The Private Sector Connection to Development

by

Carl Liedholm

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Carl K. Eicher, Carl Liedholm, and Michael T. Weber
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It is a pleasure and privilege to appear this morning before the Sub-Committee on International Development Institutions and Finance to comment on The Private Sector Connection to Development. I should like to focus my remarks primarily on the issue of what types of private sector activities should be fostered, giving particular attention to the role played by small scale private enterprises in development.

International donor agencies and the governments of many developing countries have become increasingly aware in recent years of the important role that small scale private enterprises can play in providing productive employment and earnings opportunities. President Reagan's praise of the small scale entrepreneur in his recent St. John's University speech (March 29, 1985) and USAID Administrator McPherson's stress on the private enterprise "pillar" coupled with his recent statements on the importance of mobilizing an "LDC Entrepreneurial Revolution" indicate that such a focus is a paramount concern of U.S. policymakers as well.

Yet, until recently relatively little has been known about small private firms in most developing countries, particularly those at the lower end of the enterprise size spectrum. Most elude the standard statistical nets and exist unobserved in the underground economy. Consequently, government policymakers and donors charged with formulating policies and projects to foster small scale enterprises have frequently been forced, of necessity, to make decisions unencumbered by information.

Fortunately, several studies have recently been completed that begin to fill in some of the crucial missing pieces of the small enterprise mosaic. Many of these studies were sponsored by USAID's Bureau for Science

and Technology, which in the 1970's demonstrated remarkable prescience by initiating a series of surveys designed to uncover, describe, and analyze small scale industrial enterprises in several developing countries. Some of the key findings of these studies and their policy and project implications for governments and donor agencies will now be briefly examined.

Profile of Small Scale Private Industries

What are the most important characteristics of these elusive small scale industrial enterprises in developing countries? First, small scale firms, which for the purpose of this presentation are defined as those establishments with fewer than fifty workers, form a significant component of the industrial sectors of most developing countries. Not only are most of these establishments small, they also account for the vast bulk of industrial employment (see exhibit 1). They are generally engaged in the production of light consumer goods, primarily related to clothing, furniture, food and drink.

Second, a surprising, yet important finding is that in most developing countries, the vast majority of industrial firms are located in rural areas (i.e., all localities with less than 20,000 inhabitants). These are the private firms that are most frequently invisible. Employment in small rural manufacturing frequently exceeds that generated by all urban industrial firms (see exhibit 2).

Third, the overwhelming majority of the industrial firms are not just small, but are "very small." Indeed, there are a plethora of one person firms and most employ fewer than five persons. (exhibit 3). In terms of

their large numbers and relatively low incomes, they constitute a potentially important target group for policymakers concerned with the low end of the income distribution spectrum.

Fourth, virtually all these small firms are privately owned, mainly organized as sole proprietorships. In many countries, significant numbers of the small industrial entrepreneurs are female (exhibit 4).

Fifth, small scale industrial activity appears to have been increasing in absolute terms in most developing countries. Although systematic information on growth is limited, the available evidence indicates that it has even been growing at a faster rate than large scale industries in some countries. Since small scale industries account for such a large portion of total industrial employment, the absolute increase in employment absorbed by the small scale private sector is substantial in virtually all developing countries.

What are the primary sources of demand for the products of these small enterprises? The primary markets for small firms are local. Consequently, increases in demand for their products are closely linked to increases in income, particularly among rural and low income households. The demands related to agricultural production, both for agricultural inputs and in processing their outputs, are also important and are influenced by the country's agricultural strategy. Export markets for small producers generally play a relatively small role in most developing countries, although for some particular products they can loom large.

Are these small enterprises efficient users of these countries' scarce resources? Most studies indicate that small scale enterprises are

almost always more labor intensive (that is, they generate more employment per unit of capital) than their larger scale counterparts. Since capital and foreign exchange are relatively scarce and labor, particularly unskilled, is abundant, these small scale activities would seem to be most appropriate given most developing country's factor endowments.

A key related issue, however, is whether these same labor intensive small scale firms use the scarce factor, capital, more efficiently than their larger scale counterparts. The data needed to answer this question have generally been weak and the findings of the few existing studies, which usually compare output or value added per unit of capital, have yielded mixed results. New evidence on this issue, however, has recently emerged from a series of detailed industry studies conducted by Michigan State University in collaboration with local scholars in several developing countries. The preliminary findings from these studies, some of which are presented in exhibit 6, indicate that small firms in the specific industries examined consistently generate more output per unit of capital than do their larger scale counterparts.

