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Private Sector Development and Poverty Reduction: Experiences from Developing Countries

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Preface

Economic development policies that promote the growth of the private sector and that invest in human capital (i.e. nutrition, health, and education) are effective in breaking the poverty cycle that has been hindering the development of many of the world's poorest countries. The private sector is the major contributor to GDP as it creates employment and thus generates income for the population. Private Sector Development (PSD) requires a value-added intensification in all the activities of the actors involved in the production and market exchange of goods and services. Societies with a greater capability of adding value and creating wealth have experienced economic growth and their poverty levels have been reduced.

Over the last decade much emphasis has been placed on pro-poor growth. Multilateral and bilateral organizations, as well as regional development banks have designed strategies aiming at pro-poor growth. Within the framework of poverty reduction, pro-poor growth addresses income distribution and poverty. The concepts of growth and distribution are not necessarily contradictory and they are certainly not mutually exclusive. However, in reality, development programs must identify the conditions that will allow both components to complement each other.

Over the past few years, there has been an ongoing debate about the key elements of poverty reduction strategies. There is no doubt that poverty reduction has become the main goal of the development efforts. This is evident in the adoption of the Millennium Development Goals (MDG) as a central framework for several international agencies, including the United Nations. In addition to recognizing the MDG, the World Bank Group has also adopted the Poverty Reduction Strategy Papers, prepared by governments through a participatory process involving the civil society and development partners. However, the focus of this debate is on whether such strategies should have a growth bias or whether they must concentrate mainly on empowering the poor to benefit from growth. Does growth exacerbate inequality? Which policies should be at the centre of a poverty reduction strategy?

The majority of donors (i.e. World Bank Group, UNDP) view poverty reduction in a multi-dimensional way, not only as an economic objective, but also taking into account its social dimensions. For example, ILO's principle is that "decent work" should be available for everyone, and this implies that basic conditions like freedom, equity, security and human dignity should also be present. The World Bank directly links the development of the private sector with poverty reduction. Private Sector Development (PSD) contributes to poverty reduction by enhancing competitiveness, which also contributes to growth and creates jobs. Consequently, governments can also make greater investments in the social sectors and infrastructure. The question that remains is whether or not particular PSD interventions by donors are linked with poverty reduction. If donors are active in the field of creating an enabling environment for the private sector or in the field of encouraging investments, does this necessarily mean that doing so they are also considering a contribution to poverty reduction?

This publication attempts to address this question, or rather to provide some answers. We must emphasize that this question is not exhaustively answered; indeed we try to present the experiences of different countries with the implementation of pro-poor growth strategies (PPG) and to bring in new conceptual elements into the pro-poor growth discussion.

The publication is divided into two main sections. In section 1, Utz Dornberger closely examines the PSD strategies of donor organizations and discusses in this context the position of the German development collaboration. A discussion of the role of the informal sector in economic growth processes follows in Ute Rietdorf's article. She discusses in particular the question of a contextual alignment of strategies and the direct promotion of the informal sector. Ingrid Fromm highlights the importance of the institutional level as a key element in PSD strategy implementation. Institutions and policies play a vital role in promoting SMEs and reducing poverty.

In section 2 of this publication, the successes and failures of PSD and pro-poor growth strategies are discussed on the example of four countries (Nepal, Kenya, Bolivia and China). All four articles compare the implementation of national PSD and/or PPG strategies. Victor Cladera's article examines the problems of the Bolivian government with the implementation of a Poverty Reduction Strategy which included the private sector, and he discusses the results after the first three years of implementation. In his article, Binod Shresta asks whether poverty in Nepal can be reduced through the implementation of a national SME promotion strategy and he introduces some ideas for new promotion instruments for rural micro and small enterprises. On the example of Kenya, David Cheloti emphasizes hat the promotion of micro and small enterprises in particular makes a visible contribution to poverty reduction and he discusses the current PPG strategy. In the final example, Zhenjing Li discusses the importance of SMEs in the successful fight against poverty in China, pointing out the essential elements of the SME promotion policies.

The final article of this publication analyzes the position of the German PSD strategies in strengthening and promoting business linkages between the informal and formal sector in developing countries. At the same time Utz Dornberger discusses starting points for new promotion strategies.

The contributions are a result of the First International SEPneT Workshop "International Comparisons on Private Sector Development Strategies" which took place from Nov. 6 – 10, 2004 in Haikou, China. We would like to thank the German Academic Exchange Service (DAAD) and the German Technical Cooperation Agency (GTZ) for their financial and organizational support. We would also like to thank Dr. Michael Nebelung for his support during the organizational phase of the workshop. Our most sincere gratitude goes to Ms. Xiuhua Zeng for a perfect organization of the event both before and during the workshop.

Leipzig, May 20, 2005

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Pro-Growth and Pro-Poor Growth Approaches in Private Sector Development Strategies

Utz Dornberger

1. Introduction

Private sector development strategies (PSD) in most international organizations, especially international development banks, have focused at the private sector modernization (upgrading, adoption of international standards for quality, export orientation, technology transfer and knowledge spillovers) as a decisive tool for economic growth in developing countries. Their argument concentrates on the fact that in the last 50 years only the developing countries that exposed their private sector to widespread modernization and international competition have been able to achieve higher growth rates. In addition, the long-term national economic growth appears to be a crucial basic condition for extensive and lasting poverty reduction. It is therefore not surprising that e.g. the Asian Development Bank defends this position strongly, since Southeast Asia has a number of successful examples of economic catching up processes.[1]

Critics of this strategy acknowledge the connection between economic growth and poverty reduction but argue that only very long-term economic growth (15 years and more) has a positive effect on poverty reduction. Countries like China or Chile are typical examples. Short-term economic growth in some countries even increased the gap between rich and poor because the marginalized social strata of the population did not profit from this growth. This means that the Millennium Development Goals (cutting poverty in half by 2015) cannot be achieved by economic growth alone, and that interventions are therefore necessary on the micro and small business level of the formal and informal sector to bring about positive effects in fighting poverty. In other words, international donor organizations should concentrate their support on the poorest of the poor, promoting above all activities in the rural sector (i.e. agriculture) and the urban informal sector.[2]

The present article recapitulates the substantial arguments of the different approaches in the Private Sector Development Strategy. It introduces the strategies of different international

[1] ADB, 2000.
[2] For a review see Klasen, 2003.

organizations regarding Private Sector Development reviewing their similarities as well as their differences.

2. Argumentation of Pro-Growth Advocates

As a typical advocate of the Pro-Growth-Strategies, the Asian Development Bank argues that economic growth, based on a persistent development of the private sector, is the most important "weapon" in the battle against poverty. The modernization of the private sector and its integration in the global market are seen as decisive prerequisites for economic growth. Only long-term growth can generate the necessary jobs for providing poor people a regularly income.

Data from several developing regions illustrate that the poverty incidence at any point in time is largely a reflection of a country's previous economic growth performance (see Box 1). This important relationship between poverty reduction and growth is clearly exemplified by experiences of developing countries in Asia. In East Asia, for example, the poverty incidence decreased after the growth acceleration in the 1980s and early 1990s. By contrast, poverty in Latin America and Sub-Saharan Africa during the same period increased, due to slight or partially negative economic growth. On an empirical level, a clear connection between economic growth and poverty reduction is present. The basic question is to which extent, the poor population can profit from the economic growth of a country or region. Most economic growth has not been explicitly pro-poor, providing all income groups with a roughly proportionate income increase so that the overall inequality was not reduced.[3]

The East Asian region is an interesting example of how in some countries growth lead to a poverty decline, despite an intensification of the income inequality. In Vietnam for example, poverty was significantly reduced due to a strong economic growth between 1993 and 1998. However, this situation did not prevent an increase of the inequality in the income distribution. In other Asian cases, such as in Thailand between 1975 and 1986 or in China from 1985 to 1990, the socioeconomic gap between poor and rich people was even increased in spite of economic growth. The ideal cases were registered in Malaysia (1973–1989) and Indonesia (1978–1984), where the growth and distributional effects reinforced each other and led to an even stronger impact on poverty reduction.[4]

[3] Chen & Ravallion, 2004.
[4] ADB, 2000.

Box 1: Empirical Data Explaining the Connection between Economic Growth and Poverty Reduction.

Differences in economic growth rates between the different regions of the world, and even between developing countries, can clearly illustrate the differences in poverty rates. The poverty incidence (number of individuals who have to live on less than US$ 2 per day) in Eastern Asia decreased significantly from 68% to 47% and the number of poor people was reduced from 1.028 to 864 millions between 1987 and 2001. The reason for this was a strong economic growth connected to an increase in the per-capita income of an annual average of 6% during the 1980's and early 1990's. The much weaker increase in per-capita income of 3% per year in Southeast Asia caused a decline of the poverty incidence from 87% in 1987 to 77% in 2001, although the number of poor people rose from 911 to 1.064 million.

The poverty incidence decreased slightly in Latin America and the Caribbean from 28% in 1987 to 25% in 2001 and the number of poor people increased from 115 to 118 million, because of the stagnating economic development during the 1980's and 1990's. In Sub-Saharan Africa the poverty incidence remained on a high level of 76%; while the number of poor people increased from 355 to 516 millions between 1987 and 2001.

In principle, high growth rates of any kind could be turned into a pro-poor strategy if progressive taxation and targeted government spending on the poor were taken into account. Governments spending on the poor could either promote their inclusion to benefit from economic growth and hence improve the direct linkages between growth and poverty reduction, or it could simply provide transfer payments to the poor people via a "safety net", the volume of which could increase with the increase of the economic growth. The first type of government spending is clearly preferable to the latter, although some kind of "safety net" would be important for the poor as it can indeed ensure that they directly benefit from economic growth by allowing them to take greater risks and thus reap higher rewards.[5]

It is important to note that the extent to which growth can be pro-poor also depends greatly on the amount of human capital among the poor. Empirical studies have shown that growth is highly contingent on the state of human capital in a country. Thus, countries with a sufficient amount of human capital have higher growth rates in all areas.[6] It must be emphasized that in fact all these indirect mechanisms, which present potentially important elements of pro-poor growth, are in fact contingent on a policy process that actually affects such redistribution. It is impossible to exploit these opportunities if such a policy process is

[5] World Bank, 2000a; World Bank, 2000b.
[6] e.g. Mankiw, Roemer, and Weil, 1992.

absent or lacking in the necessary political resolve. The indirect strategies mentioned are not automatic, but depend on contentious distributional battles over the resources generated by growth.

3. Argumentation of the Pro-Poor Growth (PPG) Strategies Advocates

The critics of pro-growth schemes do not doubt the empirical connection between an integration of the private sector in the international economy, economic growth and the reduction of poverty. They emphasize, however, that for pro-poor growth (PPG) to be effective, the poor must benefit more from growth than the non-poor, in other words, that the income growth rate of the poor is greater than that of the non-poor.[7]

For a direct improvement of the situation of poor populations, the strategies must be targeted towards sectors in which the poor people and their principal production factors (labor and land) predominate. Therefore, a PPG policy must concentrate on an increase of agricultural productivity matched by a respective income increase, an integration of the unemployed in the growing sectors and on the promotion of independent income-generating activities. The assumption is, however, that not all rural poor will be able to find employment. The resulting migration to the urban centers should therefore be supported by corresponding integration measures in the labor markets.

A promotion strategy that empowers the poor by focusing on basic education and health – which certainly contribute to higher productivity levels – cannot produce fast poverty reduction effects. Higher schooling rates and an increase in the number of years spent at school will not automatically reduce poverty since better primary education does not as such guarantee employment. Enabling the poor to increase their human capital in order to have fair opportunities in labor markets, however, can facilitate successful PPG. The PPG strategy advocates emphasize that this is the most sustainable way of poverty reduction.

Though advocates of an economic growth strategy also see the need of achieving PPG by financing health and social security systems, a stronger, direct promotion of production factors in the poor population is clearly more important. The most significant production factor for the poor people in rural areas and in the informal sector of urban areas is their low-priced and unskilled labor. It is discussed that the demand for unskilled labor continues to decrease in almost all countries and that the price of agricultural products is in continuous decline in the world markets. Prioritizing the support of the agricultural and urban informal

[7] see Klasen, 2003 for a comprehensive summary.

sectors means supporting areas with slight productivity and growth potential, thus cementing the structural weaknesses of a region or country. The structural changes which are necessary for economic growth (e.g. the shift from labor-intensive to knowledge-intensive industrial sectors) are chiefly driven by non-poor, urban population groups who work or manage innovative and dynamic medium-sized and big companies employing new technologies, to bring their productivity to international standards. Their contribution is of vital importance for economic growth. Focusing on the poor population instead would lead to a promotion of less innovative social groups – a strategy which ultimately cannot achieve the expected growth effects.[8]

4. Comparison of the PSD Strategies of International Donor Organizations

This section focuses on the evaluation of strategy papers of 16 regional banks, bilateral donors and multilateral institutions that are actively dealing with the problem of the interrelation between PSD and poverty alleviation. It is important to note that the arguments presented above are also reflected in the strategic orientation of the PSD activities of bilateral and multilateral donor organizations.

All these organizations attach particular importance to enhancing the macroeconomic conditions of a country or region by addressing issues such as market failures as source of non-sustainable growth, legal uncertainty, unhealthy investment climate, unprotected intellectual property, as well as low market liberalization. Moreover, they consider deficient institutional environments (lack of transparency, rent-seeking, corruption, insufficiency of human capital, weak infrastructure) as posing a barrier for growth and they recognize that difficulties in accessing to the financial services present a major obstacle for the private sector. Summarizing, it can be said that all PSD strategies analyzed here consider an abolishment of macroeconomic distortions and an improvement of the institutional environment as fundamental conditions for economic growth and for a dynamic development of the private sector.

All donor organizations agree that growth can only be reached through further development of the private sector, leading to higher employment rates and better income. This indicates that all of these organizations determine that an explicit relationship exists between PSD and poverty alleviation. The PSD strategies come to different conclusions, however, as regards the question of whether the application of a growth strategy or of a

[8] Altenburg, 2004.

pro-poor growth strategy can effectively reduce poverty. Table 1 summarizes the strategic orientation of each organization.

