, SMEs have been tightly linked to large corporations in mutually beneficial subcontracting patterns, whereas in Italy SMEs have been guided by marketing agents and have formed protective federations among themselves.

Two famous newly industrializing economies of East Asia, South Korea and Taiwan, provide examples of success with the convergent and

divergent strategies, respectively. Because it wanted to industrialize rapidly while foreclosing foreign ownership, Korea pressed hard to create large-scale heavy and chemical industries, largely ignoring SMEs until the 1980s. The result was generally successful industrialization (despite some costly missteps) and rapid economic growth, but tensions arose in industrial relations and doubts were raised about sustainability. In the 1980s Korea belatedly started to pay some attention to SMEs, making efforts to bring them into the world of high technology.

Taiwan also developed a protected, largely government-owned heavy industrial sector, but did not push it as hard as Korea did, relying more on smaller, decentralized, often light industries, including SMEs (although average plant size also rose sharply in Taiwan). Ultimately, Taiwan joined Japan and Italy as examples of the divergent path. This outcome appears to have been shaped by a policy environment that kept transaction costs low, as well as, perhaps, the competitive advantages for small business operations created by the traditional Chinese family firm.

It is noteworthy that smaller-scale industrialization in Taiwan owes almost nothing to official promotion. As in South Korea, the authorities began to pay serious attention to the promotion of small-scale industry only in the 1980s.

Unfortunately, the great majority of middle-income countries are still far from enjoying the kind of industrial success achieved by South Korea and Taiwan. In most of Latin America, and in middle-income countries elsewhere such as the Philippines, policies designed to protect large firms and their employees have frequently limited both the development of SMEs and labor absorption by large firms. As a result, large, urban informal sectors have emerged as workers who could not find jobs in existing firms created work for themselves. Many microenterprises came into existence, but few of them were able to grow into the middle-size range because the policy and regulatory environment imposed high costs on firm expansion beyond a given threshold level. One result is the "missing middle" in the enterprise size distribution of manufacturing firms in many of these countries.

Many of the countries stalled at the middle-income level of economic development have also neglected agriculture and adopted policies biased against that sector. An important lesson of development is that transition in the agricultural sector must accompany transition in the industrial and service sectors.

The principal policy reform need in countries stalled in the middle range of industrialization and economic growth appears to be for deregulation to permit the most efficient scales of operation in each line of production to come to the fore. While interest in the possibility of instituting industrial policy in emulation of South Korea and Taiwan is widespread,

both in general and in relation to SMEs, the political conditions for success in this venture appear to be demanding and probably not satisfied in most middle-income countries. When the government's ability to fend off rent seekers and withdraw proffered incentives should a firm fail to perform adequately is suspect, deregulation is probably the safer course.

Potentially successful SMEs in middle-income countries have specific financing, marketing, and technical assistance needs that are unlikely to be met by official programs. EEPA research in the Philippines and the recent four-country comparative study of the World Bank (Levy 1994) both suggest that some combination of informal and formal nongovernmental support institutions (NGOs, trade associations) is likely to work best.

Accelerated economic growth in middle-income countries will lead to the elimination of many existing SMEs while providing opportunities for the more progressive ones to grow and transform themselves. Policies to deepen human capital, improve physical infrastructure, and strengthen the integration and functioning of markets are among the most important ways of promoting the healthy development of SMEs in such settings, even though they may not seem to be directed toward that end.

Appendix A

An Approach to Analyzing Employment and Enterprise Policy and Recommending and Implementing Policy Reforms

As this book has been at pains to establish, prevailing policies in many developing countries work to the detriment of productive employment creation and the development of dynamic SMEs. Even though the great majority of developing country governments say they favor SMEs and undertake a range of credit and other programs intended to promote them, their policies tend to be biased in favor of large enterprises and against SMEs, to a greater or less extent. Policy reform to reduce this bias can make significant contributions to important social goals such as the creation of productive jobs; the development of entrepreneurial, managerial, and labor skills; greater equity, in both size distribution and regional terms; and, most significantly, to industrialization and income growth.

How does one go about deciding, in a specific setting, which specific policy reforms are the most critical? What information needs to be brought to bear to answer this question, and how does one assemble it? And once one has reached some type of understanding of what needs to be done, how does one go about persuading others?

During the course of EEPA, we devoted considerable thought to these questions. Although circumstances often conspired to prevent us from carrying out the analysis in precisely the form that we would have wished to use, it may prove useful to others if we lay out the methodology that our experience leads us to prefer. It consists of four steps and can be briefly outlined.

UNDERSTAND THE SETTING

One needs, first of all, a basic understanding of the policy-making environment. There are two main aspects to this: What kind of a country are we dealing with? What kind of government are we dealing with?

Types of Economy

A first approximation at analyzing the country would be to place it in the uniform pattern of development framework. Syrquin and Chenery 1989a and 1989b provide the latest version of this. Are we dealing with a low-income country, a lower-middle-income country, or an upper-middle-income country? It is important to understand the different types of economic structure that are typical of countries at these different levels of development. As Chapter 2 indicated, structural differences exist not only at the intersectoral level (for example, the relative sizes of the agricultural, industrial, and service sectors) but also at the interindustry level within the industrial sector (for example, the relative importance of early, middle, and late industries) and even within particular industries (the number of small, medium, and large firms operating within the manufacturing sector as a whole and many specific industries). Knowing at what stage a country is in the usual sequence of structural changes is helpful because it gives the analyst a good idea of what kinds of changes are required in the near term if the country is to advance to the next higher level of development.

It should, however, be clear by now that the existence of uniform patterns of structural change that typically accompany a rise in GNP per capita should not be taken to mean that a particular pattern must inevitably be followed, that development is a purely mechanical process. The position and prospects of the country in which one is working should of course be analyzed on an individual basis. This analysis should be informed by the fact that country size and natural resource endowments are two critical determinants of possible deviations from the standard pattern of structural change.

As discussed in Chapter 2, large countries are able to follow a more inward-focused pattern of development with less loss of efficiency than smaller countries. In these countries, economic growth and industrialization are closely tied to the changes in demand patterns which accompany a rise in income. Openness to external economic forces is an important way of promoting efficiency in large countries, as in smaller ones, but it may not be essential if the country is able to develop effectively on the primary basis of its internal market. In small countries, by contrast, openness and specialization on the basis of dynamic comparative advantage are essential for a transition to a modern industrial sector to be achieved, since even at intermediate levels of per capita income the local market is too small to support an efficient scale of production in many industries. Most reforms that help to shift from the import substitution (ISI) pattern to greater export orientation (EOI) are likely to favor the development of productive SMEs.

A country's natural resource endowment is an important determinant of the extent to which a rise in GNP per capita will have to depend on industrialization. Countries with rich natural resources are able to rely more on them, and thus have

less need for industrial development, at least up to a middle-income level of development (or much higher in rare cases such as Kuwait or Oman, where there are very large oil deposits in relation to population). Good endowments of particular natural resources may also shape the pattern of industrialization, but many attempts at resource-based industrialization have proven unsuccessful because processing industries could more profitably be located close to markets than near their raw material sources (Roemer 1979).

Other factors will also have important influences on the position and potentials of a developing country. For example, population density influences the transaction costs of both small and large firms, although which way it tips the competitive balance is unclear on an a priori basis.

Types of Government

In Chapter 3 we discussed some of the political aspects reforming employment and enterprise policy. The answers to the most critical policy questions—whether to pursue ISI or EOI, to emphasize government programs or policies that work through markets, to try to establish a level playing field on which firms can compete or actively promote particular forms of enterprise, whether to build up public sector institutions or rely more on the private sector—are influenced in important ways by the type of government that the developing country in question has. The "soft state" versus "hard state" dichotomy is useful for gaining a general idea of how much to expect from the government, but the distinction is a very broad one. Any government, whether soft or hard, will be able to do some things better than others (Roemer and Radelet 1991). Its capacities and limitations therefore require specific analysis.