An even better measure of economic efficiency is the "economic" profit generated per unit of capital, a measure that reflects profits when all inputs including family labor and capital are valued at their opportunity costs. Using this measure, a "marginal" firm would generate a zero rate of economic profit. The findings from the Michigan State studies (exhibit 6) again reveal that the small firms' "economic" profit per unit of capital not only are positive, but are consistently higher than those generated by the larger firms in these industries. These findings, while not

conclusive, do indicate that at least in several lines of activity in many developing countries small scale private industries are economically efficient.

Policy and Project Implications

In light of the many favorable characteristics of small scale portions of the private enterprise spectrum and the potential contribution these enterprises can make to the future growth in income and employment in developing countries, what can governments and donor agencies do to further enhance the role of small scale enterprises?

Two major avenues are available. The first is through seeking changes in the general policy environment that broadly affects small private enterprises, while the second is through the implementation of specific projects designed to provide direct assistance to individual firms. Each of these will be examined in turn.

There are two major ways that the general policy environment can be more supportive of small scale private enterprise in developing countries. The first is through instituting a policy environment that is at least "neutral" with respect to enterprise size. In most developing countries, however, general policies are biased <u>against</u> the smaller firms. Frequently, these biases result from the unintended side effects of investment, trade, credit and other policies that were implemented with the goal of promoting an expansion of large scale, private enterprises. Investment incentive laws frequently formally restrict the special tax concessions to large scale firms, or where such overt restrictions do not occur, small firms are ignorant of the concessions available or are unable

to undertake the protracted bureaucratic procedures required to obtain them.

Trade policies also tend to favor large over small scale enterprises. Foreign trade regimes using rationing systems for imports, coupled with overvaluation of the exchange rate, tend to discriminate against smaller firms since the larger firms are better placed politically and economically to receive the rationed import permits, foreign exchange, and tariff rebates. Even when direct controls are not imposed, the usual structure of import protection, which involves high duties on luxury consumer goods and very low duties on intermediate and capital goods, are frequently biased against small producers. An example should help illuminate this point. In Sierra Leone, large garment producers were covered by the government's industrial incentive and import substitution tariff policies and thus were able to import their machines duty-free; the ubiquitous, small scale tailors, by contrast, found that the sewing machine, their basic capital input, was classified as a luxury consumer good and was taxed accordingly.

The credit policies of most developing countries also have tended to discriminate against the smaller private firms. Governments either explicitly or implicity have imposed on the banking system interest rate ceilings or credit controls that have tended to keep the interest rate artificially low. Faced with excess demand for funds, the banks have generally responded by rationing the scarce funds to their traditional, large scale clients. Consequently, small enterprises have been forced to obtain funds either from family or from the "informal" market, where rates frequently exceed 100% per year. Efforts should be made to remove the

interest rate ceilings as a step towards ensuring that interest rates for borrowers of all sizes more closely approximate the opportunity cost of capital.

In summary, the most important first step in instituting a policy regime supportive of small enterprise growth is to eliminate the existing policy biases against the small private producer. This might be expressed in terms of the need to "level the playing field" so that policies are at least size "neutral"

The second major way that general policies can effectively be used to support small scale private enterprise growth is through enhancing the demand for their products. Most studies have made clear that one of the key constraints facing small enterprises, particularly those located in rural areas, is the limited demand for their products. Since a significant share of the low-cost consumer goods sold in rural markets is produced by small firms in that same area and the demand for these products as well as agricultural inputs is particularly high among the small scale farming households, policies that promote rapid increases in agricultural income provide a powerful stimulus for small scale enterprises. Consequently, agricultural policies such as pricing and other measures aimed at increasing the income of small farmers are important not only in their own right, but also because they can contribute in a major way to the growth of small scale private manufacturing activities. This result also demonstrates that in reviewing the general policy environment for small firms, it is of crucial importance to transcend the traditional sphere of

industrial policy and include agricultural, trade, foreign exchange and other policies as well.