Table 1: PSD-Strategies listed by Organization

PSD Strategy	Organization	Key Elements of the PSD Strategy*
Pro-Poor	UNDP	▪ Direct promotion of the informal sector ▪ Boosting growth should be originated through cooperation with local institutions and NGOs in form of PPP (e.g. telecommunication, electricity, water supply) or through the promotion of linkages between big and small enterprises.
	ILO	▪ Goal-oriented creation of employment by focusing on promotion of informal sector and SMEs ▪ Focus on developing of managerial competence, increasing productivity and improving workers' rights. ▪ Promotion of the informal-sector development
	USAID	▪ Microfinance ▪ Promotion of capacity building in micro-companies ▪ Cluster promotion for SMEs
Pro-Growth (Trickle-down)	IFC	▪ Financial system development in cooperation with the private sector ▪ Financial instruments for SMEs
	UNCTAD	▪ Promotion of foreign direct investments (FDI) ▪ Capacity building for the application of new technologies ▪ Promotion of integration into international markets
	OECD	▪ Promotion of private investments ▪ Market development
	African Development Bank	▪ Consecution of a competitive technical and social infrastructure through PPP ▪ Strengthening the financial system ▪ Trade promotion and market liberalization
	Asian Development Bank	▪ Reinforcement of the financial system and promotion of private investments ▪ Consecution of a competitive technical and social infrastructure through PPP
	World Bank	▪ Consecution of a competitive technical and social infrastructure through PPP
	ASEAN	▪ Capacity building in SME sectors
Combination of both Strategies	CIDA	▪ Support for upgrading process in the informal sector (Enterprise expansion) ▪ Promotion of SME integration into regional and international markets.
	DFID	▪ Promotion of SMEs and micro-enterprises through financial services (micro-credit) and allocation of Business Development Services (BDS). ▪ Cluster promotion
	UNIDO	▪ Promotion of the growth and up-grading of micro-companies and SME ▪ Development of clusters and networks ▪ Promotion of SME integration into value chains
	SIDA	▪ Promotion of micro-enterprise growth and upgrading ▪ Promotion of financial services for the private sector (microfinance)
	IADB	▪ Promotion of the upgrading of public infrastructure and allocation of financial instruments for the private sector ▪ Infrastructure and financial services for small enterprises

* Since all organizations consider the improvement of the macroeconomic conditions as crucial, this element is not explicitly mentioned in this table.

The chart above shows that the majority of the multilateral organizations prefer a *trickle-down* approach. Consequently, their focus is on economic growth which may be supported by different activities in the private sector. The economic growth is considered as crucial for generating employment and improving a country's taxation conditions. Ultimately, both effects are seen as leading to poverty reduction (see Box 2).

Box 2: Link between PSD and poverty reduction according to the ADB

"It is widely accepted that the private sector is needed and better suited for sustaining rapid growth. And the Asian experience shows that growth is the most powerful weapon in the fight against poverty. Growth creates jobs that use labor, the main asset of the poor. As growth proceeds, private sector employment becomes the major source of economic support for the majority of workers and their families. Thus, improving labor market operations is an important element of strategies to promote pro-poor growth and reduce poverty. It also helps allocate a country's human capital resources to their most productive uses, enhancing general economic welfare, and encouraging further growth and development. Well-designed labor market policies help societies make growth more equitable by smoothing income fluctuations and broadening access to human capital development and employment opportunities. However, it is also important to recognize the linkages across factor markets (labor, capital, and land). Thus, an integrated approach to the removal of distortions in different factor markets is essential for sustained success in the fight against poverty.

Growth also increases the tax base that enables government, acting on good governance principles, to finance labor market programs and provide basic social services. Health and education services, in particular, give the poor a better chance to increase their productivity and earning capacity. Transparency and accountability in government are crucial to ensure that such social expenditures are effective and can reach the poor."

In addition to this group of pro-growth advocates there is a number of bilateral donor organizations such as DFID, CIDA and SIDA and multilateral institutions, such as UNIDO and IADB, which also emphasize the necessity of promoting modern industrial sectors to achieve growth and generate income but which additionally emphasize the need for direct intervention in the rural and/or urban informal sectors. They share the notion that direct intervention can free upgrading potentials and growth possibilities for micro and small enterprises. The IADB argues that (IADB, 2004):

"However, economic growth alone may not suffice to raise the living standards of the poor in the absence of complementary and effective poverty reduction programs. Opportunities for achieving social inclusion and equity are also necessary to create the stability needed for sustained growth. Economic and social development policies should promote sustainable growth, and include activities targeted to the poorest segments of the population. Some targeted interventions that favor the poor include investments in human capital and infrastructure, and improved access to financing. Targeted actions to enhance the capacities of the poor are required to encourage stronger economic growth."

The problems and challenges in the informal sector are discussed in many strategy papers; however there are only a few organizations (USAID, UNDP, ILO) that suggest direct promotion measures for strengthening this sector. A representative of this group the USAID (2003) emphasizes that:

"One very promising avenue to boost the incomes of tens of millions of poor households around the world is to break their economic isolation – by linking them to the formal financial sector, and by linking their micro-enterprises to higher-value markets, better technologies, and essential information and knowledge."

5. Conclusions for the PSD Strategy of German Donor Organizations

In their discussion of the pro-growth strategy of the German donor organizations, Altenburg and Stamm (2004) suggest the following priority measures:

- Boosting foreign direct investment with effects contributing to national gain
- Promotion of new business ideas
- Promotion of spillovers between large, medium and small enterprises, or value chains
- Provision of financing instruments for enterprises with growth potential (i.e. venture capital)
- Reform of the education and research systems, to support economic orientation and to improve education opportunities for the poor

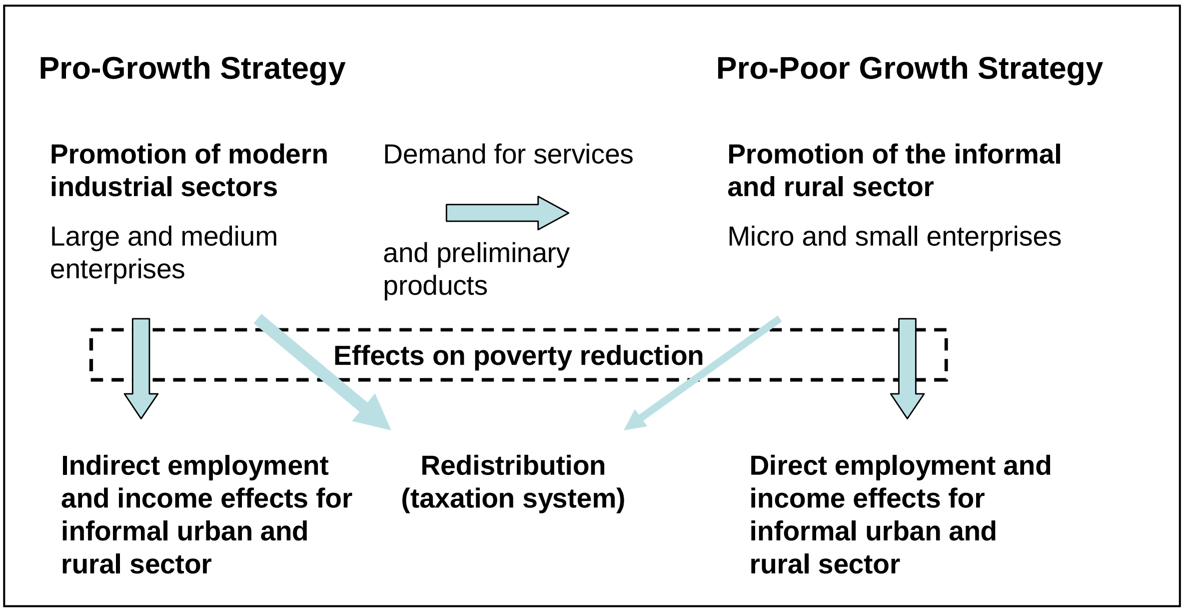
These measures are certainly of importance and form an integral part of the PSD strategy in developing as well as in developed countries. The question is, however, whether the German development cooperation should pursue the above mentioned intervention strategy in developing countries or whether it should rather concentrate on integrating the poor into growth processes to secure and increase their incomes.
The creation of jobs exactly in those areas where the poor population lives is the key to a direct reduction of poverty within the scope of measures for Private Sector Development. For this reason, growth processes must affect the poorest regions. In order to achieve this goal, it would be necessary to overcome the dichotomy of the PSD Strategies outlined above and to emphasize the connections between both strategic concepts.

The growth of the modern industrial sector in a developing country is crucial for its capacity for poverty alleviation. It is especially the taxation of dynamic industrial enterprises and their employees, which will provide the governments with important financial means for income redistribution aimed at poverty reduction (see Figure 1). At the same time, more income from the formal sector could be spent in the informal sector in compensation for services such as taxi, shoeshine, household services, etc. Furthermore, especially the food industry and other related industries would have an increasing demand for produce raw materials from small and medium-sized enterprises and from the farmers in the rural areas. These transfers propend to positive effects on the employment rate and the income in the informal urban and rural sectors. However, such effects will not occur automatically, but depend on the following essential pre-requisites:

1. The poor must have a corresponding educational and competence level in order to be able to meet the demands of the modern industrial sectors.

2. A beneficial political and legal framework must be created to facilitate a redistribution of profits from modern industrial sectors for investment in the construction of social security networks, health improvement and infrastructure development.

Figure 1: Combination of PSD strategies



The contributions of the German donor organizations should be focused on creating both of these pre-requisites in developing countries so that a German PSD strategy can effectively embrace the priority measures of poverty reduction in the implementation of its PPG strategy. In this way, the contributions of the German development cooperation in developing countries could complement the activities of large donor organizations (World Bank, IFC, and the regional development banks) as well as national efforts of the developing countries, since its activities focus more strongly on the promotion of modern, internationally competitive industrial sectors.

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Economic Growth and Poverty Reduction: What Role for the Informal Economy?

Ute Rietdorf

1. Introduction

There is widespread consensus in development thinking and cooperation that poverty reduction is the main objective of development and that it is to be achieved through economic growth which, in turn, is linked to private sector development. But which private sector do we mean? Does the formal one or the whole of private economic activities securing livelihood? In reality the average size of the informal economy is 42% of value added of the official GDP in Africa, 41% in Central and South America, 29% in Asia and 35% in transition countries[1]. This sector of the economy thus secures the livelihood of nearly half the economically active population in Africa and Latin America and of a third in Asia.[2]

If one agrees to take informal activities into consideration, the question that arises is whether firms in the informal sector are really able to level the ground for poverty reduction, as much as is been thought of in case of competitive formal enterprises. There, it is believed, growth orientation and thus rising employment opportunities and incomes eventually lead to broad-based benefits. But do informal enterprises suit the criteria in search of a link between economic growth and poverty reduction?

The common view, according to one of the World Bank's Discussion Forums, is that informality is a problem for economic growth and a constraint for (formal) private sector development because it burdens the economy with dual economic costs out of substandard operation as well as loss of market share for more productive, formal firms.[3] If this is so, is it wise or even necessary at all to promote this part of the economy, despite its income generating effects? Shouldn't private sector development and hence strategies for pro-poor growth deal only with formal enterprises then? Or are there ways of promoting the informal

[1] Schneider, 2002, Size and Measurement, p.45.

[2] Attempts to measure the size of the informal economy in terms of value added and labor force are accompanied by difficulties. Different models use different indicators which reflect monetary transactions, the participation of workers in the 'hidden' economy or the development of the markets for production inputs.[2] ILO Statistics break it down to the level of counting men and women in rural and urban areas by their main or secondary activities, using official national datasets. See ILO, 2002, ILO compendium, div. tables.

[3] http://rru.worldbank.org/Discussions/Topics/Topic37.aspx.

economy without hampering the growth of established formal firms? As will be seen, these questions reflect a rather distorted and lop-sided view of the informal economy but nevertheless point the finger at some critical aspects of dealing with it under the framework of pro-poor growth strategies.

2. Growth and (In-)Formality

In recent years, much has been said about the importance of economic growth for poverty reduction. Equally, the view that small and medium-sized enterprises are the backbone of an economy and thus worth promoting, is commonplace now. And given the fact that the majority of enterprises in developing and transformation countries consists of SMEs, even logical considerations would point to them as the main entrance into the road to enhanced welfare for most of its populations. Is there reason to believe in it if one acknowledges that a large part of them are working informally?

Across different income levels, the share of SMEs in developing countries as a source of GDP and as a share of formal employment differs nearly by 15%. Both figures correlate positively with the amount of per capita income, whereby the correlation between per capita GDP and share of SMEs as source of GDP is the stronger one.[4] This means that the link between rising per capita incomes (which one could call ‘poverty reduction’ in a narrow sense) and the size of this enterprise sector seems to be closer than the link between rising per capita incomes and its share of formal employment. To make it simple while risking over-simplifying the problem: if these economies grow in terms of per capita incomes, they do so, quite amazingly, by filling the ranks of private enterprises with more and more *informal* SMEs.

Instead of fading away in the wake of modernization and industrialization, the informal economy was growing in nearly all developing countries during the last decades. With a view on the macroeconomic, institutional and political conditions in these countries Ayyagari et al. therefore also provide data correlating the share of SMEs in formal employment with characteristics of the business environment: the influence of access to finances thereby seems strongest, followed by the rate of inflation, infrastructure, corruption, crime, exchange rate and political instability. Least of all, taxes and regulations take an influence on the scale of SMEs in formality, but secure property rights stand out again, strongly positively correlated, with formality.

[4] Ayyagari et al, 2003, Small and Medium Sized Enterprises.

These aspects point to the fact that there are important barriers to the growth of SMEs out of the shadow of informality into the open ground of being a formal employer. In countries, where macro-level economic conditions are unfavorable, meso-level institutions do a bad job, and the risk of loosing property through political turmoil is high, SMEs in general are severely restricted in their growth potential. As will be shown further on, this is one of the reasons why some of the informal enterprises even see informality as a rational choice decision, using informal, alternative mechanisms of finance, security and risk reduction, sometimes to the detriment of their formal competitors. The question of whether the growth of informal SMEs would eventually result in poverty reduction thus relates itself not only to characteristics of informal enterprises themselves, but to the wider business environment, too.

3. The Informal Economy: Only the Last Resort?

Out of the 1950s and well into the 1970s the informal sector was regarded as covering activities that were largely unrecognized, unrecorded, unprotected and unregulated by government authorities. But it steadily grew and began to include not only marginal activities, but also profitable enterprises. There are general reasons for this range from the limited absorption of surplus labor and barriers of entry into the formal economy to factors related to economic hardship. They include the disappearance of public sector jobs due to structural adjustment programs, poverty-related demand for low-cost goods and services and the weakness of institutions to provide, among other things, investment security, infrastructure and education.

Since informality[5] isn't confined to a specific sector and not an all-or-nothing state but cuts across many sectors and consists of different degrees of (in-) formality, the informal sector was and is increasingly referred to as the informal economy.[6] The term 'informal economy' thereby refers to all economic activities that are not covered by formal arrangements. Detailed definitions draw the line along:

- Activities (of economic units such as family or micro-enterprises which rarely comply with all the regulations applying to their trade)

[5] Formality, as the counterpart of informality is often referred to as 'participation in civic institutions'. Seen negatively, there is emphasis on the firms' desire to evade state regulations and controls. On the other hand, it also encompasses the inability of firms in the informal economy to access institutions which secure property rigths or enforce contracts. See Levenson/Maloney, 1998, Informal Sector, p.2.

[6] Flodman Becker, 2004, Informal Economy, pp. 8, 24-25.

- Employment categories (self-employed; paid and unpaid family workers; wage workers; casual workers; home workers; part-time workers and employers)
- The location of informal economy actors (home based; street traders; itinerant, seasonal or temporary workers on building sides etc.)
- Income and employment enhancing potentials (which cover the whole spectrum ranging from small-scale modern manufacturing and service enterprises to informal activities for survival purposes and part-time activities)[7]

Whereby activities, employment categories or the location of informal economic units simply point to the current state of affairs, the last mentioned type of possible definitions includes a dynamic perspective. 'Informality' is thus being looked at from the different potential several informal economy activities bear for poverty reduction. This makes it easier, too, to recognize the multiple linkages between enterprises in the informal and the formal economy which range from the trade of goods, raw materials and services to the acquisition of skills and know-how.