In developing countries generally, it is usually reasonable to expect that government capacity is severely limited. Although markets also may work less well in developing than in developed countries, it is usually better to limit government intervention and escape some of the problems of government action by asking it to do less. This can make it possible to avoid problems of incompetence and corruption in situations where they cannot readily be overcome by more direct means. As discussed in the text, although low-income countries may need SME government-sponsored promotion programs more than middle-income countries, they are likely to be much less capable of implementing them. Although high transportation costs and limitations in the flow of information may contribute to market imperfections and fragmentation in these countries, their consumers and small-scale producers are likely to be highly responsive to those market signals that reach them. On balance, therefore, market-based solutions are likely to be even more efficacious relative to interventionist ones in poor countries than in richer ones.

ANALYZE THE IMPACT OF EXISTING POLICIES

We suggest that this critical step be divided into two parts. The first part should consist of a broad survey of existing government policies to identify those that may

be significantly biased against SMEs. The second part should be an in-depth probe of a limited number of specific subsectors in which SMEs are active now and are believed to have significant development potential.

Policy Survey

We saw in Chapter 3 that a wide range of policies influences employment creation and the development of productive SMEs. The full range of policies and markets through which they may work that was presented in Tables 13 and 14 should be considered in the policy survey. What are the government's policies (explicit or implicit) in the areas of international trade, foreign exchange, money and banking, taxation, infrastructure, and service provision by government, labor, prices, and business regulation? Systematic review of all these policy areas should generate a list of hypotheses about which types of policy are likely to be biased against SMEs, which types are likely to be relatively neutral, and which may actually be biased in favor of SMEs. The many studies cited in Chapter 3, which indicate what the effects of particular policies have been in other countries, should facilitate this hypothesis-creating process. At the highest level of generality, a determination of whether the country is following an ISI pattern or an EOI pattern will be helpful, since characteristic policy biases normally accompany each pattern.

It should be emphasized, however, that the policy survey is broad but not deep. It is intended only to generate hypotheses. In most cases, the actual effects of a policy on SME development will depend on how it is implemented. Few policies are implemented more or less automatically. Thus, a similar, predictable impact on all classes of enterprise is unlikely. More commonly, some sort of administrative mechanism is required to implement the policy. How that mechanism is operated in practice may have as much, or more, influence on the outcome as the nature and intent of the policy itself. This is particularly true of policies that are implemented on a case-by-case basis, such as exchange control, investment licensing or promotion, tax and duty exemptions, and building permits. One cannot evaluate the impact of such policies until one gets some sense of how they are implemented in practice. This takes us to the next part of the policy evaluation process.

Subsector Analysis

To evaluate existing policy as a basis for proposing policy reforms, it is essential that one carry out both the policy survey just described and a program of detailed investigation in selected subsectors. As just mentioned, the policy survey is intended to be broad and go no further than establishing some plausible hypotheses. If it is not accompanied by detailed investigation on the ground, one risks basing recommendations on unwarranted presumptions about how policies are implemented. The broad but somewhat superficial survey should therefore be accompanied by an in-depth inquiry into selected areas of economic activity—a set of boreholes, as it were.

We emphasize that the proposed program of field interviewing is complementary to the policy survey just discussed. Field research unsupported by a broad

understanding of the national setting and the general policy framework also has severe limitations. It can lead to uncritical devotion to the idea of promoting particular lines of activity and patterns of business organization, regardless of whether these make sense in a broader framework. It also runs the risk that the researcher will uncritically accept the respondents' interpretations of the problems faced by SMEs, when a broader understanding would lend a more accurate and reliable perspective.

A good policy evaluation process, therefore, requires the policy evaluator/adviser to get out of the office and interview a number of small-scale business people. But how many of them, and which ones? We have seen that SMEs are very numerous and engage in a wide range of activities. One is faced with a difficult problem of sample design. It is hard to be categorical about how to solve it. On the one hand, one wants to interview enough business people to reach some valid general conclusions and not be unduly influenced by the special circumstances of a particular business or a particularly persuasive advocate. On the other, one's time and resources are certain to be limited. Surveying should not be overemphasized. The point is not to obtain precise measures that are statistically valid at the .99 level, but rather to learn enough about how different business patterns actually work to serve as a reliable basis for advising on government policies and programs. Since policy making is often based on little or no first-hand field investigation, a modicum of work in this area should permit significant improvements to be made.

Our recommended solution is to pick a small number of lines of production—three or four—in which SMEs are currently engaged *and* in which they appear to have potential to continue participating as the economy moves to a higher level. Within each of these subsectors, one should first consider how many different production and marketing chains, involving interacting small and large units in manufacturing and related sectors, are in operation. For example, medium-sized firms may produce an entire product and market it themselves; at the same time, smaller enterprises may also be active in the field, selling components to larger firms or completed products to marketing organizations. Firms participating in each of the major patterns should be included in the sample. In each case, several entrepreneurs should be interviewed. They should be selected to provide some variety in significant characteristics such as age, ethnicity (if relevant), scale of operations, and level of technology. If the respondents are selected appropriately, it should be possible to get a good idea of how a subsector operates in a small country from interviews with a sample of, say, eight to ten entrepreneurs. In a larger country where regional factors are more significant, a larger sample will be needed.

It is important to have a reasonably representative sample. A particularly easy way to obtain a skewed sample—and thus, very likely, a warped picture of the subsector—is to allow government officials responsible for SME promotion programs to select the respondents. Since these officials deal with only a tiny fraction of the population, and probably an unrepresentative one, and have their own axes to grind, they should not be trusted to select the respondents for the field survey.

The interview itself should strike a balance between structure and informality. The major objectives are to understand how the subsector works, how various government policies and regulations impinge on it in practice, what effects if any government programs are having, what the main constraints to further develop-

ment are and, finally, what might be done to improve the situation. A questionnaire should be prepared (see Levy 1991 for one good model) to clarify and structure the information to be sought, but the interview should take the form of a free-flowing discussion, not a questionnaire-completing session. The researcher needs to cultivate the art of allowing the respondent to carry the discussion off in whatever direction he or she wishes at a particular stage, yet still obtaining all the essential information sought at some point during the interview. The aim should be a broad understanding of the business and the way government policies and programs impact on it, not the collection of data suitable for subsequent quantitative analysis.

Although our principal concern throughout this volume has been SMEs in the manufacturing sector, many of these same points would apply if the investigation concerned SMEs in trade, services, or other sectors. Even when the focus is on manufacturing, one should, as noted earlier, avoid viewing the manufacturing process in isolation, instead seeing it as part of a chain that stretches from the production and distribution of inputs to manufacturing and then on to the marketing of the final products. Small, medium, and large manufacturing enterprises may differ not only in their manufacturing processes but also in the ways in which they obtain their materials and market their outputs. For this reason, it is often important to compare not just manufacturing units but entire production and marketing chains.[1]

Consider What Policy Reforms Would Be Practical and Effective

Recommended policy reforms flow directly from the analysis in the preceding step. If a policy seems likely to be biased against SMEs on the basis of the initial broad survey and also appears as a significant constraint in the subsector analysis, it is a strong candidate for a reform proposal. The reforms proposed can concern government policies, the mechanisms by which policy is enforced, or both. Since policy and implementation are closely interrelated, most commonly both will have to be changed. If a particular policy, say sales tax collection or the issuance of building permits, is subject to abuse in its implementation (for example, it is used to collect corrupt payments or harass an unpopular entrepreneurial minority), it is often hard to improve the implementation without changing the policy.