Projects rather than policy reforms, however, have been the primary vehicle used by governments and international donor agencies for fostering small enterprise. Small enterprises, however, are difficult targets to reach through direct project assistance. The firms are numerous, widely dispersed and not easy to assist in a cost-effective manner. Indeed, virtually all small enterprise surveys reveal that only a tiny fraction of the entrepreneurs have heard of the programs intended for them and even fewer have been aided by them. Moreover, these same studies have indicated that the constraints facing these small enterprises and thus the types of direct assistance needed vary from industry to industry and from country to country.

Credit projects have been the most commonly used method of providing direct assistance to small enterprises and are the principal concern of multilateral development banks. Although special credit programs have been designed specifically to reach the small and medium sized firms in several developing countries, the smallest firms generally end up receiving very little of the funds. Moreover, the administrative costs have generally turned out to be quite high.

Several innovative credit schemes, however, appear to have been quite successful in providing financial resources to even the smallest private enterprises (see exhibit 6). What are their common characteristics? First, loans are provided primarily for working capital rather than for the fixed capital that has been the focus of most lending schemes. Second,

loans are screened in locally-based institutions on the basis of the borrower's character. Third, loans are initially made for small amounts and for short periods to encourage and facilitate high repayment rates. Since these lending practices are closely akin to those of the informal credit institutions, it would appear that the nearer banks and other formal institutions can come to the operating procedures of the informal lender, the more likely they are going to be successful in making loans to small private enterprises. Consideration might even be given to providing technical assistance to financial institutions in order to enable them to develop more effective methods of lending to small firms.

Nonfinancial direct assistance to small enterprises involves the delivery of such things as technical, managerial, marketing and infrastructure inputs. It is frequently argued that the small firm's demand for such services is generally quite small and that a large volume of resources end up being concentrated on a relatively limited clientele.

A review of a number of nonfinancial assistance projects, however, reveals that several common characteristics are associated with successful interventions. First, the projects are industry and task specific. Second, the projects address situations where a single "constraint" needs to be overcome by the firm rather than any array of such constraints. An implication of this finding is that projects assisting existing firms are more likely to be successful than those attempting to establish new firms. Third, before the successful projects or schemes are launched, prior surveys of the industry were undertaken to uncover the demand for the activity and the number and type of "constraints." Finally, successful

projects tend to be built on proven existing institutions, even "informal" ones.

When considering the role of the private sector in development, it is imperative that the small end of enterprise size spectrum not be overlooked. The accumulating evidence, in fact, indicates that small is indeed beautiful. With judicious government policies and more carefully formulated direct assistance measures, the already sizeable contribution of the small scale component of the private sector to the economic growth of developing countries can be even further enhanced.

Exhibit 1

Table 1

Distribution of **Employment** in Manufacturing by Firm Size -- Percentage

Country and date	Per capita Income ($) 1982	Firm Size (number of workers) Large Scale 50 or more engaged	Large Scale 10-49 engaged	Small Scale below 10 engaged
India-1971	$260	38%	20%	42%
Tanzania-1967	$280	37%	7%	56%[a]
Ghana-1970	$360	15%	1%	84%[a]
Kenya-1969	$390	41%	10%	49%[a]
Sierra Leone-1974	$390	5%	5%	90%
Indonesia-1977	$580	16%	7%	77%
Honduras-1979	$660	24%	8%	68%
Thailand-1978	$790	31%	11%	58%[a]
Philippines-1974	$820	29%	5%	66%
Nigeria-1972	$860	15%	26%	59%[a]
Jamaica-1978	$1330	49%	16%	35%
Colombia-1973	$1460	35%	13%	52%
Korea-1975	$1910	53%	7%	40%

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: Africa: computed from Page (1979) and Liedholm and Chuta;
India: Mazumdar (1980);
Indonesia: computed from Snodgrass (1979);
Honduras: Stallmann (1985);
Thailand: World Bank (1983);
Philippines: Anderson and Khambata (1981);
Jamaica: Fisseha (1982);
Colombia: Berry and Pinell-Siles (1979);
Korea: Ho (1980).

Source: Carl Liedholm and Donald Mead, "Small Scale Enterprises in Developing Countries: A Review of the State of the Art," MSU International Development Papers, East Lansing, Michigan (forthcoming).

Exhibit 2

Table 5
Percentage of Manufacturing (Large and Small Scale) Employment
In "Rural Areas"

Sierra Leone[a] -- 1976	86
Indonesia[b] -- 1976	80
Sri Lanka[c] --1971	75
Jamaica[a] -- 1980	74
Bangladesh[d] -- 1974	68
Philippines[e] -- 1976	61
India[a] -- 1967	57
Pakistan[f] -- 1975	52
Taiwan[g] -- 1976	49
Malaysia[a] -- 1970	46
Korea[f] -- 1975	30

Note: rural defined as all localities under 20,000 inhabitants.