Clearly, income and employment enhancing potentials and therefore possibilities for poverty reduction are more prevalent at the upper end of this type of category. And yet, this only seems to be a tiny minority in most developing countries' informal economy. How to approach this problem? Or shouldn't one approach it at all? Three ways of thinking about informality are prevalent in the discussion: the dualistic view, the view that the informal economy is subordinated to the formal one and the view that it is a rational response and optimal decision given the preferences and constraints informal actors face.[8]

Whether one adheres to one or the other view, it remains a fact that people in the informal economy are often poor, have lower incomes adjusted for human capital and face lower rates of productivity and growth for their enterprises. There are some characteristics common to nearly all informal activities:

- The low entry requirements in terms of capital and qualifications, often acquired outside the formal education system
- The small scale of operations
- Labor-intensive methods of production

[7] Flodman Becker, 2004, Informal Economy, pp.11-15.
[8] Maloney, 2004, Informality Revisited, p. 1160.

In this view, informal enterprises are only remnants of mainstream activities, forced to exist under unfavorable circumstances, under-financed, risk-averting and exploiting cheap family, personal or otherwise unemployed labor resources. But, as Maloney points to, it is not at all clear in which direction the causality runs.[9] Is informality the cause of these characteristics or are these characteristics the cause of informality?

That small, inefficient and young firms are disproportionately informal[10], does not mean that they don't have dynamics similar to small formal firms. For some of them, informality is a rational choice decision out of the costs of going formal. The seriousness of the problems of the business environment causes informal enterprises to expand rather horizontally and diversify instead of going up into the formal sector. As indicated in another World Bank Discussion Forum: the benefits of formality are dwarfed by its costs.[11] Apart from the question of who is or is not informally active, to what degree and at which time of the year, it is important to recognize the interconnectedness of formal and informal economic activities, for instance through hiring informal laborers or subcontracting part of the production process. So, rather than concentrating on problems of definition and measurement one should look at causes and consequences of informality, and the perspectives of the role these firms play in their country-specific contexts.

The question whether promoting the informal economy can provide the missing link between strategies for growth and competitiveness on the one hand and poverty reduction on the other is yet unanswered. What seems clear, however, is that 'the informal economy' doesn't exist as such, but covers enterprises which are businesses of last resort as well as economic agents who just go undercover to avoid being trapped in poverty again.[12]

4. Current Trends of Promoting the Informal Economy

According to some authors, intellectual justifications for concrete actions of private sector development in general and the informal economy in particular are often weak and preconditions read like an endless list of ambitious interventions without a clear sequence of priorities.[13] This holds even more when strategies of private sector development are meant to foster economic growth and reduce poverty. The mainstream approach of private sector development focuses explicitly on growth and competitiveness of enterprises and only

[9] Maloney, 2003, Informal Self-Employment, pp. 65, 73.
[10] Levenson/Maloney, 1998, Informal Sector, p. 9.
[11] http://rru.worldbank.org/Discussions/Topics/Topic18.aspx.
[12] See Annex B.
[13] Schulpen/Gibbon, 2002, Private Sector Development, pp. 3-4.

indirectly on poverty alleviation. Broad-scale poverty reduction implies empowerment of the poor and the acknowledgement that poverty is multi-dimensional: it concerns issues of inequity, vulnerability and exclusion.[14] Only micro enterprise development programs cover and target firms which operate in the informal economy. Micro-credits and technology-upgrading are often the key instruments in promoting these micro and small firms, some of which are indeed upwardly mobile then. But self-employed, own-account workers who form a very large part of the informal economy are mostly overlooked again.[15]

According to some critics, the mainstream approach therefore repeats the mistakes of the past by accentuating existing market distortions through promoting successful firms and enhancing their capital intensity, thereby pushing weaker, unsupported businesses out. This leads not only *not* to poverty reduction in the informal economy as a whole but sometimes to diminishing employment potentials, too, when 'losers' go out of business at all.[16]

5. Innovative Approaches towards the Informal Economy

While it's probably right that increasing the size of the formal sector offers the best perspective to reduce poverty in the long run, the graduation from the informal to the formal economy of economic units is only one side of the coin. If productive formal firms are hampered by fiscal and regulatory obligations, too and not even able to out-compete upper-tier informal firms, then the basic question centers not around selling products and services formally or informally but around both sides' 'dead capital'[17] – an issue which concerns the institutional environment of firms.

This takes us back to definition and theory. If one sees the informal economy as only fulfilling survival functions for those people involuntarily stepping into it, then any policies will have the character of welfare programs. But if one considers it a rational choice to be and work there, any supporting policies without tackling wider problems of the business environment will only make it more attractive to be informal by saving the costs of formality.[18]

The same holds for employment options. Since the choice between employment in the formal sector and informal self-employment is often not a question of being 'worse off' but

[14] SDC, 2001, Current Trends, pp. 1, 5 ; Schneider-Barthold, 2002, Different Strategies, p.1f.
[15] Flodman Becker, 2004, Informal Economy, pp. 34, 41.
[16] Schneider-Barthold, 2002, Different Strategies, p. 2f.
[17] de Soto, 1989, The Other Path.
[18] Maloney, 2004, Informality Revisited, p. 1173.

between different 'packages' of job qualities, rewards and alternative solutions to issues ranging from methods of contract enforcement to health insurance[19], any instruments will have to take into account that delivering services to small informal businesses are just another reason to stay there. What is also often missing is the awareness that all what is done for the formal economy equally affects the informal one. Any strategy for pro-poor growth has to simultaneously consider both sides' needs and deeds if poverty is to be reduced at all.

If projects target the poorer strata of the informal economy, the effectiveness of its empowerment approach is influenced also by the pattern of its geographical distribution. Projects focusing on a concrete province or densely populated areas seem to have better chances of success, because the higher number of interrelated and co-located actors offers opportunities to press harder for accompanying changes at the meso and macro level organizations[20] - which can result in a 'social movement' for improved business environments. What an integrated, target group-specific approach can do, is shown by the success of some SIDA projects. Its Program for Local Development in Nicaragua aims at improving the physical environment and socio-economic conditions of families living in low-income marginalized urban neighborhoods. By providing community grants, matching funds and micro enterprise loans as well as loans for upgrading, replacement and expansion of houses, the project has enabled the working poor to strengthen their home-based activities and increase the title deeds for families from 15% in 1994 to over 70% in 2001, which provides them with a security and possibility to take further loans. The whole project thus contributed to formalizing informal and marginalized communities and economic actors alike.

The other example comes from Nicaragua. In this case, credits, training, and legal services like the registration of title deeds assisted coffee farmers in production and marketing. The project thereby tackled the main problem of the farmers – not the lack of land but the informality of property rights and contributed to the formalization of the production of small-scale farmers.[21]

[19] Maloney, 2003, Informal Self-Employment, pp. 66-69.
[20] Schneider-Barthold, 2002, Different Strategies, p. 6.
[21] Flodman Becker, 2004, Informal Sector, p. 40. This also points to the concrete location of programmes and projects: ILO statistics show a rather diversified picture if one looks at the region where informal sector activities concentrate. Whereas in countries like India, Ethiopia and Mali informal sector activities are overwhelmingly a rural phenomenon, persons informally employed in South Africa, Mexico or Georgia are largely city dwellers. See Annex A.

6. Conclusion

The diversity of the informal economy actors and the specificity of their resources and potentials pose a real challenge to all concerned with it. What seems clear from the forgoing passages is only the following:

First, sector-specific programs won't solve the problem of the sector's heterogeneity, its differing degrees of (in-) formality within the context of time and specific situations. Second, it is quite clear that none of the 'two economies' exists independently of the other and that policies affecting the one will have an influence on the other, too. Third, there is no way (and no reason) to separate so called upper-tier, competitive informal firms from their formal competitors in terms of different policies. And finally, country-specific strategies do also have their weaknesses since they deal with specific countries one by one without finding a common language for all of them for reasons of efficiency and accountability. Looking at the whole of the economy then, the gap between the aims of competitiveness and poverty reduction seems to be a rather theoretical spasm than a real one. There's no reason to approach them separately but indeed the very necessity to integrate them into a common framework. The following points can be made:

In a perspective of the poorer strata of the informal economy

- very favorable policies towards informal economy actors could prevent them from being motivated to 'graduate' to a higher level[22]
- the support of the lower end of informal sector businesses has to integrate the characteristics of family businesses since a 'sole-business'-approach will not work[23]

In the wider perspective of promoting economic growth

- Policy reviews should be comprehensive and consider all macro and sector policies that might have an influence on the informal economy (labor markets, infrastructure, subsidies etc.)
- Growth tendencies in the informal sector businesses depend on macroeconomic trends: if the economy grows, competition increases and some businesses expand while others fade away; while in times of slow economic growth many new businesses will enter the informal economy.[24] This in turn means that PSD projects should be flexible enough to adapt to changing economic circumstances.

[22] Haan/Serriere, 2002, Training, p. 169.
[23] SDC, 2001, Current Trends, p. 5.
[24] Liedholm/Mead, 1999, Small Enterprises, pp. 65-74.

Regarding the sequencing of measures and activities, the following steps were proposed to specifically promote pro-poor growth in case of micro and small enterprises:

1. Empowerment for the poorer strata
2. Counseling, coaching and facilitating local initiatives
3. Reforming rules and regulations, BDS start customizing informal economy actors
4. Informal economy actors avail of the reformed rules and regulations and use customized services
5. Counseling, coaching and facilitation of micro and small enterprises[25]

Whereas step 1 involves full subsidization, steps 2 to 5 only involve some, specifically targeted subsidies going down in scale and scope. In this way, a wide range of enterprises, even single, self-employed entrepreneurs would be drawn into the mainstream of economic activity and some of them able to follow the road to competitiveness. What is needed is an integrated approach 'promoting as far down as possible in the enterprise size and as broad as possible in the enterprise scale'[26] the existence of small businesses in the informal economy, be it for outright poverty-reduction or future growth.

Maybe history lends a hand to a solution: in the wave of privatization, market liberalization and globalization the structural power of formal private firms grows steadily. The term refers to the state's dependence on the private sector for achieving economic goals. Formal firms form coalitions of interests via business associations to press for more accountable, effective governments to go beyond a 'pro business' attitude towards a 'pro capitalist': one which not only allows for personal enrichment but for accumulation of productive capital, too.[27] Parallel to this, there is growing pressure on the informal economy to either give way to formal firms or step into formality themselves. If the structural power of capital translates itself into improvements in the business environment at the macro and meso level, then informal economy actors, too will take their pen again and count their costs and benefits.

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ANNEX A

Number of persons employed in the informal sector: selected countries, urban and rural areas, latest available year (in 1.000)

Country	Year	Urban	Rural	% Total urban employment	% Total rural employment
India	2000	680	35,880	38.1	55
Ethiopia	1999	1149.5	3665.3	50.6	86.9
Mali	1996	370.6	805.5	71	-
South Africa	1999	1549	1157	21.3	37.4
Mexico	1999	7448.5	1693	30.8	47.7
Georgia	1999	73.4	29.9	14.2	3.1

Source: ILO 2002

ANNEX B

	INFORMAL SECTOR		FORMAL
	Subsistence enterprises	**Unofficial enterprises**	**Official enterprises**
Degree of Informality	100%	High; Proportion of sales undeclared and workers not registered	Some proportion of sales undeclared and workers unregistered
Type of Activity	Single street traders, cottage/micro-enterprises, subsistence farmers	Small manufacturers, service providers, distributors, contractors	Small and medium manufacturers, service providers, software firms
Technology	Labour intensive	Mostly labour intensive	Knowledge and capital intensive
Owner Profile	Poor, low education, low level of skills	Poor and non-poor, well educated, high level of skills	Non-poor, highly educated, sophisticated level of skills
Markets	Low barriers to entry, highly competitive, high product homogeneity	Low barriers to entry, highly competitive, some product differentiation	Significant barriers to entry, established market/product niche
Finance Needs	Working capital	Working capital, some investment capital, supplier credit	Investment capital and working capital, letters of credit, supplier credit
Other Needs	Personal insurance, social protection	Personal and perhaps business insurance	Personal and business insurance, BDS
	Least dynamic **Completely informal**		**Highly dynamic** **Partially formal**

Source: Flodman Becker 2004

Strengthening Institutional Conditions: Interventions on the Meso-Level to Develop the Private Sector

Ingrid Fromm

1. Introduction

In recent years, increasing attention has been paid to the influence the meso-level has on the private sector's ability to contribute to employment creation and poverty reduction. The meso-level refers to the policies and business promotion instruments, and of private and public institutions involved in business promotion. A fundamental change in the way the meso-level policies are implemented has taken place. Just over ten years ago, selective government interventions to promote promising sectors were commonplace. The validity of these policies implemented by governments and institutions in developing countries has been questioned. This trend is particularly notorious in Latin America, after the failure of these interventions where little economic growth was achieved and the gap between poor and rich increased.

Many donor organizations have stated that private sector development entails not only economic growth, but the availability of sufficient incentives for the private sector to invest in its own productive capabilities and thus increase the rate of growth[1]. First and foremost, the meso-level has the task of improving conditions for these incentives to be readily available. Financial institutions working privately as well as government organizations, in accordance with macro-level policies, set the conditions for this investment to take place and capital to flow. The macro-level creates the conditions and the meso-level institutions act as facilitators for a sound private sector development. Secondly, the meso-level must ensure an effective functioning of the private sector, increasing productivity and delivering efficient, pro-poor outcomes. Finally, the meso-level must advocate for the poor and allow for social cohesion to be maintained for sustainable, long-term development to take place.

[1] See Pro-Poor Growth and Private Sector Development. OECD, 2004

2. The Meso-Level: Bridging the Public and Private Sectors

The meso-level can be described as the field of specific policies and business promotion instruments, and of private and public institutions involved in business promotion. It consists of all those organizations which are created by governments and individuals or collective actors to improve the conditions in which firms do business. The institutions in the meso-level are not necessarily responsible for creating and implementing policies, they are in many cases, a result of these policies. A policy created to improve the quality of training available for employees in a sector or industry is not created by the institutions, but by the government or the private sector and the institutions carry out this task. Meso-level policies and institutions, in comparison to the macro-level, are more selective (Table 1). Fiscal policy, monetary policy, exchange and trade policies affect all economic actors in the same way, thus they are macro-level policies. Meso-level policies are more targeted. A technology policy, for example, aims selectively at innovative companies or sectors. Its main objective is to strengthen structures, such as firms and networks of companies acting at the micro-level. The creation of competent policies is not a goal in itself, but a means to an end, which is to provide a better playing field for firms.

