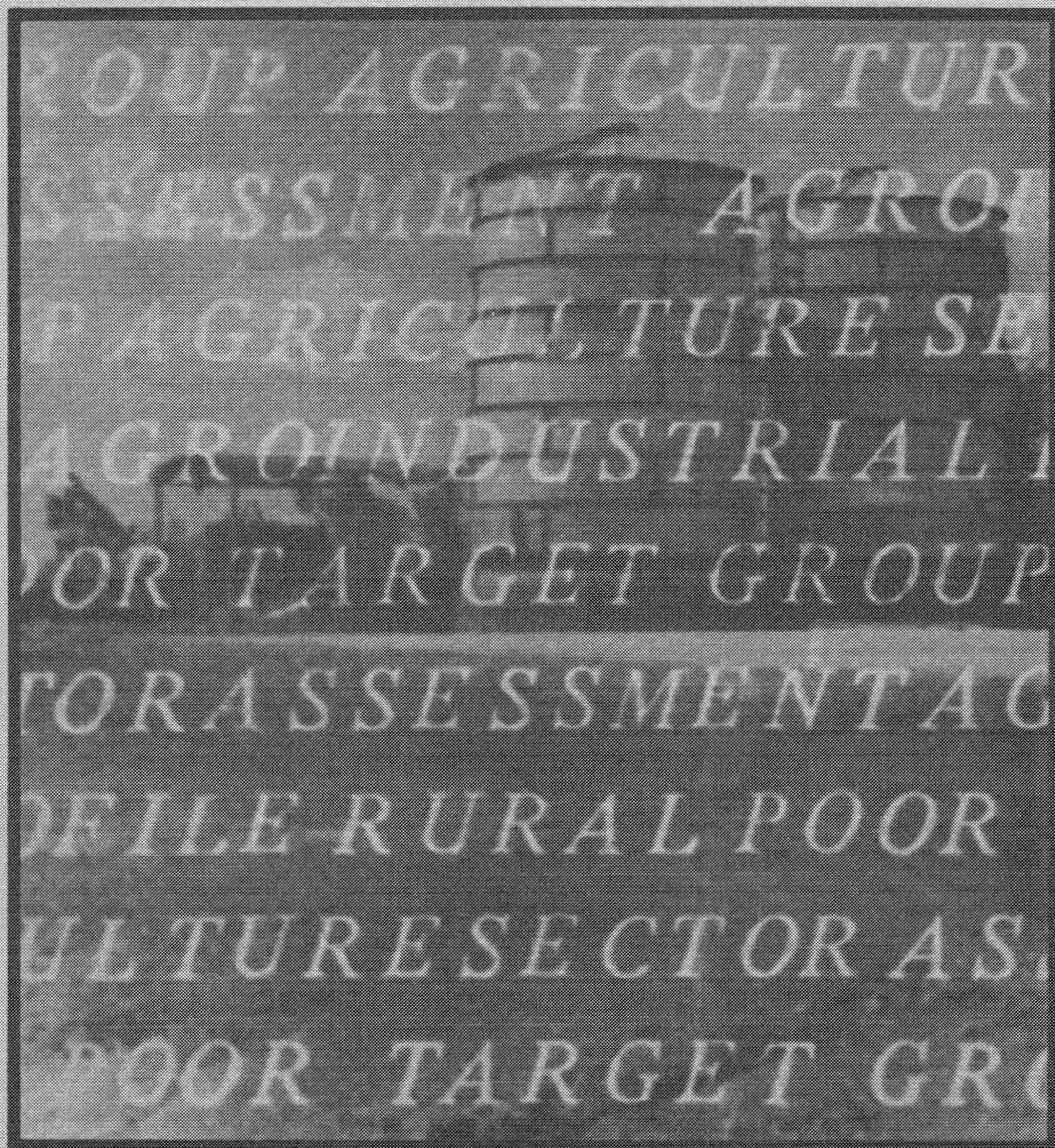


# RURAL ENTERPRISES

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AN OVERVIEW OF THE ROLE AND POTENTIAL OF RURAL ENTERPRISES TO CONTRIBUTE TO THE EMPLOYMENT AND INCOME OF THE RURAL POOR IN DEVELOPING COUNTRIES



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Washington D.C.

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## RURAL ENTERPRISES

As agricultural output increases, new opportunities develop for providing goods, services, and markets in rural areas. Farmers require additional farm inputs and processing and marketing facilities for outputs. In addition, rising rural incomes create new demand for consumer products. By providing a supportive environment for rural based enterprises, governments can potentially improve the welfare of rural populations and further stimulate agricultural production. Following is a discussion of how rural enterprises can contribute to the overall economy and what mechanisms have been used in attempts to stimulate their development.