Political judgments must be made in recommending policy reforms. While the type of inquiry already described can provide a good basis for recommending a better policy or a more workable system of implementation, the effort will not pay off unless there is a reasonable chance of getting the proposed reforms enacted. Often foreign analysts will have only a limited ability to make these political judgements. Influential local officials who are sympathetic to policy reform are virtually indispensable allies in such a venture. If such ready-made allies are absent, the next best solution is to involve potentially influential local officials and researchers in the work from the start and try to persuade them of the value of reform, in the hope that they will eventually come to a deep understanding and conviction on the subject, and will then be able to convince their countrymen. In

some cases, however, (see the Philippines discussion in Chapter 6) opponents of reform will be too powerful and well entrenched for anything significant to be achieved.

RECOMMEND AND IMPLEMENT THESE POLICIES

Chapter 3 discussed the various ways in which reform can come about, with or without the involvement of foreign aid agencies. In general, persuasion works better than "leverage," and long-term efforts to inform and train counterparts may be needed before anything is possible. At present, however, there is also a growing constituency for policy reform in the slower growing parts of the third world, notably Latin America and Africa. The policies followed by some of the more rapidly developing countries in East and Southeast Asia are becoming more widely known in these areas, and will increasingly serve as models to be emulated. The policy adviser may be able to build on this growing interest to promote reform by referring to these more successful cases of development, which are becoming increasingly well-known.

Appendix B

Papers, Reports, and Publications from EEPA

The first section in this appendix lists the EEPA Discussion Paper series by paper number. The second section lists EEPA consulting reports. The last section lists other papers based on EEPA research.

EEPA Discussion Paper Series

The responsible agencies for the EEPA Discussion Paper series are Harvard University and the Harvard Institute for International Development.

1. "The Effect of Policy and Policy Reforms on Non-Agricultural Enterprises and Employment in Developing Countries: A Review of Past Experiences," Steve Haggblade, Carl Liedholm, Donald Mead; March 1986. 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), 58–98.
2. "On Measuring Relative Efficiency in a Size Distribution of Firms," Tyler Biggs; May 1986.
3. "The Question of Political Feasibility: Approaches to the Study of Policy Space," Merilee Grindle; March 1986. Published in Merilee Grindle and John Thomas, eds., *Public Choices and Policy Change: Political Economy of Developing Countries* (Baltimore: Johns Hopkins University Press, 1991).

4. "Location Theory and the Size Distribution of Firms," Jeremy Oppenheim; March 1986.
5. "Economy-wide Models for Analyzing Policy Reform," Jeremy Oppenheim; April 1986.
6. "What Drives the Size Distribution of Firms in Developing Countries?" Tyler Biggs, Jeremy Oppenheim; November 1986.
7. "The Role of Nonfarm Activities in the Rural Economy," Peter Kilby, Carl Liedholm; November 1986. Published in Jeffrey Williamson and V. R. Panchamukhi, eds., *The Balance between Industry and Agriculture in Economic Development*, vol. 2 (New York: St. Martin's Press, 1989).
8. "Prospects and Perils for Small and Medium Enterprises in Outward-Oriented Industrial Expansion: Lessons from Korea and Taiwan," Brian Levy; November 1986.
9. "Lewis through a Looking Glass: Public Sector Employment, Rent-Seeking and Economic Growth," A. Gelb, J. B. Knight, R. H. Sabot; January 1987. Published as "Public Sector Employment, Rent Seeking and Economic Growth," *Economic Journal* 101, no. 408 (September 1991).
10. "The Political Economy of Policy Change in Developing Countries," Merilee S. Grindle, John W. Thomas; October 1987. Published as "Policy Makers, Policy Choices and Policy Outcomes: The Political Economics of Reform in Developing Countries," *Policy Sciences* 22 (1989), 213–48; also published, in a substantially expanded version, in Grindle and Thomas, eds., *Public Choices and Policy Change: Political Economy of Developing Countries* (Baltimore: Johns Hopkins University Press, 1991) and in Dwight Perkins and Michael Roemer, eds. *Reforming Economic Systems in Developing Countries* (Cambridge: Harvard University Press, 1991), 81–114.
11. "Investment Requirements and the Participation of Korean and Taiwanese Firms in Technology-Intensive Industries," Brian Levy, Wen-Jeng Kuo; October 1987.
12. "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," Brian Levy, Wen-Jeng Kuo; October 1987. Published in *World Development*, 19, no. 4 (April 1991), 363–74.
13. "Export Intermediation and the Structure of Industry in Korea and Taiwan," Brian Levy; October 1987. Published as "Transactions Costs: The Size of Firms and Industrial Policy," *Journal of Development Economics* 34, no. 1–2 (November 1990).
14. "The Informal Sector, Policy Reform, and Structural Transformation," Tyler S. Biggs, Merilee S. Grindle, Donald R. Snodgrass; July 1988. Published in Jerry Jenkins, ed., *Beyond the Informal Sector* (San Francisco: ICS Press, 1988).
15. "Financing the Emergence of Small and Medium Enterprise in Taiwan: Financial Mobilization and the Flow of Domestic Credit to the Private Sector," Tyler S. Biggs; August 1988.
16. "Heterogeneous Firms and Efficient Intermediation," Tyler S. Biggs; August 1989. Published in Michael Roemer and Christine Jones, eds., *Markets in Developing Countries: Parallel, Fragmented, and Black* (San Francisco: ICS Press, 1991).

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17. "Financing the Emergence of Small and Medium Enterprise in Taiwan: Concessional Selective Credit Programs," Tyler S. Biggs; August 1988. [Not circulated.]
18. "Education and Industrial Growth in Taiwan: A Case of Planning," Jennie Hay Woo; August 1988. Published as "Education and Economic Growth in Taiwan: A Case of Successful Planning," *World Development* 19, no. 8 (August 1991), 1029–44.
19. "Traders as Transactors: The Role of Trading Companies in Taiwan's Market-Based Economy," Klaus Llorch; August 1988. [Not circulated.]
20. "Export Intermediaries and Industrial Expansion: A Theoretical Perspective," Brian Levy; August 1988.
21. "The Impact of Financial Market Policies: A Review of the Literature and the Empirical Evidence," Jean-Jacques Deschamps, William Grant, with Albert Berry and Susan Goldmark; October 1988.
22. "Medium and Large Private Manufacturing Firms in Rwanda: Diagnostic Study of Current Situation and Policy Impact," Ngirabatware, Leonidas Murembya, Donald Mead; August 1988.
23. "Strategic Interventions and the Political Economy of Industrial Policy in Developing Countries," Tyler S. Biggs, Brian Levy; October 1988. Published in Dwight Perkins and Michael Roemer, eds., *Reforming Economic Systems in Developing Countries* (Cambridge: Harvard University Press, 1991), 365–401.
24. "A Review of Rwanda's Textile Clothing Subsector," Steven Haggblade; February 1989. Revised version published as "The Flip Side of Fashion: Used Clothing Exports to the Third World," *Journal of Development Studies* 26, no. 3 (April 1990), 505–21.
25. "Small Scale Manufacturing Growth in Africa: Initial Evidence," Carl Liedholm, Joan Parker; March 1989. Published in somewhat revised form in Frances Stewart, S. Lall, and S. Wangwe, eds., *Alternative Development Strategies in Africa* (London: Macmillan, 1991).
26. "Policy Reform and the Informal Sector in Africa," Donald C. Mead; April 1989. Published in abbreviated form in Deborah M. Orsini, ed., *The Informal Sector: Issues in Policy Reform and Programs*, report on the East and Southern Africa Regional Conference (n.p. Labat Anderson Inc., 1989).
27. "Market Structure and the Transition to High-End Export Products in Developing Countries," Tyler S. Biggs, Chang-Ho Yoon, January 1990.
28. "*Katapila* Moneylenders and Informal Financial Markets in Malawi," Bruce R. Bolnick, May 1990. Revised version published in *World Development* 20, no. 1 (January 1992): 57–68.
29. "Enterprise Scale, Economic Policy, and Development: A Synthesis of USAID's Employment and Enterprise Analysis (EEPA) Project's Research." Robert C. Young, June 1992. Revised version circulated as "Enterprise Scale, Economic Policy, and Development: Evidence on Policy Biases, Firm Size, Efficiency, and Growth," Occasional Paper Number 52 (San Francisco: ICS Press 1994). Abbreviated version published as "Policy Biases, Small Enterprises and Development," *Small Enterprises Development* (March 1993), 4–15 and in *Policies for Growth and Development in Africa* (San Francisco: ICS Press, 1994).