Table 1: Meso-level Institutions and Activities

Type of Institution and Activities	Objectives
Agricultural Research & Extension ▪ Developing productive varieties, improving technology ▪ Technology dissemination	▪ To increase agricultural productivity and productivity of agribusinesses
Research & Technology Organizations, Academia ▪ Scientific research ▪ Innovation support ▪ Operational support	▪ To provide new technology, increase rate of innovation, operational advice for successful innovation, source of entrepreneurship
Vocational & Management Training ▪ System of national vocational qualification, curricula ▪ Accrediting private sector providers ▪ Providing training for employees	▪ To increase human capital and labor productivity
Trade Facilitation Organizations ▪ Access to international markets ▪ Port & customs clearance ▪ Trade (international) promotion	▪ To increase information flows, lower transaction and marketing costs, and provide support for trade promotion

Source: OECD, 2004

Meso-level interventions (i.e. policies) must create sound and accountable private and public institutions to support a well-functioning and competitive local market. Although there is no single formula that dictates what type of interventions are necessary for PSD, there are certain initiatives that have proven to be effective in creating, as mentioned before, a better playing field for firms to do business. First of all, meso-level institutions should participate in the capacity building of businesses, providing services in the fields of vocational and management training, for instance. The meso-level must also act as a facilitator, promoting the establishment of sectoral and professional associations and labor or trade unions or other types of associations. The meso-level should likewise be involved in the promotion of local and multi-sectoral networks and partnerships.

Development policies, governments and international donors must seriously reflect upon the importance of the agricultural sector in developing countries, and in formulating policies in which meso-level institutions efficiently promote rural development. This grassroots effort can also minimize urban poverty (less migration to urban centers), and even reduce informality. In the case of the Honduran farmers receiving know-how transfer, most were also encouraged to register their enterprises and comply with sanitary and quality standards or certify their products. They received support and training during this whole procedure, which the farmers were not acquainted with.

The meso-level must count with trade-related institutions, or build them if necessary. Developing economies seeking to participate in and profit from trade need institutions strengthening the country's overall competitiveness. These institutions must act strategically to improve quality control and upgrade capabilities. Developing countries seeking to export to developed nations also have to consider good environmental management practices and in most cases, they have to follow and have certifications. It is the task of local institutions to respond to these necessities and facilitate the process of trade for enterprises. Research findings state that countries with better institutions tend to trade more and grow faster. Institutional quality appears to be a determining factor in trade growth[2].

Institutions are of critical importance in the promotion of supply-chain linkages among micro-enterprises, SMEs, and large enterprises. SMEs can always benefit from supply to larger enterprises as they have the opportunity to learn from this exchange and upgrade their products when necessary. Finally, the meso-level has to provide support for innovation and leadership in corporate social responsibility and encourage environmental responsibility as

[2] Dollar and Kraay, 2002.

well. Institutions have to ensure that successful local innovation and knowledge can be used by SMEs.

3. Interventions at the Meso-Level to develop the Private Sector

Well-functioning state institutions that work for the interests of the poor are a central component of any poverty reduction strategy. A growing body of empirical evidence provides insight on the role of institutions on economic growth. Improving institutional development promotes economic growth in developing countries[3]. There is evidence that a weak institutional system prevents poor countries from catching-up. Institutional development increases the rates of convergence between developed and developing countries[4].

3.1 Creating Conditions for PSD

A health and vigorous business climate conducive to supporting savings and investment can be achieved through several initiatives involving the meso-level. In fact, institutions and policies have an active part in creating such conditions. The meso-level has to support the development of transparent, stable, and effective regulatory and legal structures governing private sector activity. It must strengthen the rule of law in commercial and labor codes, including benefits for informal sector workers. Institutional capacity must exist to develop pro-poor growth policies, including the analysis and development of policies for the informal economy.

According to the World Bank (2002), there are four main lessons that must be considered for effective institution building:

- *Institutions must be designed to complement what exists.* The availability and cost of supporting institutions, existing levels of corruption, human capacity and technology determine the impact of a particular institution. Much of the work in building institutions lies in modifying those that already exist to complement other institutions and in recognizing what not to build in a particular context, as much as what to build.

- *Innovate and design institutions that work and drop those initiatives that do not.* Even in countries with similar incomes and capacities, innovation can create stronger institutions

[3] The causality and feedback between institutional measures (such as contract enforceability, nationalization potential, infrastructure quality, bureaucratic delays, and a composite index of the above four) and economic growth was tested. Chong and Calderón, 1997.

[4] See Knack and Keefer, 1997.

because of differences in local conditions, differences ranging from social norms to geography. Experimentation can help identify new and more effective structures.

- *Institutions should help connect communities of market players through open information flows and open trade.* Exchanging goods and services outside existing networks and communities creates demand for market-supporting institutions. Exchanging information through open debate creates demand for institutional change by holding people to account, by changing behavior, and by supplying ideas for change from outside the community.

- *Institutions have to promote competition among firms, and individuals.* Greater competition modifies the effectiveness of existing institutions, changes people's incentives and behavior, and creates demand for new institutions. Developing country actors may face too little competition, often because of current institutional structures. Changing this will improve the quality of other institutions. Competition among different states within a country or between countries highlights successful institutions and promotes demand for them.

Box 1: Business Climate in Central America

A favorable business environment is a basic precondition for being able to create positive long-term private sector development. A survey taken in 2003 of over 450 businesses in Central America provided the following outcomes:

- At least 60% of the businesses in Honduras view corruption as the main constrain for doing business. Over 50% of the firms agree that the access and cost of financing is a sever strain on them, as well as macroeconomic instability.
- In Nicaragua the results are similar to Honduras. Corruption is by far the biggest problem, 65% of the firms surveyed agreed that it is their major constrain. The other three constrains were the access and cost of financing, and economic and regulatory policy uncertainty.
- Guatemala has similar problems with corruption, over 80% of the firms naming it as the major constrain in doing business. Over 65% view economic and regulatory policy uncertainty as a factor affecting the business climate, at least 60% think that the macroeconomic instability also affects their businesses.

Firms in El Salvador agreed that anti-competitive practices is a problem (44%), as well as corruption (35%) and access to financing (31%).

Source: WBG Investment Climate Surveys, 2003

3.2 Promoting Governance and Transparency

Governance is a broad term that refers to a government's administration and management of the society and economy. It includes issues such as the rule of law, government administration, corruption, security and accountability. Corruption is a key aspect of governance that directly affects poor people's lives. It takes a heavy toll on the poor. Demands for bribes affect mostly poor people hardest. Legal and judiciary systems fail to serve poor people. Factors such as illiteracy and the inability to pay for legal representation make corruption the worst of evils for poor people. The failure of the state to protect property also hurts the poorest, because they cannot afford to protect themselves from crime and corruption. Institutional failure reduces the provision of infrastructure to the poorest in society. High and rising corruption in the developing world increases income inequality and poverty.

The quality of state institutions affects economic growth and poverty reduction. Investment is attracted to environments where there is low corruption and where laws and contracts can be easily enforced. Nevertheless, governance is associated with a higher pace of economic growth. Corruption is more common in societies where the education level of the population is lower. It is easier to improve the quality of governance when citizens are better educated. An educated society can also fight corruption in a more effective manner.

3.3 Advocating for the Poor

In the course of the 1980's and 1990's, there has been a fundamental change in the way the policies affecting the meso-level have been implemented. Just over ten years ago, selective government interventions to promote promising sectors were commonplace. The validity of almost all policies implemented at this level by governments and institutions in developing countries has been questioned. Globalization has created pressure on economies to remove unnecessary obstacles to business activities and to increase their efficiency. The fact is that most countries have seen little advance in poverty reduction. One clear example of obstacles and lack of efficiency in creating business conditions for the poor is the financial services.

In many developing countries, effective and accessible formal financial institutions (especially in the rural areas) are still rare. The main reason is the lack of complementary institutions dedicated to making finance easier for the poor. Poor farmers have a particularly difficult access to finance. Back in the times of the agricultural reform in Latin

America (1960s and 70s) financial institutions were specifically created to serve the agricultural sector, but most failed. This failure has resulted in informal financial institutions still dominating poorer countries. Among others, savings institutions in the rural areas are still informal and most of the time, not in financial assets but in physical assets such as livestock. The agricultural sector in developing countries has little choices when it comes to financing, and the meso-level institutions and policies have failed them time and again.

The urban informal sector has similar problems. Access to financing depends greatly on assets such as land ownership. Since micro and small enterprises are rarely registered, the access to formal financing is close to impossible. Credit is a tool that promotes investment in the productive capacities, helps include poor people in the economy, stimulates local markets, and extends employment opportunities as businesses grow. Institutions can help mitigate the negative effects of lack of credit in the informal sector, as well as provide adequate regulatory environments and reduce knowledge and skills deficit.

The informal sector meets an important need, sustaining the majority of poor families in many developing countries. However, the benefits of economic growth are absent both for consumers at the bottom of the pyramid who lack choice, quality or affordable goods and services, as well as for local entrepreneurs who are unable to grow their businesses to get themselves out of poverty. An informal private sector providing the poor with goods usually of higher prices and lower quality (food, water or financial services) is commonplace. In many cities in the developing world, middle-class consumers pay much less for food, medicine and other consumer goods than the poor who buy from corner stores or from street vendors in the slums.

Meso-level policies have been inefficient in setting standards and creating ample choices for the poor. A concrete action to reduce the barriers to establishing new businesses is yet another task of the meso-level. Entrepreneurs need access to business development services to support their initial entry into business. Ironically, it is at this stage though that they are least able to afford such services. Unless such services exist, new start ups are likely to have the risk of business failure. How else can a society cradle entrepreneurship which is an essential part of the private sector? The same can be said about the institutions promoting innovation.

4. Conclusion

Weak physical and institutional frameworks are great barriers to private sector development. However, the lack of transparency and corruption problems in poorly functioning institutions hinders private sector development even more than a weak institutional framework. High and rising corruption increases income inequality and poverty. Institutional conditions must be improved, but the need for good governance is imperative.

Has there been an impact on poverty reduction? From the meso-level perspective, it is difficult to measure the degree of effectiveness, let alone the impact on poverty reduction. The meso-level is only a small part of the whole, complex private sector development strategies, and the result of the work at this level is not seen at the level itself, but on the businesses which the meso-level seeks to improve. If sustained growth is achieved, if new jobs are created, if income is generated for the poor, the policies and institutions acting on the meso-level and creating these favorable conditions are partly responsible.

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SME Promotion Strategies and Poverty Alleviation in Nepal

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1. Introduction

Nepal is a landlocked country located between two giants: China in the north and India in the south. The majority of the land is mountainous (80%) and the rest is the Terai plain in the South. The country is divided into five different development regions. The per capita income is a mere $240 annually and total population is nearly 23 million. The economy is characterized by a large rural sector based on subsistence agriculture and a small industrial sector centered in manufacturing, trade and tourism. Trade and commerce account for 12.31% of the GDP and manufacturing contributes about 9.3%. The manufacturing sector is dominated by carpets, ready-made garments, hides and skins. The economy heavily depends on imports. Weak exports have resulted in a widening trade deficit of 22.8% of the GDP in 1996. Foreign debt increased to an alarming rate which represents 56% of GDP. Due to low levels of revenue, the economy is highly dependent on foreign aid which accounted for 55% of development expenditure. In recent years, the remittance by the Nepalese abroad contributed to about 11% of the GDP in 2003. GDP growth has averaged 4.5% from 1995 to 2000. The benefit of the economic growth is urban-centered and reaches only to a limited section of the population because of the absence of development strategies that would promote an inter-relationship between the agricultural and non-agricultural sector. Current political insurgency resulted in very low growth in the economy since 2000. This paper examines SME promotion in the perspective of poverty alleviation in Nepal. Therefore, the focus of the discussion will be on rural small firms which represent the livelihood and employment source of the majority of the rural poor who live in Nepal.

2. Small and Medium-Sized Enterprises in Nepal

Small and medium enterprises fall under the definition of Nepal Industrial Policy 1992. The traditional cottage industries are defined as those industries that relate to national customs, art and culture. They use local resources and skills, and traditional technology. These industries include labor intensive handicraft industries. Similarly, small industries are defined as those industries other than traditional cottage industries which have an investment of up to 30 million Rupees (about 330,000 €) in fixed assets. Medium-scale industries are those which have investment from 30 million to 100 million Rupees (1,080,000 €) in fixed assets.

Therefore, Nepalese small and medium enterprises, according to legal definition, fall under the industries having up to Rs.100 million worth of investment in fixed assets. The industries that fall under this category are SMEs in Nepal which dominate almost all (more than 98%) the manufacturing industrial establishments in Nepal. Their contributions in employment and value added generations are also high. There is no data on the contributions of small and medium scale enterprises in the trade and service sectors in which they are also predominant.

There are innumerable numbers of small enterprises in the formal as well as informal sector throughout the country. These enterprises include mostly small family enterprises involved in manufacturing, trading and personal services which are usually locally owned and operated by one person and rely on unique skills of owners. The following table shows the extent of tiny small manufacturing industries and their contributions to the economy.

Table 1: Proportion of Small Manufacturing Industries in Nepal

	10 or more Employees*	Less than 10 Employees**	Total	% of Industries having less than 10 Employees
Number of establishments	3557	43,671	47,228	92%
Number of employees	196,708	121,270	317,978	38 %
Output in Million Rupees	54,927	25,945	80,872	32%
Value Added in Million Rupees	21,875	6,675	28,550	23%

* Source: Census of Manufacturing Industry, 1996 – 1997, Central Bureau of Statistics, Katmandu, Nepal.

** Source: Survey of Small Manufacturing Industries, 1999 – 2000, CBS.

The table shows that small industries with less than 10 employees (which include household manufacturing enterprises having at least one hired laborer and the household manufacturing units without hired labor; but the enterprises are sole-income sources to run the house) represented 92% of the total manufacturing industries. There is no data regarding the industries other than manufacturing industries of this category. Nevertheless, the number of small enterprises in trade and service are tremendously high. Therefore, a great number of such small firms, which are mostly informal sector firms, represent the majority of the enterprise sector in Nepal.

3. SME Promotion Strategies and their Impact on the SME Sector

Economic reform in the early nineties liberalized trade, investment and foreign exchange regimes, unified the exchange rate, and rationalized the tariff structure and tax system. Efforts were made to promote exports, strengthen financial and capital markets, and foster private sector development. These reforms resulted in an impressive transformation of the economy to a more open market oriented economy. These reforms created an energetic private sector and expanded its role in the manufacturing industry, export, education, health, air transport, finances and power. It helped accelerate economic growth in the non-agricultural sector (trade, transport, tourism, manufacturing and services) with an annual rate of 7.5% in real terms in the first half of the nineties and the share of the non-agricultural sector rose from 51% to 59 % of the overall GDP in that period. This helped increased employment and income earning opportunities.

As stated earlier a great majority of enterprises are SMEs. The resulting growth was mostly contributed by the growing SME sector. Therefore, an impressive growth was recorded from 1990 to 1995 in manufacturing at the rate of 12% per year, and trade, hotel and restaurants and other sectors rose at the rate of 6% to 8% annually. However, the growth rate of manufacturing, trade, hotel and restaurants reduced to 5% from 1995 to 2000. These sectors did not grow at all after 2000 due to the growing level of political insurgency witnessed until now.

Since SMEs are the great contributors to the economy, strengthening the role of SMEs in national production has always been the major strategy of the country. Major policy reforms as mentioned above have helped in minimizing market distortions. The reforms are trade liberalization, privatization, deregulation and de-licensing, export and import liberalization and evolution towards full currency convertibility. These reforms created a conducive environment for the SME sector.