### Definition

The term "rural enterprises" is used in this paper to refer to small and medium rural enterprises (SMRE) located in non-metropolitan areas. Defining "small" and "medium" is difficult as the term has different implications in each country. In Ecuador, for example, "small" has been defined as those enterprises with less than \$11,000 in fixed assets, while in Korea the term is used to refer to firms with less than \$200,000.<sup>1</sup>

Working definitions which would encompass SMREs best serving A.I.D.'s priority interests should include three dimensions: Number of workers, fixed assets, and labor intensity. Small scale enterprises for A I D priority would be those with a maximum of 20 workers, \$50,000 in total assets, and maximum capital costs per workplace provided of \$5,000. A workplace should be defined as 12 person months of work, not by the number of employees or workers. Medium scale A I D. priority enterprises would be those with a maximum of 150 workers, maximum of \$500,000 in total assets and maximum capital costs for providing one workplace of \$15,000. (It should be noted that medium scale enterprises in particular may provide substantial indirect employment which should be considered when evaluating labor intensity.)

While these definitions are admittedly arbitrary, they attempt to capture those types of rural enterprises with the largest potential for the achievement of A.I.D. objectives. There is a need for exclusionary definitions in A.I.D.'s operations because of the very real tendency in all countries for the larger enterprise to be more agile in obtaining scarce resources, money, and other assistance. If there are no restrictions on the types of enterprises to be included, or if the limits are set so that few enterprise types are excluded, the bulk of the assistance may tend to be concentrated very near the upper limit.

The measure of labor intensity, i.e., capital costs per workplace created, is important since size and locational characteristics do not determine the cost per job for a given enterprise. Labor intensity, for example, varies much more widely by product types than by scale of operation or location. The income potential of rural enterprises for the poor (however measured) shows significant change depending on the type of industry. This is not to say that scale and location are not important characteristics which should be used to define an area of interest to the Agency, but only to caution against the exclusive use of these characteristics in determining the boundaries of that interest. Smaller scale *does* tend to increase labor

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<sup>1</sup>UNIDO, *Technical Services for Small Scale Industry*, p. 7.

intensity, rural industries *are* on the average more labor intensive, yet these averages conceal large differences between the labor intensity and income potential of different product and service types of enterprises. For example, the range in capital required to provide one workplace varies widely within the SMRE subsector types. A study in El Salvador indicated that approximately one-third of the small enterprise product types require less than \$1,000 per worker, approximately half from two to eight times that much and a small but not unimportant number from \$8,000 - \$15,000. It is therefore important to segment the SMRE group into subgroups not only by fixed assets and employment levels, but also according to their labor intensity in order to determine which set of SMRE best meets A.I.D.'s objectives.

As the nature of specific industries (i.e., size, location, and labor intensity) varies by country situations, no attempt will be made to define or limit the types of industries to be emphasized. SMRE considered for project support should initially include all enterprises found in non-metropolitan areas. Many of this group will not produce a product, but rather provide marketing, transport, or other service. At least one-third of the priority SMRE in most developing countries will come from the service category. Food, fiber and wood processing make up almost all of the remaining priority small scale enterprises, and only a very small percentage consists of the handicraft products. SMRE may range from very small, craftsman type operations to fairly sophisticated businesses with complex internal organization and production processes.

### Role in Developing Economy

SMRE can play an important role in a developing economy, though their ability to do so depends on the existence of an adequate environment to support SMRE growth. As the largest percentage of SMRE will generally be dependent on the demand of the domestic population for SMRE goods, development of SMRE requires the existence, or at least the simultaneous development of, an expanding agricultural sector. Stagnation or slow growth in agriculture will generally restrict opportunity for substantial development of new or existing enterprises.

In general, the potential contributions which SMRE can make to a country's economy include the following: First, as SMRE usually tend to be more labor intensive than larger enterprises, the opportunities for increasing rural employment can be maximized by encouraging SMRE development. As most developing countries under-utilize their rural populations by 25-50 percent, the reduction of this waste of human resources and the stream of attendant economic and social ills which it carries in its wake must be a first priority for the Agency. Much of the problem can and should be attacked through agriculture directly; many of the rural poor families are small farmers and will benefit directly from programs aimed at expanding and improving their production. Yet direct agriculture cannot hope to absorb all of the existing, and expanding, rural labor force. Recent research by Milton Esman et al. of Cornell indicates, "Data from Asia indicate that in all the countries surveyed the landless and near landless constitute a majority of the labor force, the figures approach 90% in Bangladesh and Pakistan. In every country in Latin America the landless and near landless are a majority,

exceeding 80% in Bolivia, El Salvador, Guatemala and the Dominican Republic. At prevailing rates of population growth and allowing for net outmigration from rural areas of one-third of the projected population increase, the rural labor force will grow by at least 50% in most of these countries by the end of the century.”<sup>2</sup> Rural enterprise projects of all types present a viable and indeed critical alternative to providing productive workplaces for rural laborers. In some geographical areas, they may also have the advantage of opening employment opportunities for women who may be culturally or economically excluded from direct agricultural pursuits.