SELECTED EEPA CONSULTING REPORTS

Biggs, Tyler, Brian Levy, Jeremy Oppenheim, and Hubert Schmitz. 1986. "The Small Business Policy Direction Study [for the Philippines]." See Biggs et al. 1986.

Deschamps, Jean-Jacques, and David Harmon. 1987. "Analysis of the Constraints Limiting Access to Investment Credit in Belize."

Fletcher, Lehman B., Gustavo Marquez, and David A. Sarfaty. 1988. "Formulating a Strategy for Employment Generation in Ecuador: Issues and Priorities." See Fletcher, Marquez, and Sarfaty 1988.

Gray, Clive. 1985. "Quantitative Analysis of Incentives and Disincentives for Expansion of Industrial Output and Employment in Somalia."

Goldmark, Susan, David Harmon, and Donald Mead. 1985. "Private Sector Development [in Tunisia]: Policies, Past Activities and Future Strategy."

Goldmark, Susan, Jean-Jacques Deschamps, William Glade, and Maria Willumsen with Maria Concepcion Lopez and Ana Cristina Mejia. 1987. "The Effect of Policy upon Small Industry Development in Honduras." See Goldmark et al. 1987.

Kannappan, Subiah, and Eric R. Nelson. 1989. "An Assessment of Employment in Sri Lanka."

Mead, Donald C., Bruce R. Bolnick, and Robert C. Young. 1989. "Strategies for Small and Medium Enterprises in Malawi." See Mead, Bolnick, and Young, 1989.

Wortzel, Lawrence H., and Heidi Vernon-Wortzel with Dara Menashi, Arunma Oteh, and Paul Ulrich. 1992. "Costs and Competitiveness in West African Manufacturing Industries."

ADDITIONAL PAPERS BASED ON EEPA RESEARCH

Grindle, Merilee, and John Thomas. "After the Decision: Implementing Policy Reforms in Developing Countries." *World Development* 18, no. 8 (1990): 1163–81.

Levy, Brian. "Korea and Taiwan as International Competitors: The Challenges Ahead." *Columbia Journal of World Business* (spring 1988).

Mead, Donald C. "Small Enterprises in Development: A Review Article." *Economic Development and Cultural Change* 39, no. 2 (January 1991): 409–20.

Snodgrass, Donald R. "An Introduction to the Employment and Enterprise Policy Analysis Project." Presented to the USAID Research Workshop for Broad-Based Growth, Washington, D.C., November 1990.

Young, Robert C. "Evaluation of the Impact of Projects to Promote Small-Scale Industrialization." Presented to the Policy Workshop on Small-Scale Industrialization at the Institute of Social Studies, The Hague, Netherlands, May 1987.

Notes

Introduction

1. For SMEs, the two are generally the same thing. Strictly speaking, however, most of our analysis concerns *plants* (unified production facilities operating on a single site), even though we sometimes refer to them as *firms* (business units with a common management operating on one or several sites).

Chapter 1

1. In general, service activities possess fewer economies of scale than manufacturing, so firms providing them tend to remain small. Many of the services are nontradable, so they must be produced on the spot; local linkages are high. Moreover, many of them have high-income elasticity of demand, which causes them to expand rapidly as the economy grows.

2. See Piore and Sable 1984. Cliff Pratten (1991: 115), Bo Carlsson (1989a), and others note that average plant and firm sizes in manufacturing have declined recently in developed countries. The reasons combine technological change with management style and strategy. Carlsson (1984: 91) comments that "the major changes in machine tool technology, from the so-called American System of Manufactures in the early 19th century to the development of 'Detroit Automation' in the 1950s, have tended to improve mass production methods. By contrast, the development of numerical control, beginning in 1948, has opened up the possibility of extending industrial production methods and automation to areas previously characterized more by handicraft methods." Carlsson (1989a) and others have observed that the rapid decline in the relative cost of communication and transportation services has reduced economies of scale. Carlsson (1989a) suggests that strategic decisions to divest noncore aspects of businesses and free up scarce resources (particularly management time) to defend and nurture core business activities has been an additional factor. Finally, the increasing popularity of Japanese management methods has been influential. As Axel Leijonhufvud notes,

> The American tradition in production management has made the most of the static advantages of the division of labor: minimum human capital requirements, maximum dexterity in the performance of individual tasks, and minimal time lost in switching between tasks—these are the principles stressed on Henry Ford's assembly lines and in Taylorite time-and-motion studies. Apparently, Japanese production management violates all of these principles. Each member of a production team is supposed to learn every work station on the assembly line. Human capital input is maximized rather than minimized. But the dynamics of the Smithian evolutionary process are improved. The Japanese teams are better at discovering potential improvements in both products and methods. (1986: 216)

All this has little immediate relevance to SMEs in developing countries, which are generally smaller than their developed country counterparts and far less capital-intensive and high-tech. It may well affect their future development, however, as the factory system evolves.

3. We deal here with the size of *plants*—that is, physically unified production sites—and not necessarily with the size of *firms*, although we occasionally use the latter term for variety because for SMEs the two are almost always synonymous. Large firms, of course, frequently carry out multiplant operations that cause the two concepts to diverge. Very large firms also appear to be in retreat at present in developed countries, but that is not really relevant to our argument.

4. Nasar (1994), reporting on several recent studies, shows that all size classes of manufacturing firms, from 0–19 employees to 50,000 or more, eliminated slightly more jobs than they created between 1973 and 1988. Small firms had high turnover (a factor ignored in Birch's earlier work), while large firms contracted their work forces in many cases but substantially expanded them in some others.

5. The most notorious case was cotton cloth production in India.

6. The work was funded by the Ford Foundation at the request of the Government of India.

7. Kilby (1988: 227) quoting Staley and Morse (1965: 352). The service and administrative structure of the Indian model is summarized by Kilby (1988: 227–28).

8. For any sector and period, TFP growth can be calculated using the following growth accounting equation:

$$G_{Vi} = aG_{Ki} + (1 - a)G_{Li} + t,$$

where G_{Vi}, G_{Ki}, and G_{Li} are the growth rates of output, capital, and labor, respectively, a and $(1 - a)$ are the elasticities of output with respect to capital and labor, respectively, and t is the growth rate of total factor productivity; t can also be regarded as the rate of technical change. The implicit assumption is that technical change is "Hicks neutral," which means that it raises output but does not affect the marginal rate of substitution between capital and labor. See Syrquin 1986: 243. Cross-sectional differences in TFP—for example, between plants of different sizes within a given industry—can be interpreted as differences in the extent to which these plants fall short of the maximum level of production obtainable from the combination of resources used. See also the discussion in Little, Mazumdar, and Page 1987: 142–53.

9. Obviously, when no data on capital are available only labor productivity can be measured. Measures of capital productivity, total factor productivity, and the capital/labor ratio are possible only when measures of capital use can be obtained.