The policy reforms brought changes in the trade and industrial policies, laws and other regulations. The major development interventions for the promotion of SMEs are tax incentives, reduction in import tariffs, duty drawbacks on exports, incentives for larger industries which subcontract to small and cottage industries. The SMEs were invited to policy dialogues for the reform activities. The cottage and small industries are reserved for Nepalese people and barred from foreign direct investment.

The reforms in policies, laws and administration were not free from flaws. As a result, the SMEs could not be promoted at the desired level. Ever growing political turmoil in the country resulted in frequent changes in key decision makers, political interferences, delays in improving rules and processes. In addition, an abuse of power and delays from the side of the government staff responsible for policy administration resulted in bribery, delays and procedural complications. There have been frequent changes in trade and taxation policy and procedures announced through annual budgets. The confidential departmental circular in the SME promotion related government organizations also discouraged SME sectors.

Besides, an inadequate infrastructure such as telecommunications, roads, electricity, and skilled labor are major constrains to SME promotion. The other constrains include problems of access to inputs and markets. The competition with Indian products is really harsh as the cost of production in Nepalese industries using the raw materials imported from India is higher than Indian finished products produced from the same raw material. This is because tax rate imposed on import of raw material is higher than that for the final products. Unauthorized entry of goods from India through porous borders also reduced the competitiveness of Nepalese products.

The provisions for support services are also made to promote the SME sector. For this purpose various institutions have been established and strengthened to provide training, finance and other inputs. However there are reports of inefficient implementation of the support services due to high bureaucracies and less committed staff in these organizations. In addition, the support activities are largely confined to the capital and urban areas at the district headquarters. Support agencies generally lack specialized staff. Due to economic liberalization, many banks were also established in the rural areas. There are numerous rural banks operating micro lending schemes. Improvement in the financial sector transferred rural savings to urban areas as many banks are reluctant to fund small enterprises. The small enterprises see these banks as complicated and bureaucratic.

4. Poverty situation in Nepal

A national living standard survey taken in 1996 estimated the poverty threshold to be an annual per capita income of Rs. 4,404, which is the amount required to meet daily minimum average calories for food and non-food requirements. The threshold amount stands now at Rs. 6,100 (65.60 € at current exchange rate of 1€ = Rs.93) after considering inflation. The survey estimated that the poverty rate in Nepal is 42%. The poverty line is estimated to be 44% in rural areas and 23% in urban areas. Poverty exists predominantly in rural areas and the mid-west and far west regions of Nepal. The determinants for being poor are limited resource endowment, ill health, and land locked and rugged terrain. Though some growth took place outside agriculture, it is a dominant economic sector in the rural areas and did not grow where 86% of the population lives and over 90% of the poor live. Over the past 12 years, non-agricultural sectors grew at the rate of 6% but agriculture grew at the rate of 2.3%, which is equivalent to population growth rate. The household income of the poor people consists of agriculture, self employment and wage employment. There are fewer opportunities for non-agricultural employment opportunities in rural areas. This contributed to low educational achievement and skills of the poor people. This in turn contributes to difficulties in obtaining higher paying non-agricultural employment.

Agricultural yield levels could not be improved beyond 0.07% because of the small uneconomical farm size, lack of programs in providing year round irrigation and low use of modern inputs and extension service. In addition, the poor quality of land, lack of access to institutional credit and distance from roads and less access to markets are other determinants of increasing poverty.

Nepal is a pluralistic society. There are 60 recorded castes and ethnic groups (Indo-Aryan and Mongol) and 70 languages and dialects (Indo-Aryan and Tibeto-Burman). The poorest are the indigenous ethnic and caste (disadvantaged people). The poor people do not get access to basic social and economic infrastructure, education to upgrade their condition and health care and water for improving living standards and life expectancy. The non-agricultural sector (manufacturing, trade, tourism and service) which grew in the early nineties had driven the growth of exports, public investment and demand for urban services. Income and employment opportunities rose rapidly in urban areas. Therefore, Katmandu has merely 4% poverty rate and other urban areas have 23% whereas 44% of the rural population is poor.

These results show that the SME promotion strategies that have been implemented in the 1990's did not result in poverty alleviation. The poverty level remained at the same level during the period in comparison to the past but the absolute number of poor increased as a result of population growth. The main reasons seem to be absence of SME development strategies which embrace the development of rural areas, agriculture, and rural and urban linkages. This situation results in glaring disparities between urban and rural areas, with Katmandu as the center of investment with rising property values, financial services, and infrastructure. The inflow of remittance from foreign labor also concentrated in Katmandu.

These disparities in the income between rural and urban regions, ethnic and caste groups are said to be contributing factors to social disorder and the present political conflict and insurgencies.

4.1 Characteristics of SMEs in Poverty-stricken Rural Areas

In an effort to assess whether the SME promotion strategies fit the rural enterprise, an attempt is made to analyze the characteristics of rural SMEs. As stated earlier, Nepal's income generating activities and micro enterprises are based on agricultural products, non-timber forestry products, tourism, small tea shops, hotels, lodges and handicrafts. These enterprises sustain the poor people with less income, small land holding, less opportunities for modern inputs and technology. In fact, a great majority of such enterprises in Nepal are informal small firms.

4.1.1 Market Situation

Most of the simple products or services manufactured by the local informal rural small enterprises are consumed within local markets. The products produced by the formal sector are also distributed by the local informal sector such as local retailers. There is usually growth of particular enterprises based on favorable demand conditions in the locations especially because of low entry barriers and the huge flexibility of household production decisions. This type of behavior is found in animal husbandry, vegetable farming and other simple production firms encouraged and supported by the government and donor-supported promotional organizations. These situations quite often lead to the collapse of all the enterprises once the supply outruns the demand and the support is withdrawn without making the sector sustainable. Most of the small enterprises are price takers serving local market and expanding their market to other areas might not be feasible at all because of higher transportation costs and less bargaining power of the small firms. However, the products produced by special skills, which are known to the market or distributed through subcontracting systems have access to the market. Examples are Nepalese paper and handicraft materials. Nevertheless, the products which have market potential in the urban areas are usually produced in the urban sectors making the small enterprises in the rural sector uncompetitive in the market. The enterprises selling to formal sector are mostly hindered due to lack of information about market, lack of access to these markets, and the inability to produce the required standards and maintain a consistent product standard to meet the scale of demand with their limited production capacity.

4.1.2 Production System

Family members run overwhelmingly the majority of small enterprises with their own capital. Most of the family's resources are utilized in the enterprises and the family members do most of the work. As a result, the primary objective of the enterprises is not the maximization of profits to the enterprises, but to generate an expected utility to the household. Allocating the labor time of family members between various purposes such as agriculture, wage employment, involvement in one or more enterprises gives the family a fair degree of flexibility. In addition, the few capital goods that the household owns are often utilized for a number of different purposes. Therefore, there is a little separation of labor and capital structure between the households and the enterprises. Their primary objective is to secure the family's income through productive employment. A high-risk aversion is typical for their business behavior because of the often precarious economic situation. They establish long-term personal relations with suppliers and customers, preferably within their kinship, even if they loose short-term benefits. Their innovation and flexibility are of a defensive nature. In an economic environment that is characterized by scarcity and insecurity, they have to adapt permanently and localize new market niches. They are able to do so because they can simultaneously adapt their production, consumption and reproduction behavior to changing conditions, a task that would be impossible to small modern businesses.

4.1.3 Input Market

Input for small enterprises could be acquired through backward linkages, in most cases agriculture and forest-based products. Improvement in these inputs could only be made if there are efficient local capacities for the processing and distribution of these products. More often than not, there are formal sector enterprises to cater the processing and distribution functions, which usually are inefficient in Nepal. Small enterprises import a large share of their inputs from the urban formal sector. Due to insufficient information on the sources, the terms and conditions of the purchase of these inputs from the formal sector, many small firms are unable to get access to appropriate sources of raw materials. The small firms often face monopoly pricing, scarcity, and lower quality from these sources. In some of the cases, local firms such as local black smith and carpenters produce low-priced simple tools, which are reliable sources of input. Small entrepreneurs usually lack formal qualification resulting in information and management slackness.

It is obvious that the small firms in Nepal face major problems due to the constraints in the output and input market. Since rural small firms are run by the people with less education, networking skills and exposure, they cannot solve the constraints by themselves. As a result, their internal production system is very much dependent on kinship. Nevertheless, the small firms are mostly dependent on other enterprises, usually small firms such as merchants (middlemen, traders and small producers) for finance, market and input supply. Therefore, harsh (exploitative) terms and conditions agreed in informal (usually verbal) contracts with the merchants may never make the small firms sustainable. In addition, the breaking down of relationships with the merchants collapses the small firms in the rural areas. The personal and family expenses of the small firm owners are great threats to such enterprises. The owners themselves may be tempted to spend more, and situations such as sickness of family members and compulsory social rituals may drain up the capital. The ignorance and absence of business skills of the owners may increase the costs of production. They also suffer losses, not only in the business accounting sense, but also their labor costs (of the owners and family members). These situations quite often lead to life-long debt of the owners and family as a whole.

Those firms which seek input (finance and other inputs) and market in the formal sector may suffer from inaccessibility, delays and long bureaucratic procedures. Similarly, they may face scarcity of raw materials and equipment in the input markets. They will start to experience the competition in the output market. Lack of sufficient information and education makes them incapable to deal with the formal procedures in input and output markets.

Therefore, owners of the small firms need to overcome these hurdles in order to transform themselves into full-fledged small entrepreneurs. Once they attain this stage, they could run their enterprises autonomously. Some owners who are fairly successful in sustaining their enterprises will be satisfied with their employment situation and economic condition of the family. As a result, they develop a stagnant mentality and are reluctant to further expand the enterprises. In addition, an unsupportive business environment and the lack of information and education about the formal economic system prevent these enterprises from transforming into formal enterprises. Consequently, the enterprises having further expansion motives tend to expand with multiple informal sector small enterprises.

5. Can poverty be reduced through SME promotion strategy?

As stated above, the policy reforms and resulting economic growth did not result in poverty alleviation. On the contrary, the benefit of the economic growth is urban-centered and reaches only to a limited section of the people. The response to the policy reforms were made by the most developed sectors of the society who are few in number in Nepal. Since most of Nepal lies in rural areas which are not economically feasible for the private sector, the growing economy is ignored the rural areas. Therefore, the policy reforms which brought SME promotion strategies produced counter-productive results in the country by increasing disparities between poor and rich, and urban and rural. This situation is blamed for the emergence of the ongoing conflict in Nepal which has already crippled the economy and killed thousands of people.

Failure to achieve poverty reduction has created a daunting challenge to Nepal. One of the policy measures proposed in the development plans is entrepreneurship development in agriculture, which has been conspicuously lacking. In order to promote entrepreneurship, policy measures are required to attract the SME sector to indulge in the supply of modern inputs, providing safe and adequate storage facilities and market access to the agricultural output. The middlemen who are blamed of profiting at the cost of farmers and consumers should instead be promoted and facilitated for the mutual benefits of the farmers, entrepreneurs and customers. Similarly, the SME sector should be encouraged to make backward and forward linkages with the rural sector for agriculture and forest based products, local skill-based products and tourism. The government should devise and announce the policies and institutional mechanisms for promoting and facilitating inter-firm linkages through subcontracting, alliances and clustering practices.

With the policy reform, Nepal has introduced enterprise development support programs. The government is still continuing such support packages to develop the rural sector. Therefore, there are many government and non-government organizations established to promote rural economic activities. Most of the support programs such as management and skills training, and other business development services are usually developed on the basis of modern business management concepts. This type of program is not suitable for rural small firms as indicated by the nature, economics and growth patterns of rural enterprises. If the marginal firms and income generating activities at the subsistence level have to be developed, they need support which includes input supply and market access rather than training for individual entrepreneurs and management capacity development. This type of support could be provided by independent enterprises as a part of their supply chain management. Encouraging and facilitating independent enterprises in rural and urban areas to integrate backwards to the rural resources will develop rural and urban relationships. Such practices are now evolving in Nepal mainly in handicraft, herbs and agricultural products such as vegetables and milk. There is evidence that such practices have emerged automatically in Nepal in a few places and sectors. These practices contributed a lot to the establishment of new small firms, creation of new jobs and generation of industrial output. The booming carpet manufacturing sector once helped many small firms through such practices. Similarly, such practices have been observed in cash crops, fruits, vegetable, herbs and handicrafts in recent years. The entrepreneurs through their networking and relationship with the local people contact the local farmers and craft producers. They sign contracts, train the local people and provide other support when required, and bring the products to the urban areas and exported them to other countries. Nevertheless, these practices have taken place in Nepal so far without government initiation and policy support. Such practices have been found to be unnoticed, unregulated and left to run as it is. This situation prevents gaining multiplier effects, and the huge potential of generating collective efficiency has not been exploited.

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The Fight against Poverty and Unemployment in Kenya

David Cheloti

1. Introduction

Following independence in 1963, poverty was identified as the primary enemy of development that needed to be dealt with by the new government. After many years of anti-poverty interventions, poverty continues to increase. Poverty assessments in Kenya have revealed that different people view poverty differently. Government officials at the grassroots view the poor as lazy, idle, drunkards, criminals, prostitutes as well as people with little concern about their future. The poor, on the other hand, view themselves as having only a small parcel of land if at all, inadequate food, a large family, not always able to meet hospital and school fees, and usually engaged in odd jobs.[1] Most recent analysis on poverty describes it in terms of its prevalence, depth and severity. Such analyses reveal that the poor are predominantly found among subsistence farmers, pastoralists in the drier parts of Kenya, casual and unskilled laborers, households headed by females and unskilled persons, the handicapped, orphans and street children.

This suggests that the larger the size of a household, the more likely the household is to be absolutely poor[2]. It is evident that absolute poverty is less pervasive among smaller households, so that the size of a household has an important bearing on the odds for being absolutely poor. The household head's gender also makes an important difference. Male-headed households appear less likely to be absolutely poor in relation to those that are female-headed. In other words, households headed by females are inherently poorer.

The results also reveal that households located in rural Kenya are more likely to be absolutely poor in comparison with those that are urban-based. Other study findings suggest a greater proportion of poor households among rural residents.[3] Again, being rural-based probably shadows the effects of the rural environment, which may represent inadequate access to markets and services partly on account of poor infrastructure and failures in factor and produce markets. Furthermore, the results indicate that households with

[1] Institute of Policy Analysis and Research, 2000.

[2] The absolutely poor are viewed as those unable to meet their basic needs including those related to food. They can be compared with the food poor who are unable to meet their food energy needs, and the chronically poor who, even if they spent all their resource in buying food, would not be able to meet their food requirements.

[3] Government of Kenya, 2000.

a greater proportion of non-agricultural assets are less likely to be absolutely poor. The non-agricultural assets variable probably picks up a wealth effect (and conversely low agricultural productivity) and is a pointer to the importance of the diversification of activities at the household level away from agriculture, with important implications for household fortunes. Other results that pick the wealth effect include land ownership. Households with larger land holdings are less likely to be poor in comparison to those with smaller holdings. This opens a doorway for additional analysis on the economics of agricultural production and optimality of land holdings, both of which have a bearing on the odds for observing an absolutely poor household in Kenya. It is also evident that households that are able to generate non-agricultural business incomes are also less likely to be absolutely poor. In other words, the ability to generate non-agricultural incomes reduces the odds for being absolutely poor. From this perspective, micro and small-scale enterprises that now dominate the business sector in Kenya are therefore important in the context of poverty reduction.