Second, SMRE may contribute to the income and employment of small farm families. To begin with, it has been demonstrated in many countries that the most profitable alternatives for small farmers are intensive crops which carry attendant high risks, involve increased credit, require post-harvest processing and/or efficient marketing links to prevent massive losses through spoilage. SMRE involved in processing and marketing can be catalytic in allowing small farmers to pursue this high income alternative. In fact, in many cases it is the SMRE development which *precedes* the small farmer entrance into intensive crop production. SMREs can open markets, provide credit and technical links to small farmers which will directly expand the employment of both farm and landless rural families in agricultural production. In addition, on-farm enterprises owned and managed by the small farm family can absorb slack labor during the off season, and provide additional income sources from added value to farm production. Capturing as much income as possible from adding value to farm product before it crosses the farm gate may be an important income alternative in some commodities. Livestock, fiber and wood products are the best commodities for on-farm processing enterprises.

Third, SMREs have the potential to improve income distribution by increasing the number of workers participating in the labor force, improving income possibilities for small farmers, and, in the case of very small establishments, providing landless families with opportunities to become entrepreneurs rather than laborers. New opportunities for the landless are particularly important in LDCs where expanding rural populations and sluggish economic growth have resulted in a large and increasing pool of unemployed workers. While product markets have remained reasonably responsive and prices for products have risen consistently, wages have not. This situation, characteristic of much of the developing world, has meant that people whose income comes from the sale of products in the product markets have a brighter *potential* future than those who must enter the depressed labor markets for their income.

In both Guatemala and El Salvador the small farmer makes almost twice as much income from each day productively worked on his farm as he makes from each day worked as a laborer, due largely to this disparity between the labor and product markets. Hence, employment inside his farm should be looked to as a more attractive income alternative than outside. For the landless, more income will come to laborer-entrepreneurs in most depressed

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<sup>2</sup>Milton Esman and Associates, *The Landless and Near Landless in Developing Countries*, Executive Summary, Cornell University, 1977, p. 2.

labor market situations than to laborers alone. Attention has focused in many international development institutions on the plight of the landless rural families who constitute a large proportion of the rural poor, and probably the poorest of the rural poor. More than one-half of all rural poor are without income productive assets except their own labor, and are thus locked into obtaining what income they can from the depressed labor markets. One of the largest potential contributions of the very small enterprises is to convert these landless laborer families into small scale entrepreneurs and allow them to enter product not labor markets for their incomes.

In attempting to evaluate the target group potential of SMRE, some analysts have measured labor productivity, and finding it significantly lower in small scale establishments, have reached the incorrect conclusion that they had little income potential. In both El Salvador and Guatemala, labor productivity is about four or five times as high in large scale enterprises than in small scale ones, and one might think therefore that it would be better to expand large scale enterprises and provide increased benefits to the rural poor by employing them rather than to spread inefficiency by emphasizing small scale enterprise expansion. This argument ignores two important facts usually characteristic of the rural sector in developing countries. First, much of the added labor productivity is due to substitution of capital for labor, not increased labor efficiency, and may result in larger payments to owners of capital, while laborers stay at the minimum wage floor. Second, even at lower labor efficiencies, laborers will capture a larger share of income in very small scale laborer owned and operated enterprises. Empirical studies<sup>3</sup> have indicated that in food, clothing and wood products, even though labor productivity is one-fourth that of large scale establishments, net income per worker is 15-55 percent higher in firms with less than five workers.

Fourth, by focusing on areas outside of the major metropolitan areas, governments can encourage decentralization of industrial development. Decentralization is a factor in improved income distribution and can contribute to stemming the migration to metropolitan areas. The potential of small and medium scale rural industry to decentralize the process and benefits of growth were found to be particularly important in studies on Brazil and Colombia.<sup>4</sup>

Finally, SMRE in appropriate lines of activity can contribute to growth of the overall economy by being efficient users of capital. Though the evidence is not conclusive, studies<sup>5</sup> do indicate that in many industries, the output per unit of capital is higher for small scale than large scale enterprises. Hence, in industries where this holds true, support of labor intensive SMRE will not be at the cost of increased output, but will rather be the best means to achieve improved social and economic welfare.

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<sup>3</sup>See S. Daines, *El Salvador Agroindustrial Profile*, AID Mission to El Salvador, 1977, p. 26.

<sup>4</sup>See S. Daines, *Analysis of Industrial Structure, Technology and Productivity in The Food Processing Sector of Brazil*, Cambridge, Massachusetts Institute of Technology, CPA, 1975, 126 pp.

<sup>5</sup>See Eicher et al., *West Africa*; and Daines, *Brazil, El Salvador, Costa Rica*.