Sources:
[a] Chuta and Liedholm (1979)
[b] Snodgrass (1979), p. 32
[c] Sethuraman (1978), p. 62
[d] BIDS (1981), p. 63
[e] Anderson and Khambata (1981), p. 92
[f] Amjad (1984), p. 18; rural defined as localities under 5000 inhabitants
[g] Ho (1980), p. 21

Source: **Carl Liedholm and Donald Mead, "Small Scale Enterprises in Developing Countries: A Review of the State of the Art," MSU International Development Papers, East Lansing, Michigan (forthcoming).**

Table 6
Distribution of Small Scale Manufacturing Establishments by Size

-- Percentage --

Size (Number of Persons)	Bangladesh	India		Sierra Leone	Indonesia	Honduras	Egypt	Jamaica
	11 Thanas	Punjab Rural	Haryana Rural	All	All	3 Rural Provinces	2 Rural Governorates	All
	1980	1971	1971	1976	1974	1980	1982	1979
1	15	65	52	42	66	60	63	62
2 - 5	69	32	38	53	30	35	34	32
6 - 9	12	2	2	4	2	4	2	4
10 - 50	4	1	3	1	2	1	11	2

Source: MSU Country Studies plus:

India: computed from Gupta (1984, p. 79); includes "households" plus "establishments"

Indonesia: computed from Snodgrass (1979, pp. 13 and 23); intermediate categories are 2-4 and 5-9

Source: Carl Liedholm and Donald Mead, "Small Scale Enterprises in Developing Countries: A Review of the State of the Art," MSU International Development Papers, East Lansing, Michigan (forthcoming).

Exhibit 3

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Table 7: Ownership of Small Scale Manufacturing Enterprises
-- Percentages --

Country		Public	Sole Proprietorship	Partner-ship	Corpora-tion	Cooperative	Total All	Female Ownership
Africa:	Nigeria [three states]	---	98	1.4	0.2	0.4	100	NA
	Egypt [two governorates]	0.1	99.7	---	---	0.1	100	43
Asia:	Bangladesh [11 Thanas]	---	98.7	1.0	0.2	0.1	100	3.3
	Thailand [rural towns]	---	80.4	16.2	3.4	---	100	37
Latin America:	Honduras [rural provinces]	---	98.7	1.2	0.1	0.3	100	61
	Jamaica [entire country]	---	94.3	4.0	0.7	0.8	100	49

Source: Nigeria: Aluko et al., 1972 and 1973; Egypt: Davies et al., 1984; Bangladesh: BIDS, 1981; Thailand: Naronchi et al., 1983; Honduras: MSU country study, 1980; Jamaica: Fisseha and Davies, 1981.

Source: Carl Liedholm and Donald Mead, "Small Scale Enterprises in Developing Countries: A Review of the State of the Art," MSU International Development Papers, East Lansing, Michigan (forthcoming).

Exhibit 4

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Exhibit 5

Table 13

Capital Productivity and Economic Profits -- Large and Small Scale Enterprises in Africa and Latin America

Country/Enterprise Type	Value Added / Capital Services		Economic Profit[3] / Capital Stock	
	Large[1] Scale	Small[2] Scale	Large Scale	Small Scale
Sierra Leone (1974)				
Clothing	1.7	8.3	-27%	+59%
Bread	1.7	12.4	-11%	+12%
Rice Milling	1.4	57.1	-30%	+80%
Botswana (1982)				
Sorghum Beer	6.2	19.6	+130%	+190%
Egypt (1982)				
Clothing	2.6	8.5	+17%	+42%
Metal Products	1.5	18.5	-3%	+103%
Honduras (1980)				
Clothing	2.5	6.9	-21%	+45%
Furniture	1.9	13.9	-26%	+58%
Shoes	0.9	12.5	-22%	+102%
Leather Products	1.5	10.6	-21%	+79%
Metal Products	1.4	12.1	-24%	+23%
Jamaica (1979)				
Clothing	1.6	10.5	-11%	+86%
Furniture	2.3	13.1	-0.4%	+173%
Shoes	2.3	17.8	-6%	+247%
Metal Products	2.8	6.6	16.9%	+56%