10. Alternatively, and perhaps more realistically, the small business sector grays as proprietors remain in business until retirement, then close down because their heirs have opted for paid employment in large enterprises.

11. Based on data published by the World Bank (World Bank, *World Development Report*, 1991, 1992, and 1993), 82 percent of manufacturing value added in 1992 occurred in high-income economies. (The former Soviet Union and a few other countries are excluded from this calculation for lack of data; very small countries are also omitted.) While this share has apparently not changed since 1970, the eighteen countries classified as upper middle-income economies produced 8.5 percent of the total in 1990, compared with 6.4 percent in 1970. Countries classified as low-income economies and lower-middle-income economies in 1990 lost world manufacturing share over the two decades, falling from 6.1 percent to 5.2 percent and from 5.3 percent to 4.2 percent, respectively. About 26 percent of GDP derived from manufacturing in upper-middle-income economies in 1990, compared to 23 percent (a sharp fall from 27 percent in 1970) for high-income economies.

12. In James M. Barrie's play, "The Admirable Chrichton," a Victorian family is shipwrecked together with their butler, who turns out to possess all the skills needed for their collective survival and thus rises to the top of the social order as long as they remain stranded on the island. After they are rescued, the butler reverts to his subservient position.

CHAPTER 2

1. As indicated by the citations given, this section summarizes past work on structural change attributable primarily to Hollis Chenery and associates. Readers who do not need to be reminded of the major pertinent findings of Chenery and his associates may skip directly to the next section, which applies the argument to the issue of plant size.

2. This range is a rough approximation in 1990 prices. The original specification was from $300 to $4,000 in 1980 prices.

3. In the data set studied by Moshe Syrquin (1986: 246–57), TFP growth averaged 0.4 percent a year in the poorest countries, compared to 2.8 percent in the richest countries. On average in the poorest countries, there was no TFP growth at all in the dominant agricultural sector. In the economy as a whole, TFP growth contributed only 11 percent to output growth in the lowest-income countries, versus 50 percent in those with the highest incomes.

4. The income elasticity of demand is the percentage rise in the quantity demanded of a particular good in response to a given percentage rise in income. If the quantity demanded rises by the same percentage as income, the income elasticity of demand equals one.

5. According to Syrquin (1986: 246–47), the contribution of TFP growth to output growth in the economy as a whole rises from 11 percent of the total on average in the poorest countries to 50 percent in the richest countries. Capital accumulation contributes 48 percent in the poorest countries but only 32 percent in the richest. The contribution of increases in labor supply falls even more sharply, from 36 to 18 percent. In the manufacturing sector, the rise in TFP's contribution is even sharper (from 10 to 56 percent), as are the declines experienced by both capital (from 59 to 35 percent) and labor (from 31 to 9 percent).

6. Since this suggests that changes in the uniform patterns of development occur over time, why should one expect the cross-sectional patterns or past experiences of developed countries to have any necessary validity for developing countries? Syrquin and Chenery (1989b) checked whether the patterns between the 1950–1973 and 1974–1983 periods and found that "the shares of manufactured output and industrial employment are almost the same before and after 1973 in low- and middle-income countries, but fall significantly in the richer countries" (p. 68).

7. This section and the next, "Convergent and Divergent Cases," are primarily attributable to Tyler Biggs.

8. Defined as cost reductions arising from increases in the output of particular products.

9. Defined as cost reductions arising from production of a widening range of complementary products, or the undertaking of complementary functions such as research and development, production, and marketing.

10. In other words, if the employment share of small firms remained the same within each industry as GNP per capita rose and only the industrial structure within the manufacturing sector changed, the increase in average plant size within manufacturing would have been only one-fifth as great as it actually was. By inference, the remaining four-fifths of the rise in average plant size is attributable to increases in average plant size within particular industries. Biggs and Oppenheim (1986) obtained similar results using more disaggregated data.

11. Taiwan is an intriguing exception to these generalizations, as discussed in Chapter 7. Only about one-quarter of Taiwan's exports were shipped by the largest 500 firms (a group that included virtually all firms with more than 300 employees) in 1975–1981 (Chou 1985a). One important reason why Taiwan's SMEs were able to enjoy exceptional success in export markets is that trading companies served as unusually effective intermediaries between smaller producers and overseas markets.

12. The term "bounded rationality" refers to limitations on calculating capacity and ability to foresee the future. Opportunism occurs when one party to a contract tries to shift its terms in his own favor by taking advantage of the fact that the other party is already committed. This is related to asset specificity, that is, one of the parties to the contract may already have acquired assets (for example, machinery) that are tailored specifically for use in the transaction covered by the contract and are much less useful, or even totally useless, in other transactions.

13. A homothetic production function is one in which changing the scale of operation does not affect the elasticity of substitution between capital and labor.

CHAPTER 3

1. We define this group to include countries that managed to raise GNP per capita by an average of 2 percent per annum or better in 1965–1990. It includes seven low-income countries with a population of about 1.5 billion in 1990 (China bulks large here, but the group also includes Indonesia, Pakistan, and Egypt) and twenty-three middle-income countries with over 600 million residents.

2. Discussion of how to do this would take us far beyond the limits of the present volume and is discussed in many other works. See, for example, the survey discussion in Gillis, Perkins, Roemer, and Snodgrass 1992.

3. The group includes thirty-six out of forty-three low-income countries and twenty-nine out of fifty-two middle-income countries. Just over half the 1990 population of low-income countries (1.55 billion) live in countries that experienced low, nil, or negative growth rates in 1965–1990. About one-third of the population of middle-income countries (roughly 335 million people) live in economically sluggish, stagnant, or declining countries. Most Africans fall into this category; only eight countries on that continent (Algeria, Botswana, Burundi, Cameroon, Congo, Egypt, Lesotho, and Morocco) were able to sustain 2 percent growth in GNP per capita over the 1965–1990 period.

4. This section is based on a review of this topic carried out by Steven Haggblade, Carl Liedholm, and Donald Mead (1986). That survey, however, has been reinterpreted by the authors and additional materials have been included.

5. Others, such as quotas, licensing, and zoning, work through access. Such entitlements are supposed to be allocated on nonprice criteria, and prices enter in only if an enterprising official decides to sell the rights at his disposal.

6. See also Berry and Sabot 1978; Knight and Sabot 1980; Kannappan 1983.

7. In some countries government intervention supported union demands, while in others it undermined them. Several countries that suppressed or severely restricted labor unions (Korea, Singapore, Malaysia, Taiwan, Chile) have achieved high rates of employment increase in large enterprises and rapid economic growth. Freeman (1993) considers whether their success is attributable to any significant degree to their antiunion policies. Noting Horton, Kanbur, and Mazumdar's (1991) finding that union responses to structural adjustment programs have ranged from militant opposition to active cooperation, and also that weakening unions in countries such as Bolivia did not ensure recovery, he concludes that there is no proof that unions in general severely distort labor markets in developing countries, or that weakening them can reduce such distortions.

8. Anderson and Khambata (1985) argue that this process could be accelerated by subsidization of banks' learning costs. Like infant industry protection, to which it is analogous, such subsidization could prove hard to terminate later on, when it is no longer needed to induce banks to lend to SMEs.

9. Effective protection is protection of processes that create local value added, as opposed to protection of products. It is increased by protection of outputs, decreased by protection of inputs, and sensitive to the proportion of the sales price that represents local value added. The effective rate of protection (ERP) can be measured as

$$\text{ERP} = \frac{\text{value added (domestic prices)} - \text{value added (world prices)}}{\text{value added (world prices)}}$$

The ERP is positive when outputs are more heavily protected than inputs. If local value added is a small share of sales, the ERP can be much higher than the nominal rate of protection on the product. The ERP is negative in situations in which producers would be better off if they could operate entirely in a regime of world prices.