### Selective Support of SMRE Development

If an underlying dynamism exists in the agricultural sector, SMRE growth will undoubtedly occur without government efforts. Reasonable support, however, has the potential to maximize their development in appropriate industries by improving the efficiency and effectiveness of their operations. Generally, specific efforts to support SMRE development will realize the best results in areas where SMRE enjoy competitive advantages. Trying to stimulate SMRE which have significant employment potential but which have no competitive advantage vis-a-vis larger, metropolitan enterprises often proves difficult, if not impossible, and fosters inefficiency.

Morse and Staley in *Modern Small Industry for Development* identify three primary influences which significantly bear on the relative competitive advantages of small and large enterprises: location, processes, and markets. Specifically, they argue that smaller enterprises are most suited where factors encourage dispersed locations, where scale economies are not pronounced or process advantages exist in small scale operation, and where markets are small or highly differentiated.

Locational influences favoring small and dispersed enterprises might include industries where a) local markets and high transfer costs make localized production more economical (e.g., prepared animal feed, concrete blocks and bricks, ice cream, and soft drinks), b) raw material is dispersed (e.g., butter, cheese, grease, tallow, or wood products), and c) localized services are required to ensure timely and flexible customer contact (e.g., printing, typesetting, grain storage, and milling).

Favorable process influences include those where: a) operations are based on localized skills, which may include craft or precision handwork (e.g., furniture, leather goods, and blacksmithing), b) manufacturing operations are separable (e.g., machine shop products, castings, and dies and tools), and c) operations require simple assembly, mixing, and finishing (e.g., food flavorings, footwear, fertilizer mixing, and wood products).

Industries with market influences favoring SMRE would include those with: a) differentiated products which have low scale economies (e.g., women's dresses), and b) small markets which are best served by a locally based enterprise (e.g., fresh/frozen fish, cottonseed oil mills, carts and wheelbarrows).<sup>6</sup>

In general, SMRE engaged in activities in these classifications should enjoy a natural competitive advantage. By directing support selectively to these SMRE, government or other donor efforts have the potential to stimulate those enterprises which can theoretically make the most positive contribution to the overall economy.

### Problems Common to SMRE

The form of government support will vary with the problems specific to that country's SMRE sector. Following is a general discussion of problems which are common in many

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<sup>6</sup>E. Staley and R. Morse, *Modern Small Industry for Developing Countries*, pp. 112-124.

industries in many countries, though they may not be universal. Some of these problems are shared by large scale operations. In general, however, the problems are more pronounced for SMRE which, by virtue of their smaller size, are unable to resolve many of them without external support, be it private or public. Common difficulties include:

1. **Government Disincentives:** One of the most serious problems faced by SMRE are disincentives established through government actions. These can include:
  - a. Distortion in factor prices which may result in investment in large, overly capital-intensive operations. Artificially low interest rates and overvalued foreign exchange make purchase of capital equipment more attractive when in fact abundant, cheap labor and scarce capital should favor the development of labor-intensive operations.
  - b. Burdensome rules and regulations such as those requiring overly detailed reports, records and licensing, which can consume valuable time and may discourage growth, as many of these requirements often become more involved as the firm grows larger.
  - c. Taxes and tariffs which favor large firms, giving them artificial advantages in comparison to SMRE. Also, a tax structure which discourages growth of small enterprises by rapidly increasing taxes once the enterprise has reached a certain size.

2. **Management:** In many small firms, one individual is responsible for the production, management, marketing and finance operations. The entrepreneur, who, for example, may be a skilled craftsman, often lacks expertise in all of these areas. Although the firm's operations may appear to be fairly straightforward, e.g., dressmaking, the entrepreneur still has to make decisions relating to each of the above functions, e.g., how many machines to purchase or workers to hire, how much money to borrow, and how to better sell his or her services.

The ill-informed businessperson can easily make decisions resulting in an inefficient use of resources and thereby seriously affect the enterprise's ability to compete effectively. These entrepreneurs are often reluctant to accept outside assistance and are unable to identify their specific problems. Many of the other difficulties outlined below stem largely from this lack of specialized management.

3. **Technical Information:** The entrepreneur's limitations are further aggravated by the lack of access to current technical information. Consequently, decisions regarding technology, production processes and planning, inventory levels, and related facts are often based on out-dated and inefficient practices still in use in the immediate vicinity.

4. **Marketing:** Whereas large firms usually have the staff and contacts to keep abreast of market developments, rural, smaller firms do not. Consequently, their knowledge of new or changing opportunities is limited to their immediate environs. In addition, large firms can afford transport and storage facilities, advertising and product development efforts which an individual SMRE again cannot.

5. **Credit:** Most Small Scale Enterprises (SSE) and, to a slightly lesser degree, Medium Scale Enterprises (MSE) are forced to rely on personal savings, money from friends or relatives,

and moneylenders. They therefore find it difficult to obtain working capital or long term credit needed for capital investment on an adequate or timely basis and on reasonable terms.