Sources: **Honduras** - small scale: data collected during 1980 survey of 485 rural small scale industries conducted by CDI and MSU; large scale: computed from worksheets of 1975 Industrial Census of Honduras (firms included ranged in size from 50 to 500 employees; **Jamaica** - small scale: data collected during 1979 survey of 197 rural and urban firms conducted by MSU, SEDCO, and University of the West Indies; large scale: 1977 industrial survey conducted by NPA; **Botswana** - Steve Haggblade, "The Shabeen Queen," Ph.D. dissertation, MSU, 1983; **Egypt** - small scale: data collected during 1982 survey of 460 manufacturing enterprises in two governorates, Fayoum and Kalyubiya; large scale: GOFI Investment Approvals, 1976. **Sierra Leone** - C. Liedholm and E. Chuta, The Economics of Rural and Urban Small Scale Industries in Sierra Leone, African Rural Economy Paper #14, 1976.

Notes: [1]Large scale firms are those employing fifty or more workers. [2]Small scale firms are those employing less than fifty workers. [3]In making these calculations, the following have been subtracted from value added: a) capital services valued at shadow interest rate; b. labor costs, including inputs of family workers and proprietors valued at the competitive wage in that industry. A marginal firm or industry would posses economic profits of zero.

Source: Carl Liedholm and Donald Mead, "Small Scale Enterprises in Developing Countries: A Review of the State of the Art," MSU International Development Papers, East Lansing, Michigan (forthcoming).

Table 2: Administrative Costs of Small Enterprise Credit Schemes

Credit Organization	Country	Type	Administrative Cost per Loan	Average Loan Value	Administrative Cost (% of loan)	Arrears (% of loans outstanding)
		A. Credit Only				
Krishi[1]	Bangladesh	Government-owned Commercial Bank	$5.00	$126	4.0	10.5
Agrani[1]	Bangladesh	Government-owned Commercial Bank	$5.27	$101	5.2	4.3
BKK[2]	Indonesia	Government	$2.37	$44.43	5.3	6
Janata[1]	Bangladesh	Government-owned Commercial Bank	$6.60	$125	5.3	14.5
Rupali[1]	Bangladesh	Government-owned Commercial Bank	$7.33	$119	6.2	6.2
F.D.R./Peru[6]	Peru	Development Bank	$531	$5961	9.0	8
Banco de Pacifico[4]	Ecuador	Commercial Bank	$140	$1100	13.0	7.0
D.B. Mauritius[4]	Mauritius	Development Bank	$108	$830	13.0	NA
Uttara[1]	Bangladesh	Government-owned Commercial Bank (cooperative)	$31.27	$122	25.6	12.1
Bank Money Shops[3]	Philippines	Commercial Bank	$197	$687	28.0	NA
SEDCO	Jamaica	Development Bank	$843	$280	275.0	NA
		B. Credit and Technical Assistance				
DDF/Solidarity[6]	Dominican Republic	PVO	$242	$1267	19.1	33
IDH[6]	Honduras	PVO	$561	$1724	32.5	42
DDF/"Micro"	Dominican Republic	PVO	$739	$1680	44.0	42
UNO[7]	Brazil	PVO	$1700	$200	85.0	8
PfP/BF[6]	Burkina Faso	PVO	$1238	$670	185.0	23

Sources: [1]J. Brown (1983); the credit organizations listed (e.g., Krishi) are government-owned commercial banks; [2]S. Goldmark and Rosengard (1983); BKK is the Badan Kredit Kecamatan (the sub-district credit body) program in Central Java; [3]M. Farbman (1981); [4]V. Raghaven and T. Timberg (1982); [5]M. Wilson (1981); SEDCO is the Small Enterprise Development Corporation; [6]P. Kilby and J. D'Zumura (1984); F.D.R./Peru is the Rural Development Fund Program of the Industrial Bank of Peru; DDF/Solidarity is the Solidarity Group component of the Dominican Development Foundation. I.D.H. is the Institute for Honduran Development; PfP/BF is the Partnership for Productivity Project in Burkina Faso; [7]J. Tendler (1983); UNO is Northeast Union of Assistance to Small Business Project.

Source: Carl Liedholm, "Small Scale Enterprise Credit Schemes: Administrative Costs and the Role of Inventory Norms," MSU International Development Working Paper, East Lansing, Michigan, 1985.

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