10. This can be defined as

$$\sigma = \frac{\delta(K/L)}{\delta(w/r)} \cdot \frac{w/r}{K/L}$$

where K is the amount of capital, L the amount of labor, w the wage rate, r the cost of capital, and δ signifies a change. The elasticity of substitution is thus the percentage change in the capital/labor ratio, $\delta(K/L)/(K/L)$, that results from a given percentage change in the ratio of the price of labor to that of capital, $\delta(w/r)/(w/r)$. For example, if a 10 percent fall in the price of labor relative to that of capital leads to a 5 percent decline in the capital-labor ratio, the elasticity of substitution is 0.5. This would mean that in the future it would take 5 percent less capital to employ a given amount of labor; alternatively, a given amount of capital could employ 5 percent more workers.

11. Michael Roemer and Steven C. Radelet (1991) cite estimates ranging from less than 1 percent of GDP to 9 percent. Unsurprisingly, calculations based on the assumption that the economy is perfectly competitive produce much smaller estimates of the gains from trade liberalization than calculations that assume that there are economies of scale and improved X-efficiency to be gained and rents from imperfect competition to be eliminated.

12. Samples from a burgeoning literature include Grindle and Thomas 1991, part of which work was done under EEPA, as well as Helleiner 1986; Deyo 1987: 182–202; Amsden 1989; Nelson 1989; Stallings and Kaufman 1989; Haggard 1990; Nelson 1990; Wade 1990; Mosley, Harrigan, and Troye 1991; Haggard and Kaufman 1992; and Levy 1993.

13. This can be called the class interests approach. See Amin 1976; Trimberger 1978; and Cardoso and Faletto 1979.

14. This is called the pluralistic approach. It was developed for the United States by David Truman (1951) and has been applied to developing countries by Gabriel Almond and James Coleman (1960), David E. Apter (1965), and Tony Killick (1976).

15. The *locus classicum* is Graham Allison's (1971) book on the Cuban missile crisis.

16. This approach sees policy as the outcome of competition among different views of the national interest within the government. See Bardhan 1984; Bennett and Sharpe 1985; Haggard and Moon 1983; and Grindle 1986a. For a critique, see Migdal 1987.

17. This is the public choice approach, which explains policy in terms of the desire of political elites to develop their countries and remain in power (Bates 1981; Russell and Nicholson 1981). Initially, these elites often select policies that extract

resources from society to fuel efforts at industrialization, but in time they come under pressure to use public resources to maintain the political support of economically powerful actors.

18. Malaysia and Indonesia provide examples of this situation. The Malaysian government has responded with explicitly preferential policies intended to help Malay businessmen compete with ethnic Chinese. Similar but less explicit preferential policies have been adopted in Indonesia.

19. This section draws upon the work of Haggblade, Liedholm, and Mead (1986). However, extensive discussion by them of the effectiveness of different methods of influencing development policies has been omitted and the analysis has been reformulated.

20. Of course, many training, research, and data collection projects are also funded, independent of policy advisory work. Although such activities may ultimately have an influence on policies that affect SMEs, the connection is more remote than that of the activities discussed here.

21. Most of this experience involved program loans, although conditions were also attached to PL480 food aid in some cases.

22. Haggblade, Liedholm, and Mead warn that current policy leverage efforts by USAID may be adversely affected by important differences between today's situation and that of the 1960s. First, USAID has a much smaller policy lever than it had in the earlier era. While in six of the eight countries studied by Snodgrass with Rice (1970) program loans alone amounted to 10 percent of imports, today total aid exceeds 10 percent of the import bill in only a few politically important countries. And observers agree that large aid volumes provide little leverage in these countries because overriding political imperatives rule out credible threats to withdraw (nearly all Economic Support Funds and one-half of development assistance are now earmarked by country; see Weintraub 1989). Another problem is that personnel cutbacks have sharply reduced the analytical capacity of USAID missions.

23. This may well be related to the fact that the ILO is a tripartite agency, with representatives of labor unions and employer groups as well as governments. Richard Freeman (1993) points out that while the World Bank invariably opposes minimum wage laws, the ILO traditionally backs them. According to him, the evidence supports neither ILO assumptions about their benefits to workers nor World Bank fears about their negative effects on employment creation.

CHAPTER 4

1. For a sampling of official and semiofficial policy statements and analyses by the various organizations involved in the effort, see Organization for Economic Cooperation and Development 1969; World Bank 1978b; Allal and Chuta 1982; Chuta and Sethuraman 1984; Neck and Nelson 1987; United Nations Development Program, Government of the Netherlands, International Labor Organization, and United Nations Industrial Development Organization 1988, and Asian Development Bank 1990.

2. Webster (1991: 2) reports that the seventy projects she reviewed, which attracted $3.2 billion in World Bank lending, had a total cost of $7.5 billion including government and sub-borrower contributions.

3. For discussions of the methodological problems of evaluating SME promotion programs, see Goldmark and Rosengard 1985; Kilby and D'Zmura 1985; and Bolnick and Nelson 1990.

4. "The pool of eligible sub-borrowers in Asia and LAC [Latin America and the Caribbean] is much larger, in part, because industry is more highly articulated with viable firms of all sizes, as opposed to more dualistic industrial structures in Africa and EMENA where the majority of firms are either large or small with few in the middle" (Webster 1991: 8).

5. "Credit components disburse more slowly in Africa; pressure from the Bank may have resulted in fewer, larger loans to keep credit lines moving." This appears to mean that larger sub-loans make it easier for the World Bank to disburse funds to the local lending institution, which now needs to negotiate fewer sub-loans to move a given amount of money. But it is unclear why this would accelerate disbursements to the ultimate borrowers, since larger sub-loans would not be expected to disburse any faster, on average, than smaller sub-loans (Webster 1991:8).

6. "According to project officers, the basic costs of doing business in Africa are higher due, in general, to recent economic crises and, more specifically, to high labor costs, project delays, higher transport and construction costs, the need to import a high proportion of inputs and to carry large inventories, and the common practice of building larger capacity than needed" (Webster 1991: 8).

7. Even ignoring the KIK/KMKP project, 135,000 jobs, nearly half the total reported, were in Asia.

8. Peter Kilby (1988) provides an interesting analysis of the problems encountered in a UNIDO-financed attempt to apply the Indian-inspired multifaceted program model in an African setting (Kenya).

9. For example, the thirty-three completed World Bank–supported SME lending projects analyzed by Webster involved only 23,570 sub-loans, out of many millions of SMEs in the developing world (Webster 1991: 9).

10. Agricultural products are far more standardized than industrial products, although growing conditions vary from farm to farm, creating a need for considerable adaptation of the standard recommendations of agricultural extension services in some cases.

11. We argue elsewhere that the employment share of SMEs *in manufacturing* declines with development. This is not necessarily inconsistent with Meyer's assertions, since numbers of SMEs can rise as their employment share declines, numbers of SMEs in other nonagricultural sectors can rise as numbers in manufacturing decline, and countries do not necessarily develop over time, in which case numbers of SMEs may well increase.

12. Loans are small; the cost of processing is high relative to the cost of the loan; the track record and reputation of the borrower are likely to be limited; accounting systems are rudimentary to nonexistent; the risk of business failure is high, even for well-conceived new ventures.

13. "The fiscal burden represents the disincentive effects of taxation—a disincentive borne by taxpaying firms of all sizes, and one which increases in magnitude as tax rates rise" (Levy 1991: 46).