Formal credit channels are often closed for several reasons. The general problems faced by rural industry, compounded by the lack of accurate accounting records, make it higher risk for credit institutions which can lend to more stable customers or even invest funds in other money instruments. Also, lending to SMRE rather than larger, metropolitan-based industry usually means higher administrative costs due to the smaller size of the loan and the additional time bank personnel may need to spend in reviewing, monitoring, and assisting the rural customer. Banking practices further complicate the situation. They often require substantial collateral to insure the loan, and commercial banks in particular are often unable or reluctant to lend on a long term basis because most of their funds are short or medium term.

Government policies tend to aggravate the situation further when policies such as those discussed above foster "over-development" of larger, more capital-intensive operations and thereby make them favored customers.

6. Raw Materials/Equipment: Large-scale enterprises usually enjoy several advantages in purchasing raw materials and equipment; they can make bulk purchases, have specialized procurement staffs, and have more political, social, and financial influence with government and suppliers. This affords significant price advantage and invaluable control in LDCs where the supplier and sales networks are often inadequately developed and raw materials and equipment are usually in chronic short supply.<sup>7</sup>

7. Socio-cultural factors: Socio-cultural factors may be a serious handicap to the development of SMRE. The rural entrepreneur may be expected to share his/her wealth among relatives, which limits funds available for reinvestment; profits may be discouraged by the community, thereby discouraging aggressiveness and growth; leisure time may be highly regarded and consequently discourage efforts to utilize available equipment at full capacity, etc. In addition, the social structure in some countries may be such that an elite can control access to government, sources of credit and supplies, markets, etc., so effectively that it denies SMRE needed support for development. These considerations may seriously affect any program intended to develop SMRE and should be carefully evaluated.

8. Infrastructure: Many of the less traditional and larger SMREs require access to basic infrastructure such as roads, electricity, and water. Inadequate or unreliable access to such amenities can seriously hamper or even prevent new SMRE growth. Hence, external efforts to stimulate rural enterprises may often follow infrastructure development.

### Mechanisms to Support SMRE

Providing or stimulating the support necessary to minimize these problems and hence improve SMRE performance has proven difficult. If the overall environment appears supportive, efforts would be made to address those problems most critical to promising SMRE sub-sectors. Initially, those constraints which can be alleviated by policy decisions should be

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<sup>7</sup>*Ibid.*, p. 379.

identified, as policy usually plays a dominant role in SMRE development. Next, the business and technical needs should be outlined and, if the government so desires, a program developed to address these needs.

Following is a discussion of the components often included in programs intended to provide direct support to small and/or rural industry.

1. **Training:** Short-term courses, on-the-job guidance, self-education aids, and preparatory training are some of the more common means used to transfer relevant technical or managerial information. Instruction in basic accounting, marketing (e.g., demand analysis, promotion, distribution), production (e.g., planning, quality control), finance, and organization (e.g., personnel, organizational structure) can enable the manager to improve his-her operations. On-the-job short-term training tends to be most useful when it is directly relevant to the entrepreneur's business problems. In addition, as small firms are often hard-pressed to release key individuals who could benefit most from training, courses which are most effective tend to be short and followed up by on-site visits.

As SMRE requires a significant percent of skilled laborers, formal preparatory vocational training can contribute to the development of a more skilled labor force. In most countries, such training is accomplished through apprenticeships or the like which, although effective in transmitting skills, may perpetuate inefficient practices. Courses attuned to local employment opportunities can equip students with new or improved skills and thereby improve the performance of SMRE.<sup>8</sup>

2. **Research Services:** Techno-economic services, which are often included within one or more existing government or private institutions, often include economic research such as general statistics by industry, market surveys, and industry feasibility studies, and technical research on production processes and appropriate/modern technology. As the objective of such services is to provide the necessary knowledge for the entrepreneur to make well-informed business decisions and the government to improve policy affecting that entrepreneur, the research services must be closely attuned to the needs of the country's SMRE. It is therefore important to establish effective communication between organizations such as extension services which are familiar with the specific needs of target industries and which can assist in disseminating relevant information.<sup>9</sup> Some research services which have been included within organizations with wider responsibilities have suffered due to low priority relative to other tasks.

3. **Advisory Services:** Managerial and technical advice in all critical areas, i.e., marketing, production, accounting, management, and finance, is usually offered through a variety of mechanisms. In some programs, the government develops and supports an extension service within an existing body such as the Department of Industry. Unfortunately, government bodies have frequently been unable to recruit and retain highly qualified agents; civil service regulations limit the salaries and promotional opportunities, and those with real business acumen usually go into business themselves. In addition, many governments have been slow in

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<sup>8</sup>IBRD, "Non-Farm Employment," p. 64.

<sup>9</sup>UNIDO, *Op. Cit.*, pp. 9, 21.

committing adequate resources to technical assistance agencies, thereby seriously handicapping their ability to service SMRE entrepreneurs.