2. Policy Interventions

Kenya has enhanced its family planning program as part of the strategy to reduce poverty by shifting household sizes towards points of optimality. Holding other socio-economic characteristics constant, smaller households mean greater access to education and health services, both of which are important for increased productivity. Since it may not be possible to address the circumstances that generate female headed households, part of the strategy against poverty includes attempts to empower women and tip the intra-household power relations and property rights balance in their favor. Female education tends to be helpful in that process. Given the spatial differences in the incidence of poverty, greater attention is being paid to improving the production and marketing environment in rural Kenya. Addressing failures in markets for land, labor, credit and insurance, and ensuring ready access to markets in rural Kenya is having greatest pay-off regarding poverty reduction. Mobilizing savings and asset accumulation and diversification also seems to have considerable poverty reduction value. Recent government preoccupation with micro and small-scale enterprises is also being sustained, given the importance of non-agricultural incomes in reducing the odds for observing an absolutely poor household. But it is the inequality in land ownership and distribution, and the movement towards extensive land fragmentation which are the greatest villains for rural poverty and that must be urgently addressed before Kenya can make any meaningful progress in reducing poverty. This calls for the development of a clear land ownership and utilization policy, and institutional structures that facilitate the evolution of land markets. These interventions would pave the way for the eventual replacement of inefficient farmers with those that are more efficient, a shift to more high value crop enterprises, and a movement toward optimal landholding. All these developments are important strategies against poverty.

With 80% of the population and the majority of the poor living in rural areas and reliant upon small-holder agriculture and livestock production, often at subsistence levels, it is evident that poverty reduction calls for higher agricultural growth rates. But with increasing population pressure on the land, it is equally important to expand non-farm employment in the rural areas. For the poor in urban centers, increased access to employment and self-employment in both the formal and informal sectors is vital. As female-headed households constitute a significant proportion of the poor, any intervention must be gender-sensitive. All these require very substantial improvements in infrastructure services and in the legal and regulatory environment.

The current strategies and priorities of the Kenya government on socio-economic development have recently refocused on the question of poverty. Poverty afflicts rural adults, households and individuals in proportions ranging from 30% to 53% of absolute poverty. Urban figures for absolute poverty nearly equal those of rural areas. Several documents form the emerging framework of the shift to a strategic focus on poverty reduction. The Eighth National Development Plan (1997-2001) set the goals and objectives of the 5-year cycle. The National Poverty Eradication Plan (NPEP) prepared in 1998 and launched in March 1999 described the scope of poverty and set reduction targets. The Interim Poverty Reduction Strategy Paper (IPRSP) 2000-2003 incorporated adoption of the Medium Term Expenditure Framework (MTEF) as the organizing budgetary framework for use of domestic and external resources, and development policies and objectives which started with fiscal year 2000-2001.

The NPEP had two principal objectives: to reduce the incidence of poverty in both rural and urban areas by 50% by the year 2015; and to strengthen the capabilities of the poor and vulnerable groups to earn income, narrow gender and geographical disparities and engender a healthy, better educated and a more productive population.

3. The role of SMEs in Poverty Reduction

Small enterprises include: hawkers, street vendors, Jua kali artisans and modern small-scale and medium enterprises. These enterprises do not make up a homogenous group whose interests can be articulated in one combined statement or policy. It would be unrealistic to expect any program to address all of the constraints this sector experiences to reduce poverty. The focus of this section on small enterprises will be on the disenfranchised portion of this sector that for the most part have had limited access to public resources since independence.

In many countries, small and medium enterprises are a significant source of innovation and jobs often employing more people than the large-scale enterprises. SMEs are equally important in Kenya employing more than 4.6 million people and accounting for 18.4% of the GDP[4]. While this number is statistically important, more than 56 % of Kenyans still live in absolute poverty[5]. However, the contribution of SMEs to the economy in its effort to reduce poverty cannot be ignored.

Box 1 The SME Sector

Why is this sector important in reducing poverty?

The Economic Importance:

- The sector comprises of 98% of all businesses in the country
- It contributes 30% of total employment. Of this, it contributes 40% to manufacturing, 79% to wholesale and retail employment and 40% to the service sector
- It provides 40% of all urban and wage employment in the country
- Today 75% of all new jobs are created in this sector
- It is growing at 14% annually against 2.3% in the modern wage sector
- Total capital employed in this sector is Kshs. 28 billion
- Jobs can be created at one tenth of the cost of the formal sector
- It requires less expensive infrastructure to flourish

The Political Importance:

- Small enterprises are to be found in all parts of the nation
- As available agricultural land diminishes, this sector will be the most attractive alternative occupation for future voters.
- It is the "small man's" right to grow and participate in the Kenyan economy
- Its promotion is consistent with policies of both rural and urban development

The Social Importance:

- Small enterprises promote a strong work ethic
- They are the seedbed of tomorrow's entrepreneurs
- They stimulate the emergence of a strong and stable middle class
- They represent the beginning of an "enterprise culture"

[4] GoK, 2002.
[5] GoK, 1999.

The important role of SMEs as a source of income and employment for poor households in Kenya has been widely acknowledged since the early 1970s, following the publication of an influential ILO report[6]. However, it was not until the first national baseline survey of SMEs, conducted in 1993, that the magnitude of the sector and its contribution to income and employment among the poor in the country became well known.[7]

In the last decade, the economy has seen the formal sector (the large corporate organizations) which have been employing many Kenyans succumb to socio-political and economic pressure resulting in massive redundancies, retrenchments and increased poverty. To alleviate poverty, the obvious option that these people have had is to join their counterparts in the SMEs sector, by starting their own businesses. The greatest impact of the SMEs is to strive to bridge the divide between the rich and the poor.

4. The Need for Reform

Why so little progress? Kenya has one of the longest histories of promoting small-scale industries in Africa. As early as 1967, the foundations were laid for its first industrial Estate. The primary emphasis of the immediate post-independence era was on re-addressing the balance of foreign and indigenous business ownership. Because of this, the first two Five Year Plans (1964-70, 1970-74) were aimed at establishing new economic institutions such as Industrial Credit Development Corporation and Kenya Industrial Estates specifically to provide investment capital for an embryonic class of Kenyan entrepreneurs whose opportunities had been severely limited in the independence period. At the same time, religious institutions were active through NGOs such as the National Council of Churches of Kenya who pioneered the establishment of village polytechnics. Today, there are hundreds of village polytechnics, which supply a pool of technical manpower for the formal and informal sectors.

The central actor, however, in the promotion and establishment of new small industries was the government, which in fashioning its policies and measures drew heavily on the Indian Model sometimes called the "Integrated Approach". The model is based on the premise that for small businesses to start and expand, a whole range of subsidized services are needed: pre-constructed commercial sheds, extension services that provide advice on technology and feasibility; management and technical training, raw material supplies, marketing outlets and interest credits. Fueled by grants from Germany, Sweden, Denmark, the European

[6] ILO, 1972.
[7] Parker, 1994.

Economic Community and others, the major portion of government investment was directed to the establishment of industrial estates in the larger urban centers of Nairobi, Mombassa, Nakuru, Kisumu and Eldoret. These estates operated as nerve centers for an outreach program offering (in varying degrees) the kinds of services mentioned above.

A similar approach was conceived and implemented for more rural or medium-sized towns through Rural Industries Development Centers (RIDCs). The most important distinction of the RIDCs was the emphasis on extension services for businesses located away from the central workshop facility. However, the approach turned out to be extremely expensive, and the benefits extremely small.

In 1972 the Kenyan 'Informal Sector' was discovered and given prominence in an ILO report entitled "Employment, Incomes and Equity in Kenya". It was argued that if small businesses could be given a chance to accumulate and invest capital, (something they are known to do efficiently), then spontaneous growth would occur in a well-dispersed manner. In spite of early recognition of the sector, there was a poor response to the challenge of creating access to capital, a factor so vital for small enterprise growth. Many still saw the presence of the informal sector as a scourge or an unacceptable reminder of the inequalities of income, which they believed, would disappear when development took off. Because of this ambivalence and reluctance to promote a sector operating on the fringes of legitimacy, donors and government continued, well into the 1980s, to support the industrial estate and RIDC models. The major assumption was that by spreading these investments over a wider geographical area, particularly the more rural locations, 'prime mover' industries would encourage many other enterprises with forward and backward linkages.

The small enterprise promotional model followed in Kenya for many years has been designed on the premise that the African entrepreneur is an "invalid" who must be spoon-fed on subsidized interest rates, subsidized rents in industrial estates, free training and marketing assistance. The result of this approach was that while the government was "feather-bedding" about 1000 enterprises (65% of which failed), the unassisted small enterprise sector grew from an insignificant number at independence to between 400 to 450,000 businesses within a short time. The implications of this failure are that government efforts should not be directed at providing integrated services for a limited few, but rather allowing the access of many to a few critical public resources, namely urban infrastructure, credit at market rates, and skills and information acquisition. This hands-off approach to the private sector forms the basis of creating the enabling environment.

4.1 The Enabling Environment

Agriculture contributes 25% of the GDP and employs about 75% of the labor force. It provides 75% of industrial raw materials and meets most of the domestic demand for food. Indirectly, agriculture-related transportation, trading and processing activities account for another 20 to 30% of the total economic activity. One half of the national economic activity is therefore attributable to agriculture. Poverty reduction strategies must pay attention to agriculture. Recent baseline surveys suggest that the small business sector also plays a critical role in Kenya's economic development, generating incomes and employment for the majority of Kenya's poor. In 1993, there were 910,000 small businesses employing 2 million Kenyans and generating a substantial part of the country's GDP.[8] Most of these small businesses thrive on the agricultural sector, exploiting systemic inter-sectoral links. Two considerations make these sectors crucial in poverty reduction. Kenyan poverty is essentially rural where smallholder subsistence agriculture dominates. Studies have also demonstrated that non-agricultural business activities enabling households to generate incomes from such businesses reduce the likelihood of absolute poverty. Micro and small-scale activities dominate Kenya's business sector.

Although the estate sector and larger medium and larger industrial concerns need policy support to continue expanding production and creating wealth, new strategies are needed to optimize poverty reduction. The facts suggest that policy attention must be paid to small-holder agriculture and the small business sector to enhance poverty reduction. In the recent past, the agricultural sector's performance has declined. The small business sector has not performed well either. The reasons for the poor performance include weak and inadequate infrastructure, especially feeder roads, electricity and markets, inappropriate technologies especially for smallholder farming, limited access to credit especially by women farmers and entrepreneurs, high cost of farm inputs, ethnic and regional violence and insecurity that has undermined investors' confidence.

A specific area that deserves policy attention is productivity. This is because it will be difficult to increase the incomes of the poor unless attention is paid to the productivity of the activities in which they are engaged. In other words, interventions targeted at increasing the productivity of small-holder agriculture and the small business sector should assist in reducing poverty. An appropriate framework from which to address production in smallholder agriculture and small business sector is to understand the nature of production relationships in these two sectors, and to use the information on such relationships to

[8] National MSE Baseline Survey, 1999.

develop interventions for increasing productivity. Specific targets and policy changes that could yield poverty reduction impacts in the program in Kenya include:

1. Setting specific poverty reduction targets to be monitored periodically and to be linked to real GDP growth rates, reflecting the targets to be achieved and keeping on track the 50% poverty reduction goal by the year 2015.

2. Tilting reductions in tax burden to the poor and other vulnerable groups. In welfare and consumption, this would imply relatively greater tax reductions for core consumption commodities among the poor (maize meal, kerosene, clothing, power, etc.). In productive services, it would imply greater incentives for labor-absorbing activities such as a lower tax on raw materials and transport used by the poor to generate incomes.

3. Shifting expenditures to the poor and to the areas of the economy (i.e. rural small scale sector and women) where poverty has been shown to be concentrated. Allocate key expenditures that open up infrastructure, supply extension services, transportation, security, etc.

4. Applying the financial sector more rigorously to the objectives of growth and poverty reduction. Kenya could benefit from the experiences of South East Asian countries in two key aspects. First, take financial services to the village level and micro-business, but with supportive business plans that make even small branches profitable. Second, contrary to Bretton Woods institutions, IPAR supports credit allocation to promote growth and poverty reduction objectives in the productive sectors.

Apart from the labor and capital inputs that form the core of productive processes, agricultural inputs and human capital variables are crucial in explaining levels of production.[9] In particular, netting out the effects of farm labor and agricultural assets, the analysis reveals that availability of purchased inputs, especially fertilizer, and having an educated person in the household, increase output from smallholder farms.

What about the productivity of the small businesses sector? Analysis based on the 1999 Baseline Survey of micro and small-scale enterprises indicates that controlling for the labor and capital inputs, productivity is positively affected by access to credit and membership of

[9] Pinckney, T. C., 1995.

the entrepreneurs to support groups. In other words, enterprises that have access to credit and/or are owned by persons who are members of business support groups produce more goods and services than other enterprises. This information partly holds the key to the development of interventions for increasing smallholder and small business productivity, and for reducing poverty. First, it is necessary to use channels that ensure adequate financial resources to the sector. Such resources will include those that find their way directly to the small-holders and small business sector through the financial markets. In that regard, it is important to remove institutional bottlenecks that constrict the flow of credit to, and flow of repayment from small-holder agriculture and the small business sector. Regarding the financing of small-holder agriculture, mechanisms for re-establishing links between produce and credit markets that broke down following liberalization will be needed. Other resources will be needed to improve rural infrastructure in order to open up and expand rural commerce and create the necessary links with overlapping jurisdictions of the national markets.

Further work is required to redress the market failures that condemn small-holders in subsistence production. These include failures in land, labor markets, credit and insurance market. Agricultural input markets changed dramatically against small-holder agriculture following price controls and general liberalization. Restoring traditional levels of input application will have to be guided by studies to examine recent shifts in value-cost ratios and the relative profitability of different crop enterprises. This information will then form the basis for appropriate interventions.

4.2 Poverty Reduction through Education

In Kenya, investment in quality education makes people more productive in the home and at work. Studies show that schooling raises labor productivity through increasing cognitive competencies of people, enhancing their literacy levels, providing sounder technical knowledge and greater capacity for logical and analytical thinking and reasoning. Besides, quality education enhances other non-cognitive competencies, which are relevant for economic and social change. It enhances, for example, individuals' personalities and social relations. Educated people become better informed; they have a different sense of time, are open to more and varied information, and have a stronger sense of personal and social efficacy, and are more open to new ideas and value technological changes. Quality education does not only enhance rates of economic growth, but also facilitates the achievement of other social objectives. In particular, the improvement in health, nutrition and literacy, and the strengthening of political participation, good governance and achievement of gender equity at both macro and micro levels. There is also evidence that the economic and social returns on investment in basic education in an agricultural country like Kenya are higher than other forms of educational investment.