14. "The bureaucratic burden represents the costs to SMEs—most importantly the opportunity cost of the entrepreneur's time—of dealing with the various agencies of government, with the magnitude of the burden inversely proportional to the efficiency with which the government agencies carry out their assigned tasks" (Levy 1991: 46–47).

15. "The threshold burden represents a discontinuity in the structure of costs that results from the imposition of some tax-related fiscal burden or tax-or-regulatory related bureaucratic burden only on firms larger than some minimum threshold size" (Levy 1991: 47). We refer to it elsewhere as the small-firm growth trap.

CHAPTER 5

1. The idea that labor in the agricultural sector is literally in surplus, that it contributes nothing at all to output, is not supported by empirical findings that the marginal product of labor is nearly always positive, although it may be very low in settings where many workers must toil with few complementary resources.

2. Of the forty-seven countries placed in the low-income group by the World Bank in 1991, nineteen experienced a decline in per capita income between 1980 and 1991, according to the World Bank (*World Development Report 1993*, Tables 1 and 1a). Data were unavailable for a further twelve countries, which are likely to have had similarly unsatisfactory results. Of the thirty-one countries that were thus apparently unable to raise income from low levels that existed in 1980, twenty-one were located in Sub-Saharan Africa (see section on Sub-Saharan Africa later in this chapter). The remaining ten were scattered among Asia (six countries), Latin America (three), and North Africa (one country). Of the sixteen low-income countries that did raise GNP per capita in 1980–1991, two experienced slow growth (less than 1 percent a year per capita on average), eight moderate growth (1–3 percent), and six rapid growth (3 percent or more).

3. Including the 47 low-income countries discussed in the previous footnote, there were 120 developing countries with a million or more people in 1991 (*World Development Report 1993*, Tables 1 and 1a). Although the 1980s was not a good decade for economic development, at least 39 of these countries were able to increase GNP per capita between 1980 and 1991, according to World Bank calculations. Of the 39 countries that are known to have raised per capita income, 12 achieved rapid growth (3 percent or more per capita) while 17 grew at moderate rates (1–3 percent in per capita terms) and 10 at slow rates (less than 1 percent).

4. For example, large parts of the rural population of the densely populated Indonesian island of Java engage in nonagricultural work, largely because they lack access to the severely limited supply of arable land. In some villages, as few as one-third of the employed work primarily in agriculture. Many of the nonagricultural activities pursued (that is, petty trading and traditional manufacturing

processes such as the boiling of palm sugar and making of cassava-based snacks) have provided lower returns to labor than agricultural work. As rapid economic growth in recent years has lifted Indonesia close to middle-income status, Javanese villagers have been drawn into more productive forms of nonagricultural economic activity. High population density and a relatively good transportation system have made it possible for many of these activities to take place in villages and not require those engaged in them to undertake rural-urban migration.

5. This section is based in large part on research conducted in Bangladesh for EEPA under the leadership of Gian S. Sahota.

6. Eighty-six percent of the population are poor, according to United Nations Development Program (UNDP) (1991: 153).

7. For a definition, see footnote 9 in Chapter 3.

8. Although the EEPA research was carried out in the late 1980s, based mainly on data from the mid-1980s, the conclusion seems to have stood up in the early 1990s. See Khatkhate 1992.

9. The effective rate of assistance (ERA) is analogous to the effective rate of protection (ERP) defined in footnote 9, Chapter 3. The ERA broadens the concept of the ERP by adding the impact of domestic taxes and subsidies on the prices of outputs and inputs to the effects of the taxes and subsidies on international trade included in the ERP. It thus tries to measure the overall level of assistance (subsidization) given to value added in a particular industry.

10. An ERA above 100 percent indicates that value added in the industry concerned is subsidized to such an extent that the value of subsidy is greater than the social value of its value added. An ERA above 200 percent means that the value of the subsidy is at least twice as great as the social value of its value added.

11. This section is based on a draft prepared by Carl Liedholm and Donald Mead.

12. The World Bank (*World Development Report*, 1992) lists forty-eight countries in Sub-Saharan Africa, including South Africa and ten countries with populations of less than one million. The text discussion deals with the thirty-seven countries other than South Africa whose populations exceed one million. Not all data series are available for all countries, however.

13. Although data for some countries are missing, it appears from Table 22 that the poorest nations in Sub-Saharan Africa are actually slightly more highly industrialized than their somewhat richer neighbors. Several African countries industrialized behind high protective walls, prematurely shrinking their agricultural sectors through policy distortions.

14. In the twentieth country, Côte d'Ivoire, per capita income was unchanged.

15. The relative importance of the service sector rose in some countries and fell in others. Since service sector employment is highly diverse, particularly in low-income countries, little can be said about changes in the quality of employment on the basis of these aggregate data.

16. Recent surveys in Botswana, Lesotho, Malawi, Swaziland, and Zimbabwe indicate that 67–88 percent of SME employment is located in rural areas. Ten to 32 percent is located in principal cities, while 2–20 percent is in secondary towns. This includes SMEs in construction, transportation, and other services as well as manufacturing. See Liedholm and Mead 1993: 6.

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17. GEMINI stands for Growth and Equity through Microenterprise Development Investments and Institutions. Development Alternatives, Inc., and Michigan State University, subcontractors under EEPA, were involved in carrying out GEMINI.

18. EEPA studies in this area include those by Augustin Ngirabatware, Leonidas Murembya, and Donald Mead (1988); Enyinna Chuta (1989); Mead (1989); Steven Haggblade (1989); and Carl Liedholm and Joan Parker (1989). Non-EEPA studies include Liedholm 1990; Steel and Webster 1990; and Liedholm and Mead 1993.

19. See Liedholm and Mead 1993, which notes that the disappearance of a small firm is not necessarily an indication of business failure. In four countries for which survey information was collected (Botswana, Kenya, Swaziland, and Zimbabwe), bad business conditions was given as the reason for closure in 40–57 percent of the cases. Other factors commonly cited included personal reasons (22–28 percent), better options (5–21 percent), and government actions/natural disasters (2–6 percent in three countries but 26 percent in Kenya). [Why government actions and natural disasters were grouped together as causes is not explained!] For a discussion of SME closures and research problems that arise in attempts to study them, see Liedholm and Mead 1993: 24–30.

20. In surveys carried out in seven countries of Eastern and Southern Africa, 49–77 percent of SMEs had not expanded employment between their start-up date and the date when they were surveyed (Liedholm and Mead 1993: 17–20).

21. This section draws heavily on "Strategies for Small and Medium Enterprises [in Malawi]," a consulting report prepared under EEPA by Donald C. Mead, Bruce R. Bolnick, and Robert C. Young (August 3, 1989).

22. Malawi under former President H. K. Banda appears to have been a bit too tightly organized for successful economic development. "An outsider coming for the first time to Malawi is struck by the extent to which the country is neat, clean, and organized. It is impressive. Yet it is also true that dynamic development is often disorganized and helter-skelter. Insistence on regularity, on meeting norms of cleanliness and safety can have a stifling effect on initiative and creativity, factors which have to be at the heart of the development process" (Mead, Bolnick, and Young 1989: 18).

23. "One may ask about rules concerning the hours during which enterprises may be open. One wonders why no petrol station is permitted to stay open after 6:00 pm. There are clearly people who would be happy for a job working on a later shift. The rule does cost jobs, then, as well as inconveniencing consumers. The argument that robbers would take advantage of any station which remains open later seems thoroughly unconvincing" (Mead, Bolnick, and Young 1989: 18).

24. The section is based primarily on work done in Rwanda under EEPA (known locally as the PRIME Project) by Donald C. Mead, other consultants, and Rwandan counterparts. It was written before the outbreak of civil war in 1994.