To get around these problems, some programs have assisted in developing and/or funding both non-profit and profit organizations which provide T. A. alone or in combination with other services. For example, T. A. services have been included as part of the function of credit institutions. This arrangement can increase the incentives for the consulting group to provide useful and effective services so as to improve the probability of being repaid, but it can also reduce the credit institutions' objectivity in reviewing loan applications.

Whether public or private institutions provide the assistance, rural industry is not always eager to make use of it. There is frequently a "lack of education, personal hostility to the source (e.g., distrust of a government agent), resistance to the extension method, cultural resistance to innovation, or a lack of (necessary) complementary resources."<sup>10</sup> To ensure that services are adequately utilized, the project should be designed to minimize these difficulties. For example, T. A. could be oriented towards newer industries which tend to be more receptive to outside advice, or credit components could be available to businesses which decide to use the technical knowledge provided but need additional funding to do so.

When the difficulties in encouraging rural industry to use T. A. services have been minimized, those services which are specifically tailored to the entrepreneur's operations can be extremely useful in identifying and solving specific constraints. Some of the more useful T. A. programs have been implemented by larger firms dependent on the small supplier (see sub-contracting).

4. Credit Programs: Rural entrepreneurs frequently identify credit as their primary problem. Although in many cases, credit is a major constraint, it is often only symptomatic of more fundamental problems. Consequently, programs offering credit along are often not effective in addressing the major constraints to the development of SMRE. Hence, though credit needs clearly need to be addressed, other factors should also be reviewed and perhaps included as project components.

Facilitating the flow of credit is a multifaceted problem. If efforts to change policy or improve capabilities of SMRE entrepreneurs are successful, those enterprises may become more attractive customers for private commercial/development banks.

Macropolicies in particular have a significant, if not the dominant, influence on lending activities. One of the first steps should be to ensure that such policies do not discriminate against the smaller, labor-intensive enterprises. Any government intervention should support credit and other resource allocation in the direction of true scarcity, though identifying the critical variables to achieve this end has proven difficult.<sup>11</sup> (In general, the countries which

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<sup>10</sup>J. E. Stepanek, *Small Industry Advisory Services*, p. 16.

<sup>11</sup>A. S. Bhalla, "Lessons from the Case Studies," *Technology and Employment in Industry*, p. 319.

have shown the most rapid increase in manufacturing output have been those which have adopted prices for capital and labor reflecting their relative scarcity.<sup>12</sup>

A more direct approach includes providing concessional loan funds for long term and working capital which allow sufficient spread to cover increased administrative costs, loan defaults, and even T.A. The Latin American Agribusiness Development Corporation (LAAD) is one example of a recipient of such funds. A loan to Peru beginning FY'77 is another. These funds can provide the lending institution valuable experience in lending to a group of new customers, can assist in getting certain rural enterprises started, and can provide the badly needed working and long term capital often needed in the rural sector of capital-short economies.

Provision of such funds, however, may represent only short term solutions; unless the costs and risks in lending to SMRE are reduced, the lending institutions may not be able to maintain a viable SMRE program once concessional funds are no longer available.

Another direct approach is development of guarantee schemes to make the higher risks more acceptable to lending institutions and to encourage those institutions to ease their collateral requirements. Experience indicates that such schemes should minimize the time and effort involved for credit institutions to obtain government guarantees. While guarantees can reduce risk, however, alone they do not always provide adequate incentive for private lenders to get involved in a new and still relatively unattractive area of lending. Also, if not carefully designed, they can result in a costly review process at two levels, the lending institution and the government body providing the guarantee.

Another approach is improving the capabilities of lending institutions which express reluctance to move into this area because of a lack of trained personnel. T.A. can be directed toward developing bankers' skills in credit analysis, monitoring, and packaging to enable them to deal effectively with smaller, rural customers.

In countries where banking facilities are not situated so as to have direct contact with potential SMRE customers, other mechanisms are sometimes employed to identify customers and establish contact between the borrower and lender. (See AID-supported Nigeria project, for example, page 22). In addition, policy or government controlled incentives can be used to encourage movement of lending enterprises to rural areas.

5. Facilitating Procurement of Raw Materials/Equipment: Facilitating procurement of raw materials/equipment can involve several approaches. First, basic policies affecting the scarcity of goods—e.g., those related to inflation, foreign exchange, or capital formation, should be reviewed to avoid any unnecessary shortages. Second, concerted efforts to improve the efficiency and effectiveness of the purchasing and distribution system must be made. Increased availability of information on supply and demand conditions can minimize the vulnerability of smaller rural entrepreneurs. Specific training in inventory planning and control can improve distributors' and entrepreneurs' performance. Efforts can be made to encourage enough independent distributors to minimize monopoly control of supply channels, though care must be given to avoid fragmenting distribution functions that require a minimum scale for efficiency.