The increased public demand for and investment in education by the government and other partners symbolizes the awareness of the power and usefulness of education. Education has been accepted as an important vehicle for poverty reduction in the country. However, many obstacles hinder its impact on economic and social goals. Education in Kenya remains inefficient, ineffective, wasting resources and accelerating the incidence of poverty.

The results of the previous attempts to develop education in Kenya indicate that the main problems and challenges facing the sector lie in failures in implementation, not design of policies and plans. The Education for All (EFA) 2000 assessment has revealed that progress made since the World Declaration on Education for All[10] has been much slower than anticipated in relation to most of the major indicators of a working educational system. While it is true that more educational opportunities have been created by the introduction of free education in primary schools, many eligible school-age children, aged 6 to13 are still out of school, especially in the arid, semi-arid and coastal areas.

Many children, who enroll in primary school in Kenya, particularly girls, do not stay long enough to complete the primary school level, nor proceed for further education. For example, in the last decade, completion at primary level has remained at 47%. Students' achievement at all levels has not been encouraging, just like the relevance of the education offered in the country. This explains why the Report of the Commission of Inquiry into the Education System of Kenya[11] recommended radical transformation of the 8-4-4 system of education.

The provision of quality education and the achievement of universal primary education (UPE), as a basic right and need, means tackling the effect of poverty on children's participation and achievement in school. National education strategies will have to include poverty analysis, which is regional and gender responsive. Such analysis would provide useful information at both micro and macro levels for planning, developing and implementing pro-poor interventions, which would accelerate access, enrolment, completion and achievement in education. Education strategies must promote both intra and inter-ministerial linkages. The budget should target efficiency and cost recovery measures for the

[10] Jomtien, 1990.
[11] Koech Report, 1999

benefit of the disadvantaged, especially the girls from poor households, reduce cost of education and achieve universal primary education by 2015. However, we also know that poverty is increasing in the country and more and more parents will find it difficult to invest in their children's education. It is therefore critical that the government puts education at the core of poverty eradication.

Many organizations have sprung up in the last few years to provide management and entrepreneurial training to people with small-scale enterprises in Kenya. The curriculum of the 8-4-4 educational system has incorporated elementary business skills and entrepreneurial training orienting the young towards self employment. This is in addition to two other public institutions, the Kenya Institute of Business Training and the Women's Bureau, which are providing managerial training and advisory services to people with small-scale enterprises.

Box 2 Training offered to SMEs

Management and Entrepreneurial Training in Kenya

Problems:

- Most training courses are too expensive, and there are not many courses on offer
- The training of trainers in this field is still at an embryonic stage in Kenya, and the existing training is offered to a narrow target group

Recommended solutions:

- Make the Directorate of Industrial Training (DIT) an autonomous body. The DIT operates very inefficiently; it is recommended that it be converted to an autonomous body with heavy participation by the private sector
- The use of the Training Levy must be extended to incorporate SME entrepreneurs
- Government should change the policy, which perpetuates training institutions, which can never be sustainable. The government should focus its activities on those areas where private sector involvement is limited or to other strategic options where the social and economic benefits justify public intervention.
- Immediate action should be undertaken to identify the most effective and efficient ways of developing skills in the SME sector through formally licensing the existing "'informal apprentices system" by identifying master craftsmen to provide a more practical and systematic training and by issuing certificates at the end of the training which shall be recognized by the concerned ministry
- Establish a Fund for Enterprise Training to feed private sector organizations involved in the provision of managerial and entrepreneurial training to the small enterprise sector

5. Conclusion

The government won the election on the platform of poverty reduction. The discussion of the strategies mentioned represents the articulation of government's response to the urgent need to reduce the incidence of poverty in Kenya. The strategies have been the result of an intensive, wide ranging consultation process. The consultation to views and ideas has been done thorough and involved all sectors of our society but particularly the poor themselves together with civic organizations long experienced in addressing poverty. The resultant strategy is comprehensive in its treatment of all issues surrounding the battle against poverty and mobilizing all available resources. It is expected that the policies, priorities, programs and mechanisms for combating poverty will move forward.

Both the Poverty Reduction Strategy and the process of its articulation represent government's commitment to change. Changes in the focus on national development to make a concerted effort to reduce poverty and change that brings together all our resources to devise better policies and programs and to mobilize all available resources are needed. It is the government's hope that all sectors of our society and our development partners will accept the challenges and opportunities and work with a unity of purpose towards the goal of eradicating poverty in Kenya.

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Bolivian Strategy for Poverty Reduction: From Actors to Policies – Promoting the Micro, Small and Medium-sized Enterprises

Victor Cladera

1. Introduction

Bolivia, a nation with a population of 8.3 million (2000), is a land-locked country in the heart of South America. The central government comprises 16 ministries. In each of the nine Departments, there is a regional administration, headed by a centrally appointed governor and at the local level there are 314 municipalities. Following a period of harsh military rule during the 1970s, Bolivia underwent profound economic and social change after the return to democracy in 1984. The reasons for this change were; first a hyperinflationary process, second an over dimensioned public sector unable to apply austerity measures to avoid the mentioned process and third the collapse of the tin mining sector, once the mainstay of the economy.

Bolivia was one of the first countries, together with Ghana, to sign an IMF structural adjustment program in 1984. The economic reforms applied then focused on the tasks in the macroeconomic stability and the privatization process to avoid the hyperinflation and reduce the public deficit but the reform program could not carry out deeper administration reforms and postponed needed development policies. Even though the privatization program brought a major change in the role of the state from direct producer to that of market regulator, the lack of deeper administration reforms denoted institutional weakness and poor public coordination. The later, together with high dependency, was one of the main factors to bring about the economic stagnation, unemployment and growing levels of poverty until now.

As consequence of the economic stagnation Bolivia remains one of the poorest countries in the western hemisphere with an average annual per capita income of $1,000 (2000). In mid-2004 the unskilled wage averaged only $17 per week. To change those living standards, poverty alleviation has become a major focus of the reform agenda. State priorities have switched from productive sectors to social sectors (i.e. health, education, housing and sanitation), which now comprise more than half of public expenditure. In order to improve the economic growth, administrative decentralization has been promoted to include local governments and citizen's participation in local development issues. However, until now, this level of decentralization has not allowed the local governments to use local resources to finance social investments due the fears of the central government to lose possible sources to finance fiscal shortages.

The results of the economic stagnation and the lack of coherent development policies can be seen in the 2001 census. For example, the figures of the census show only a minimal decline in rural poverty and increasing unemployment levels in the urban area. The 2002 Human Development Report for Bolivia shows an improvement in social indicators but not in household income. Despite considerable foreign aid to the education sector, national surveys have shown only a small improvement in the efficiency and performance of the sector since 1996. In the economic area, Bolivia remains heavily dependent on foreign aid. From 1989 to 1999, aid disbursements reached an equivalent of 10% of GDP. Over the ten-year period from 1992 to 2001, approximately 50% of the total public investment was financed from external aid sources reaching 62% in 2004.

External pressures encouraged the Bolivian government to carry out a participatory process to fit the government priorities with the needs of the civil society. The World Bank (WB) articulated in 1999 the Comprehensive Development Framework (CDF), a holistic strategic vision to promote development focused on the poverty reduction. This new vision of the WB allowed the Bolivian government even a greater ownership to decide over the development policies gaining time avoiding the red tapes concerning the development policies.

In October 1997, the government convened the first national dialogue with the civil society. Following the bases of the HIPC I and recommendations of earlier Paris Club meetings this consultation process included at the beginning only social issues but it was broadened to include economic development and politic issues clustered in three agendas. The outcome, based in results of the three agendas, was the identification of needs and the formulation of proposals for poverty alleviation as the top priority for national development. A second, more participatory national dialogue took place from May to August 2000. The outcome was the formulation of a detailed poverty-focused development strategy, the "Bolivian Strategy for Poverty Reduction" (BPRS or EBRP in Spanish). The strategy aims to increase the level of stable employment, raise incomes and increase the share of public expenditure on social sectors (education, health, etc.) and the share of public investment disbursed through local governments. The basic funding of the BPRS came from the HIPC program complemented with foreign aid and public funds.

At the beginning, the crucial objective of the BPRS was to bring about a better 'fit' between the sector, sub-sector needs and geographical allocation of foreign aid and the development priorities of the Government. To structure this better "fit" the government developed a sector matrix in order to allocate the existing aid portfolio within 14 broad 'actions' identified as priority by the BPRS. In practice this meant closing down over 100, mainly smaller aid projects that did not fit within the priority areas. The greater clarity in expenditure priorities now means that government regularly rejects aid proposals that are not priority-focused. This clear strategy for the allocation of resources concerning the development policies allowed the access to the HIPC II funds.

As mentioned above, the government created a national strategic agenda for economic development which is a participatory process that involves the social, business and aid community in the planning process of development policies. This process represents a structural challenge in order to create an organized bureaucratic system and a networked private sector for a better coordination with one objective; to begin a productive transformation and restructure the income and employment contribution of the entrepreneurial pyramid. In terms of number and employment, the micro enterprise is the base of the pyramid, then the SMEs and at the top the large enterprises, but in monetary terms, the contribution of the micro and SME (M&SME) is very low. The Bolivian economy is characterized by a strong concentration of the production factors that causes a polarization of the employment and income.

2. The Small Enterprise in Bolivia

To understand the actual situation of the Bolivian economy and the role of the M&SME it is necessary to review the hindrances that influence its development. The growth pattern of the Bolivian economy is restricted by many structural factors. Among them we can mention: primary export orientation, low diversification, high dependency of external markets, lack of roads network, hard geography, as well as lack of articulation of the inner market, institutional weakness which increase the transaction costs, low competitiveness, over-dimensioned bureaucracy and corruption. In the last ten years, the privatization process generated an increase of the foreign investment mostly in the service and extractive sectors increasing the GDP but with almost zero effect in the poverty reduction due to the absence of linkages of these sectors with the rest of the economy and the lack of better distributive policies.

The structure of the GDP showed that on average, in the last 12 years the manufacturing sector contributed to only 17% of the GDP compared to more than the 53% of the tertiary sector and 25% of agriculture, mining and oil. The primary orientation to produce commodities caused an extreme concentration of the property of the production factors, mostly land and capital, thus the main effect was the polarization of the income structure in comparison with employment generation.

If we analyze the structure of the employment and the contribution to GDP by size of the enterprises in Table 1, we will see the two extremes of the above mentioned polarization. On one extreme, the large enterprises represent 65%[1] of the GDP but generate only the 8% of the employment. On the other side we can see the micro enterprise with a share of 25% of the GDP and generating 83% of the employment. This polarization is one of the main hindrances of the economic growth with equity in the distribution. Recent figures indicate that in the last three years there was no important change in the above mentioned figures but there were changes in the employment levels mostly in the micro enterprise that reduced the employment rate to 79.4 in 2001 (the medium and big enterprise had a slight increase). According to the statistics, the unemployment level grew from 8.5 to 8.7% between 2001 and 2002 and the people employed in the informal sector from 61.3 to 64.7% in the same period.

Table 1: Income and Employment Generation by Size of the Enterprises

GDP and Employment Structure by Number of Workers 1999				
Size (by number of employees)	**GDP %**	**Employment %**	**Labor Productivity Bs (Avr.)**	**Skilled workers* %**
Micro (1 – 9)	25.5	83.1	699	23.1
Small (10 – 19)	2.7	4.7	1,313	64.2
Medium (20 – 49)	3.4	3.4	2,228	66.0
Large (over 50)	65.3	8.7	17,084	80.0
Difference (adjusted)	3.0	0.0	-	-
Total	100	100	2,276	31.7

*Workers with 10 or more years of education.
Source: Ministry of Labor, 2001.

Another consequence of the concentration of the production factors is the gap in productivity. The productivity gap between the smaller and larger enterprises (Table 1) can be explained mainly because the large enterprise has more access to capital (financial,

[1] Mostly oil and mining products for export.

human, etc.), technology and markets. In addition, we can mention that almost all the larger enterprises that generate a big percentage of the income are in the primary sector. Most of those larger enterprises are trans-national corporations exporting primary goods or commodities like oil, minerals or soy. In this sector of the Bolivian economy no linkages exist between the large and small enterprises or external economies which can be absorbed by the rest of the industry. Moreover, the later means that any rise in the demand or in the prices of oil or tin will increase the GDP but without almost zero effects over growth variables like employment.

3. From Actors to Policies: the Bolivian Experience

3.1 The Consultation Process

With a bottom-up approach in 1997 the Bolivian government began a participatory planning process called national dialogue. The National Dialogue, which was the essential forerunner and source of input to the Bolivian Poverty Reduction Strategy (BPRS), was designed as a public forum in which society's participants, both territorial and functional, could meet with the political system's players and agree on a state policy to reduce poverty and social exclusion. The process was initially structured around a social agenda to define the distribution and control mechanisms of the HIPC. For the second submit in 2000, the process was broadened to discuss economic and political issues with its own agendas. Carried out through a series of local workshops for each agenda, this process ended with a national round table based mainly on the results of the social and economic agendas to face coherent development policies.

The Social Agenda organized workshops at local and regional level involving local and regional governments as well as social organizations. The agenda established resolutions on a number of topics grouped into seven areas closely related to the economic agenda: production infrastructure, education, health and basic sanitation, land and territorial issues, and policy-making and institutional issues such as bureaucracy, transparency and networking. Actions agreed to support the production and improve the production infrastructure involved the establishment of policies on finance, development, and promotion to benefit small producers, product marketing systems, technical assistance and productive training, and construction, maintenance, and improvement of roads and irrigation systems.
The political agenda was an input to define the institutional framework to reduce poverty. The agenda sought to discuss and sign political agreements in an effort to analyze alternative solutions in issues like participatory democracy, inclusive citizenship and transparency in public management and lawmaking including the modernization of the

political system. The key players in this summit were the political parties, the civil organizations and the government. This consultation identified problems in the public administration affecting policy making and institutional clearness. The most visible problems were corruption and bureaucracy. Special attention was given to the overly centralizing tendency exhibited by the state that avoids the equitable distribution of the public resources. Even though there was no signed political agreement, there was an agreement to give to the municipalities the administration of the HIPC II resources through the banking system.

The Economic Agenda began with a strategic proposal of the development ministry. To agree over the discussion issues of the national development workshop preparatory sessions at local levels were arranged. The local sessions gathered producers (especially small ones), civil organizations and government officials in order to structure a coherent agenda for the national economic development workshop. The meetings were structured in three stages.

The first stage included 17 preparatory workshops at local and sectoral level, 10 for the discussion of sector policies and development issues and 7 for the discussion of production chains. The sector workshops included micro, small, medium and large enterprises, business organizations, unions, political parties and the government. For the Production Chains Workshops (PCW) the Bolivian System for Production and Competitiveness (government) together with the National Chamber of Industries selected 7 production chains based on employment generation, income generation, regional development impact, export development or import substitution, and investment requirements. The actors taking part in the PCW´s were key players in every link of the production chain.