25. Including 2,800 in seven wholly government-owned enterprises. See Ngirabatware, Murembya, and Mead 1988: 4.

26. The principal such tax in Rwanda is the *patente*, a flat tax paid annually by all who engage in productive activities. It is considered a minimum contribution that must be paid regardless of the firm's profitability. If profits are made and profit

taxes paid, the *patente* may be deducted from the profit tax payment. See Ngirabatware, Murembya, and Mead 1988: 60–61.

CHAPTER 6

1. This section is based in part on an EEPA consulting report, "The Small Business Policy Direction Study" by Tyler Biggs, Brian Levy, Jeremy Oppenheim, and Hubert Schmitz (see Biggs et al. 1986).

2. The term, which was not coined by the EEPA team, has been variously attributed to Peter Kilby and William F. Steel. The phenomenon, minus the name, was also identified by Clifford Barton in work done on Vietnam (Barton 1977), as well as by the Ranis/ILO Philippines mission discussed in the text.

3. See the following section.

4. They were also examined as part of the extensive study of Philippines SMEs carried out by Anderson and Khambata (1981: 40–59).

5. This section is based on a draft prepared by Gustavo Marquez and Eric Nelson.

6. This discussion draws heavily on an EEPA study, "Formulating a Strategy for Employment Generation in Ecuador: Issues and Priorities," by Lehman B. Fletcher, Gustavo A. Marquez, and David E. Sarfaty (1988).

7. The average GNP per capita in the region in 1990 was $2,180.

8. The towns are Quito, Guayaquil, and Cuenca. The finding is based on a household survey that defined the informal sector to include (1) all owners and workers in private establishments of fewer than five workers; (2) all self-employed workers in nonprofessional, nonmanagerial occupations; and (3) all unpaid family workers (Fletcher, Marquez, and Sarfaty 1988: 32–33).

9. This section is based largely on an EEPA study, "The Effect of Policy upon Small Industry Development in Honduras" (September 1987). The report on this study was prepared by Susan Goldmark (team leader), Jean-Jacques Deschamps, William Glade, and Maria Willumsen (Goldmark et al. 1987).

10. "The [policy implementation] process is sufficiently complicated and costly to discourage smaller firms from attempting to receive benefits under the Industrial Incentives Laws, to import products directly or, to a lesser degree, to export. Although it is illegal to be unregistered, the cost of legality includes paying all back taxes due since the firm began operations. Thus, unregistered microenterprises must leap over a high barrier of costs to join their formal sector counterparts and grow." (Goldmark et al. 1987: xi–xii).

11. Logically, one would expect such "growth taxes" to induce small firms to duplicate themselves rather than grow in scale, since two small firms would be liable to pay lower taxes and benefits than one larger firm equal to their combined size. We have no evidence, however, on the extent to which firms in Latin America in fact restructure themselves in this way to reduce costs.

12. Interest rate ceilings also discourage the growth of savings accounts in banks and may even reduce the aggregate saving of society. These effects, while injurious, are less directly related to our story than the ones discussed in the text.

13. In his well-known book, *The Other Path*, Hernando de Soto (1989) recounts the experience of Institute for Liberty and Democracy (ILD) in registering a small garment factory on the outskirts of Lima, Peru. The process involved eleven separate legal procedures, took 289 days to complete, and cost $1,231, a large sum for a small business person. Later, the ILD repeated the experiment in Miami at far lower cost in time and money.

CHAPTER 7

1. See, for example, the works of Charles Frank, K. S. Kim, and Larry Westphal (1978); John Cody, Helen Hughes, and David Wall (1980); Bela Balassa (1981); Ian Little (1981, 1982a, 1982b); and Anne O. Krueger et al. (1983).
2. Although careful advocates of the earlier view never really said that they were, as the above quotations from Little indicate.
3. Among many available analyses, see those by Neil H. Jacoby (1966); Ching-Yuan Lin (1973); Samuel P. S. Ho (1977); Walter Galenson (1979); John C. H. Fei, Gustav Ranis, and Shirley Kuo (1979); Kuo, Ranis, and Fei (1981); Kuo (1983); S. C. Tsiang (1988); K. T. Li (1988); and Ranis (1992).
4. Manufacturing SMEs were defined as establishments with less than NT$40 million of paid-up equity and less than NT$120 million in total assets.
5. This is in concurrence with findings for India by Thomas A. Timberg and C. V. Aiyar (1984).
6. We say "perceived" because he cites no statistics to support the implication that small-firm growth is any slower in Taiwan than would be expected on the basis of experience in other countries.
7. For more on this debate, see Howard Pack (1992).

APPENDIX A

1. For more on subsector analysis, see Boomgard et al. 1992. Other papers on the subject include Mead 1984; Haggblade 1987; and Mead 1992.

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Abbreviations and Acronyms

BOI	Board of Investment
BRI	Bank Rakyat Indonesia (Indonesian People's Bank)
BSCIC	Bangladesh Small and Cottage Industries Corporation
CES	constant elasticity of substitution
CGE	computable general equilibrium
CMI	Census of Manufacturing Industries
DAI	Development Alternatives, Incorporated
DFIs	Development Finance Institutions
EEPA	Employment and Enterprise Policy Analysis Project
EMENA	Europe, the Middle East, and North Africa
EOI	export-oriented industrialization
EPIDC	East Pakistan Industrial Development Corporation
EPZ	export processing zone
ERA	effective rate of assistance
ERP	effective rate of protection
ERR	effective rate of return
ESAF	extended structural adjustment facility
ESEPP	Employment and Small Enterprise Policy Project (Bangladesh)
FY	fiscal year
GDP	gross domestic product
GEMINI	Growth and Equity through Microenterprise Development Investments and Institutions
GNP	gross national product
HCI	heavy and chemical industries
HIID	Harvard Institute for International Development
ILD	Institute for Liberty and Democracy
ILO	International Labor Organization/Office
IMF	International Monetary Fund
ISI	import-substituting industrialization
ISIS	Institute for Strategic and International Studies (Malaysia)
ITRI	Industrial Technology Research Institute (Taiwan)

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KIK/KMKP	Small investment/working capital credit program (Indonesia)
KMT	Kuomintang (Chinese Nationalist Party)
KUPEDES	General Rural Credit (Indonesia)
LAC	Latin America and the Caribbean
LDC	less developed countries
LDP	Liberal Democratic Party (Japan)
MASICAP	Medium and Small Industries Coordinated Action Program (Philippines)
MES	minimum efficient scale
MSBA	Medium and Small Business Administration (Taiwan)
MSU	Michigan State University
NGO	nongovernmental organization
NIC	newly industrializing country
NIE	newly industrializing economy
NIP82	New Industrial Policy, 1982 (Bangladesh)
NT$	New Taiwan dollar
OECD	Organization for Economic Cooperation and Development
OEM	original equipment manufacturing
PIDC	Pakistan Industrial Development Corporation
PISCES	Program for Investment in the Small Capital Enterprise Sector
PRIME	(Local designation for EEPA in Rwanda)
PVO	private voluntary organization
R&D	research and development
RERR	realized economic rate of return
RIP86	Revised Industrial Policy, 1986 (Bangladesh)
SAF	structural adjustment facility
SAL	structural adjustment loan
SBAC	small business advisory center (Philippines)
SCIs	small and cottage industries
SECAL	sectoral adjustment loan
SENA	national vocational training institute (Colombia)
SMEs	small and medium enterprises
SMI	small and medium industry
SSE	small-scale enterprise
SSI	small-scale industry
TFP	total factor productivity
TIP	Trade and Industry Project (Bangladesh)
UNDP	United Nations Development Program
UNEPROM	(a public lending body in Ecuador)
UNICEF	United Nations Children's Fund
UNIDO	United Nations Industrial Development Organization
USAID	United States Agency for International Development

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