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<sup>12</sup>E. Owens and R. Shaw, *Development Reconsidered*, p. 109.

Also, purchasing organizations (e.g., cooperatives) can be formed to allow for the economies of bulk purchases. Such organizations, however, should not be regarded as panaceas; they will not remedy problems resulting from poor distribution or scarcity.<sup>13</sup> Also, a cooperative type arrangement may have difficulties attracting trained managers.

Medium-scale operations relying on small suppliers in particular can improve raw material purchasing through establishing incentives for a steady, adequate supply of material. Contracts, for instance, allow greater price stability to both supplier and purchaser and offer an assured market to the supplier, thereby encouraging his participation.

6. Marketing Aids: Aside from training and advisory services directed toward improved marketing, other approaches include improving the flow of market information, strengthening associations, and/or providing government or cooperative outlets for goods.

Better market information has often been included as part of the research service function. The government can perform market analyses or compile trade directories. In addition, efforts to encourage industrial associations or private firms to adopt such responsibilities can also be undertaken.<sup>14</sup>

Publicly-owned outlets have frequently been established to purchase exclusively from small and/or rural firms. Many such efforts have met with substantial difficulties due to poor planning and/or to the nature of most government operations. Government operated outlets tend to be less able to make business decisions quickly and to provide incentives to managers to ensure aggressive selling.<sup>15</sup> However, in state run economies or where the government takes on this responsibility, the approach could be one of providing management, T. A. and/or training.

Another approach, which can be somewhat similar to subcontracting, includes facilitating cooperation between small and large firms. Large wholesale or retail operations can provide valuable market information and outlets for small firms and often provide T. A. and credit. Information exchange through clearinghouses or other means can enable firms with complementary needs to identify one another.

7. Sub-contracting: Sub-contracting is generally used to refer to a relationship between large and small industries where the smaller firms manufacture parts and components or perform processing and finishing operations needed by larger firms. Information exchanges on the needs of larger industries and the specific capabilities of SMRE facilitates development of these mutually beneficial relationships. Usual mechanisms include development of clearinghouses or utilization of T. A. agencies as information conduits.<sup>16</sup> A large firm usually chooses to sub-contract when it is uneconomical for it to perform the function itself (e.g., the volume

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<sup>13</sup>Staley and Morse, *Op. cit.*, pp. 379-381.

<sup>14</sup>*Ibid.*, p. 381.

<sup>15</sup>*Ibid.*

<sup>16</sup>*Ibid.*

demanded for a specific part does not justify purchase and operation of necessary equipment) or when government legislation prohibits its operation in specific areas.

To establish a viable relationship, the smaller supplier must operate efficiently and produce goods of reasonable quality. In many sub-contracting relationships, the larger firm provides some technical and managerial assistance, which can be highly effective due to its specific nature, and may provide credit.

Sub-contracting relationships can offer the small firm a more secure outlet and can significantly improve access to marketing information, thereby allowing increased responsiveness. As overdependence on one purchaser reduces the small firm's flexibility and limits control over price and related factors, the smaller enterprise must evaluate the risks and returns for itself.

In India, some recent evidence appears to indicate that the smaller firms have found government efforts to improve information on sub-contracting possibilities the most useful component in the small industry program. Given that the larger private firms can provide product specific assistance and have a financial stake in ensuring their supply is adequate and of high quality, it is reasonable to expect that smaller firms may benefit more from improved commercial contacts than most other forms of assistance.

#### Specific Examples of Past Efforts

A.I.D. and other donors have had some experience in supporting projects to assist SMRE. Much of that experience highlights the difficulties in designing effective projects. Following is a description of projects representative of general past A.I.D. approaches and, to the extent available, an evaluation of the results.

1. Support of Technical Assistance Centers: "Indigenous Industrial Development," 620-714 (Nigeria, FY'62-71—\$3,376,000 grant). Objective: To develop small and medium scale indigenous industries. Means: Financial and technical assistance to Industrial Development Centers (I.D.C.'s) which were to:

- a. Provide technical and management assistance to small entrepreneurs through on-the-job counseling and short seminars.
- b. Prepare feasibility studies for credit institutions.
- c. Train indigenous staff to assume responsibility for continuing an effective program after USAID support was terminated.

The project was evaluated in 1972 as having been fairly successful; the evaluation stated that many entrepreneurs had made use of the centers and had obtained financing as a result of the IDCs' assistance. The reasons cited for the success of IDCs were the centers' specialization in five industries, the design of course content around *specific* needs identified by entrepreneurs and IDC field teams, as well as the post-seminar follow-up visits, and the coupling of IDC activities with credit availability offered through separate institutions.

In contrast, Uma Lele in *The Design of Rural Development* argues that the project was not especially successful. Rather than a focused program offering adequate on-site follow-up, she points out that the centers were too wide-ranging in industries covered (e.g., auto repairing

to leather working) and that on-the-spot technical assistance was not adequately provided. In addition, the businessmen who were able—with considerable difficulty—to attend the one week seminars found them either too general or not especially relevant. Many of these problems have been attributed to the shortage of trained staff.

In addition, Lele implies that the program was developed without there being adequate underlying demand; “it is only where rural enterprises enjoy a buoyant demand for their services that increase in their profitability can occur.”<sup>17</sup>

2. Financial Assistance Through Existing Institutions: “Small Business-Earthquake Zone in Peru,” (Peru, FY’72-75 \$2,446,152 loan). Objective: Credit to small and medium enterprises located in the post-earthquake area in order to:

- a. Re-establish and develop local industry and commerce
- b. Stimulate production of goods and provision of services
- c. Generate employment opportunities, and
- d. Stimulate private initiative.

Means: Financial, technical and administrative support to establish and operate a fund in the Central Reserve Bank of Peru. \$50,000 was included for T.A., including the preparation of the credit manual, training, and project promotion. The balance was intended to allow for financing of sub-projects identified/studied by the implementing agency and local financial institutions. The financial intermediaries and borrower had to provide some of the counterpart financing.

Evaluation (Loan Completion Report): A total of 202 short and medium term loans were made over the life of the project at an average cost of \$3,159 per job created. Although several loans were made, the project did run into several difficulties. The major problems cited include: 1) Sub-projects did not receive necessary T.A. or supervision during implementation and hence required additional supervision after disbursement. The primary reasons for this were the lack of commercial incentive in the original project for financial institutions to ensure sound investment and repayment, and an ambiguous allocation of responsibility for sub-project supervision between financial agents and ORDEZA, the government agency responsible for T.A. and credit review. 2) Institutional impact was short-lived as the financial institutions did not have any incentive to continue with the program once concessional funds were initially disbursed. 3) ORDEZA suffered from a conflict of interest due to involvement in both technical design and credit approvals. 4) Uneven GOP support was provided due to a budget crunch in 1974 and 1975. And 5) ORDEZA did not adequately utilize the available funds for T.A.

3. Financial and Technical Assistance Through Specialized Institution: “LAAD Agribusiness Development,” 596-011 (Central America, FY’72-75, \$6mm loan); and 596-015 (FY’75-78, \$5 mm loan). Objectives of first loan:

- a. To support and substantially augment the capabilities of a unique regional private sector effort to deal with Central American agribusiness as a total interrelated process, with the emphasis on the promotion of non-traditional exports.

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<sup>17</sup>Uma Lele, *The Design of Rural Development*, p. 166.

b. To contribute to the development of a capital market in Central America as a continuing source of financing for agricultural development. Means: 1) Use of AID and other funds to promote and finance agro-industrial enterprises; 2) use of shareholders' (U.S. Agribusiness companies) services and AID funds to provide technical assistance and feasibility studies for sub-projects; and 3) investment in and resale of sub-projects' equity.

Objectives of the second loan:

a. To continue support of private agribusiness sector with increased support for participation of the rural poor.

b. To develop LAAD into a self-sustaining financial operation based on commercially available capital. Means: The first and second means employed in the first loan were to continue with increased emphasis on labor-intensive sub-projects with strong backward linkages, as required under the Congressional mandate, which was introduced after the first loan. The third means, development of the capital market, was de-emphasized as LAAD had not been able to sell its equity easily and the AID requirement that LAAD had to lend two-thirds of its loan funds for long term financing with equity features had caused it to become "unnecessarily involved" in very high risk businesses.

Evaluation: An evaluation presented by Checchi and Company on November 23, 1977, states that LAAD has been successful in encouraging the development of non-traditional exports and that small farmers have benefited from assured markets for higher value crops and greater price stability when processing plants have entered into contracts with them. Similar to experience in many small industry projects where those entrepreneurs most receptive are already in business, many farmers who have been most receptive to new product and marketing techniques have been those already active in commercial agriculture.

In terms of direct employment generated, LAAD's sub-projects appear capital intensive with the average cost per job at \$16,393. The capital intensive operations are judged necessary to manufacture products competitive in the international market. Indirect employment generated—i.e., small farmers involved in production—is estimated to be substantial and may offset the high cost per job of the plants themselves. Unfortunately, the evaluators were not able to estimate the indirect impact with any sense of confidence. The technical assistance offered by processing plant employees to small farmers in particular appears to have been quite effective due to its product-specific nature.

Checchi concludes that LAAD's financial viability is tentative; without further concessional financing and/or significant equity capital, it appears that LAAD may have to abandon its financing of non-traditional businesses in favor of less risky and hence less costly customers. As borrowing on the commercial market would be too costly and additional equity may be difficult to obtain without an improved earnings record, which does not appear feasible without additional funds, LAAD's earnings, Checchi estimates, will reach at best a plateau in FY'78.

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