The seventeenth workshops gathered the results in 10 strategic issues to promote productivity, competitiveness and enhance the capacity of the productive sector to generate added value and employment. Those ten strategic areas are: infrastructure and services, R&D innovation and technical assistance, finance and credit flexibility, external markets access and development, trade incentives, state purchases and promotion of internal markets, export promotion, information access and market intelligence, investment promotion, legal adaptation (i.e. tax policies flexibility to promote the formalization of the productive sector and the modernization of the labor regulations to fit the reality of the micro and small-scale enterprises), public management reform to reduce the red tape (bureaucracy) and to avoid transaction costs, and development policies based on technical criteria for each sector that include promotion and empowerment of business organizations with authority to participate in the design of policies and to monitor policy execution in the production networks. The development policies must include a transparent regulatory framework for legal security to avoid uncertainties that affects the investments in the productive sector. These results were the base for the second stage, the national agenda for economic development.

The second stage was the national economic development workshop. The objective was to make agreements in key economic development issues and specify priority intervention areas to implement the needed action. The national development workshop used, as analytical tools, the results of social agenda and the 17 preparatory workshops of the economic agenda. Going beyond the analysis, this stage was centered on the work regarding the action guidelines and intervention priorities. The methodology integrated 8 cross-cutting issues as intervention priorities and the promotion of the production and non-financial mechanisms, which include actions for markets development, investment promotion, production chain development technical assistance and competitiveness support.

The third stage was the lawmaking discussion and it was included in the national dialogue round table. However, this stage was not executed properly due the lack of coordination between the two powers of the state involved in this step. The discussions involved the key actors of the three agendas and the two powers of the state legislative and executive. Even though this stage was not properly executed, the national dialogue proceedings followed the action lines defined by the results of the consultation process and a national dialogue law was approved. The law called "Law of the Dialogue 2000" included the main results of the proceedings and institutionalized the consultation process.

The results of the three agendas identify social, political and economical bottlenecks affecting development and priority actions in key intervention areas. The four strategic components enhanced employment and income opportunities for the poor. The action lines to follow in this area were the implementation of policies oriented to promote the development of the micro and small enterprise, the development of infrastructure and services, technical assistance, and the regulation of financial services. This component involves actions to overcome obstacles affecting directly or indirectly the formation of human capital including health education and basic services.
This systematization promoted agreements between the social actors and the government in order to design structured priority actions for poverty reduction. The national round table grouped the talks for poverty reduction in sector subjects, political issues, and the mechanism for the assignation of the HIPC resources, social control of the BPRS actions and institutionalization of the national dialogue. Those agreements were the cornerstones of the

BPRS and national laws or law-ranking decrees that together with the economic plan of the government pursue to enable the competitiveness of the productive sectors, increase the economic growth to acceptable levels and reduce poverty.

3.2 The Bolivian Poverty Reduction Strategy

Based on the results of the national dialogue, the BPRS was structured with four interrelated strategic components and cross-cutting issues that define actions to combat poverty. These are aimed at the expansion of employment and income opportunities, the development of people's capabilities, safety and protection for the poor, and the promotion of social integration and participation.

3.2.1 Expanding Employment and Income Opportunities for the Poor

To expand employment opportunities and incomes for the poor, the BPRS proposes strategic actions and specific policies related to the promotion of rural development, the development of micro-finance, and technological assistance, among others.

3.2.1.1 Promotion of Rural Development

To achieve this objective, the BPRS established the following strategic actions such as the expansion and improvement of productive infrastructure through the creation of irrigation and micro-irrigation infrastructure, local roads, rural electrification, definition of the land property rights and expansion of rural communications. The widening and strengthening of access mechanisms to land as a resource was also a priority. Additionally, another action was to increase competitiveness through production chains like agro-food and agro-export. A final action was the promotion and diversification of non-agricultural employment opportunities in rural areas to increase the non-agricultural income through paid employment not related to agro-activities.

3.2.1.2 Promoting the Development of Micro and Small Enterprises

The strategic actions to promote SMEs were focused on the creation of a competitive environment to promote the M&SE's by simplifying, modernizing, and adapting the current legal systems (taxes, labor, etc). The development of a non-financial services market to respond to the needs of the private sector in technical assistance, training, information access and marketing was also part of the plan. The BPRS identified two actions to promote the non-financial services market. First, providing technical assistance services, training in business management, information and marketing; and second, coordinating the incentives for artisan production through programs for craftsmen and small industry.

3.1.1.3 Developing Microfinance

The actions in this area are oriented to diversify and expand the coverage of microfinance in the urban and rural areas, strengthening the institutional and regulatory framework, and the improvement of the quality in the supply of microfinance services. Promoting micro enterprise is closely linked to the micro credit and microfinance policy that are greatly needed among low access groups such as the rural population– traditionally shut out of the financial system.

3.1.1.4 Supporting technical assistance

This action foresees the support for research and technological innovation that are directly tied to the access and dissemination of information, which in turn makes it possible to reduce the transaction costs, production costs, and marketing costs for agricultural and industrial products. With these actions the BPRS wants to improve the product quality, and increase the competitiveness of production. This component will be carried out as part of the national development plan for the M&SE with the following actions: implementation and support of a new system of technological innovation in urban and rural areas, promotion of the private supply of technical assistance and training, creation of information systems to link supply and demand for technical assistance through the Technical Assistance Service of the government, and to develop a system of comprehensive technical assistance using the model of training of trainers under multi sector and multi topic instruction.

3.1.1.5 Expanding Income Opportunities for Bolivians as Owners of Assets

The Law on Property and Cooperative Credit (PCP) created two benefits using the resources of the Collective Capitalization Fund (FCC), which come from the capitalization of public enterprises. Those benefits are the "*Boli-vida*" and "*Acciones Populares (AP's)*". Boli-vida is an annual allowance to those over 65 years of age. AP's are transferable fiduciary certificates which will be distributed to all Bolivian citizens over the age of 21 and less than 50 years of age. An AP may be sold, conveyed in an estate, used as a down payment for access to low-cost housing, or as a loan guarantee. Since AP's can be used as guarantees for micro credit (either by individuals or among various micro enterprises) more democratized access to credit will be promoted. This will make possible an increase in the possibilities for creating or expanding M&SE's, particularly in rural areas given the difficulties that small producers in this sector have in providing guarantees.

In order to create the long-term conditions, to consolidate the BPRS as a state policy, an action plan for the government has been developed. The plan indicates the most relevant actions to be carried out by the government in the short term and establishes the foundations for the BPRS implementation and the attainment of the central poverty reduction objectives ensuring continuity. The plan considered actions up to the year 2002 proposed in the BPRS. The development of the action plan was a participatory planning process involving all the relevant ministries and branches of the government to gather relevant information about priorities and schedules in each sector of the government. The information made possible the design of the plan with two components: Structural Actions and Sector Actions.

The structural actions are related to the institutional reforms and organizational changes to ensure the viability of the BPRS. These actions cover issues concerning the sustainability of the strategy and its relationship with international cooperation partners, monitoring, evaluation and law approval. The sector actions are related to basic measures that ensure the viability of the strategic components and the cross-cutting issues of the BPRS.

3.2.2 Small enterprises and poverty reduction

The objective of the medium- and long-term Bolivian economic program is to achieve growth rates between 5.0 percent and 5.5 percent in 15 years, this will help to reduce the headcount poverty index from 63% to 41% and reduce the extreme poverty from 37% to 17%. On average, the Headcount Index of poverty and extreme poverty would be reduced to annual rates of 1.5 percent and 1.3 percent respectively. The economic growth was expected to increase gradually from 4.0% in 2001 to 5.0% in 2003. Thereafter, the rate will increase to 5.5% in 2008 remaining in this trend until 2015. Nevertheless, the composition of this growth would not vary substantially in terms of structure, it is foreseen that more sustainable growth could be achieved if productivity and competitiveness are improved in labor-intensive sectors. The monetary policy will seek to preserve price stability and keep inflation rates below 4.0%. In addition, the exchange policy will retain an exchange rate that is competitive for exports. The current account deficit of the balance of payments (8%) will tend to fall until reaching levels below 5 percent of GDP, the external savings will be lower and the investment will be financed with an increasing percentage of domestic savings.

In this sense, the BPRS seeks to produce growth with greater utilization of the labor force. Consequently, it emphasizes the support of the M&SE's. However, the contribution of other domestic and foreign medium and large enterprises will continue to be essential to achieve increased growth rates and thus support measures for those are designed. In this way, the foreseen macroeconomic scenarios depend on the consolidation of appropriate economic and legal frameworks for the development of the private sector through enhancements in the productivity of sectors with intense use of labor.

The impact of the BPRS strengthens the environment for economic growth, particularly in sectors involving traditional agriculture and small production units in both urban and rural areas. In these sectors, the levels of productivity and competitiveness will be increased through concrete actions which have more short- and medium-term effects on growth giving in this way more opportunities to the population. The development of small production units (urban and rural) foresee the adaptation of regulations for their operation, coordination between the public and private sectors, and the development of the non financial services market as an instrument for enhancing efficiency and competitiveness in order to generate stable employment in these units. A greater role for micro and small enterprises is also anticipated in the domestic market through active participation in production networks and in the provision of goods and services, for road maintenance and construction, construction of irrigation and micro-irrigation networks and basic sanitation at the local, regional and national levels.

The BPRS understands the micro and SME development as the central strategic instrument to open employment opportunities for the poor and identifies three strategic guidelines for its development: First, creation of a competitive environment, second, development of the market for non-financial services, and, third, strengthening of the private and public supply to support the micro and SME's. Hence, important actions will be taken concerning the improvement of the regulatory and legal framework and the provision of technical and entrepreneurial assistance services as well as better access to micro credit and financial services for small-scale activities.

3.2.3 Indicators

Impact indicators summarize changes in the dimensions of poverty. These indicators express the result of economic and social determinants of the population's levels of well-being and provide an overall view of poverty reduction. It is anticipated that levels of well-being among the poor population will improve around the period 2001–2006, with increased average family per capita income, higher educational levels and a better health situation. The projected impact outcome indicators were based on economic growth rates and the degree of urbanization at levels similar to those average levels currently encountered for Latin America. Attainment of the poverty reduction goals depends on improvements in employment and income conditions, especially for small producers. Greater capacities (particularly higher levels of schooling) will reduce poverty to the extent that social programs are consolidated and the labor market is able to absorb a larger percentage of the skilled labor force.

Outcome indicators are evaluation measures that supplement the impact indicators in order to observe the effects of the Strategy in shorter periods. The goals for these indicators are consistent with the intermediate indicators. As a result of rural development and economic growth actions, per capita family income is expected to increase up to 50 percent in the year 2015.

Intermediate indicators are associated with the outcome indicators and are closely related to the action plans. To help pinpoint goals, entities responsible for achieving them have been identified. The intermediate indicators are associated with programs and projections contained in the BPRS action plan and thus represent a monitoring instrument. The effectiveness of actions will be reflected in the outcome indicators and more indirectly in the impact indicators. The goals were set in coordination with the sector ministries, based on projections and experiences in other countries. For monitoring purposes, the intermediate indicators have been grouped together according to the four strategic components (opportunities, capacities, security, and participation). Three cross-cutting themes are also included: ethnicity, gender and the environment. The priority actions in each strategic component can affect each of the dimensions of poverty. Thus, for example, increased incomes in rural areas not only expand opportunities for the poor, they also give families more and better access to education and health services and this helps to build their capacities.

The indicators for the income and employment opportunities for the poor are considered in three sectors: rural development, road infrastructure, and microfinance. There are specific quantitative and qualitative indicators that bring strategic actions and policy measures together. Developing quantitative indicators in the case of the M&SE's requires private sector participation and the development of information systems to supplement current systems.

4. Evaluation of the BPRS

Almost three years have gone after the implementation of the opportunities component of the BPRS. During those three years, the implementation was focused on strengthening institutions and the defining the norms to provide financial resources to the small enterprises but these actions failed due a lack of coordination between the different ministries and organizations working on rural development and SME promotion. Concerning the specific sector plans and policies there was not a meaningful progress mainly due the institutional weakness of the public and private sector. The promotion of production linkages between the small producers and the big enterprises were not properly developed and the articulation between the components of the BPRS (i.e. opportunities-capacities) was inexistent due the lack of a regulatory framework. The lack of a technical education curriculum and programs is an example of this failure to connect the demands of the labor market with the supply of human capital technically formed.

Most of the foreseen results were not reached because the projections were not accurate enough. On one side the foreseen growth levels were not reached and the effects on poverty reduction were lower than the expected. Recent evaluations show that increases in economic growth rates generates reductions less than proportional in poverty; but even though a proportionality between the two variables could exist, (unitary elasticity) it would not be possible to reach the goals of the BPRS due to the lack of capacity of the productive sector to generate stable employment. The preliminary estimations suggests that the average growth for the 2006-2015 will be 4.8% much lower than the original estimations of the BPRS.

4.1 Growth and Poverty Reduction

The importance of economic growth for poverty reduction is explained through the trickle down mechanisms. The mechanism describes an overflow caused by development policies that induce the reduction of poverty levels The literature about this issue[2] indicates that poverty levels can be reduced by combining the growth effect (income increase) with the distribution effect (fair transfers to the poorest). The empirical evidence[3] shows that in developing countries the poverty level is less sensible to positive growth mostly because the development processes are characterized by weak distributive effects, low linkages and networking levels between the productive sectors and a high concentration of production factors and natural resources. In the poorest countries, where the transfer of resources is highly unequal and the percentage of poor population is very high, the effect of economic growth on the poverty level is very low. Initiatives to reduce poverty are condemned to fail if they do not foresee stronger distributive mechanisms to encourage growth within a favorable model.

[2] Dollar & Kraay, 2000; Ravallion, 2001.
[3] Dagdeviran et. al., 2002.

As stated above, the poverty levels in Bolivia show a low sensibility to positive growth. The reason is that Bolivia has one of the highest levels of inequity and poverty in Latin America[4] and the increases in the GDP are generated by the exportation of low value-added commodities which do not have significant effects over employment or income distribution. In Bolivia, for each positive point of growth (1%), the percentage of poor population is reduced only to 0.6% in the urban areas and 0.3% in the rural area. These figures are under the estimations of researchers like Dollar and Kraay[5] who express reduction averages of 1. Considering this framework we can say that the possibility to reduce poverty in Bolivia depends not only on distributive mechanisms and growth levels but also on the capabilities of the productive sectors to encourage growth within an equitable distributive model.

4.2 Adjustments of the BPRS´s Opportunities Component

Preliminary evaluation of the BPRS shows the need to adjust central issues in the BPRS design in order to increase its effectiveness. In this sense it is necessary to articulate the growth patterns with the needs of employment and income creation. This adjustment means a productive transformation that will be achieved with the inclusion of strategic actions to increase economic growth. It is based on the increase of the productivity level of the small industry mainly and on a strong articulation of all economic agents involved in the production processes. Productivity will enhance the competitiveness levels of the economy that will provide a better participation in international markets. This will generate synergies and external economies that benefit small enterprises, which can generate better insertion conditions in the labor market. Following this line of action, it is necessary to build a close link between technical education and the needs of human capital in different sectors of the economy. Thus, the labor market will be capable to respond to the requirements of human capital.

4.3 Productive transformation

The actions to reformulate the BPRS aim to promote improvements in the quality levels of the workforce. These actions seek to develop differentiated incentives to increase the productivity and competitiveness of the smaller and bigger enterprises and to promote the

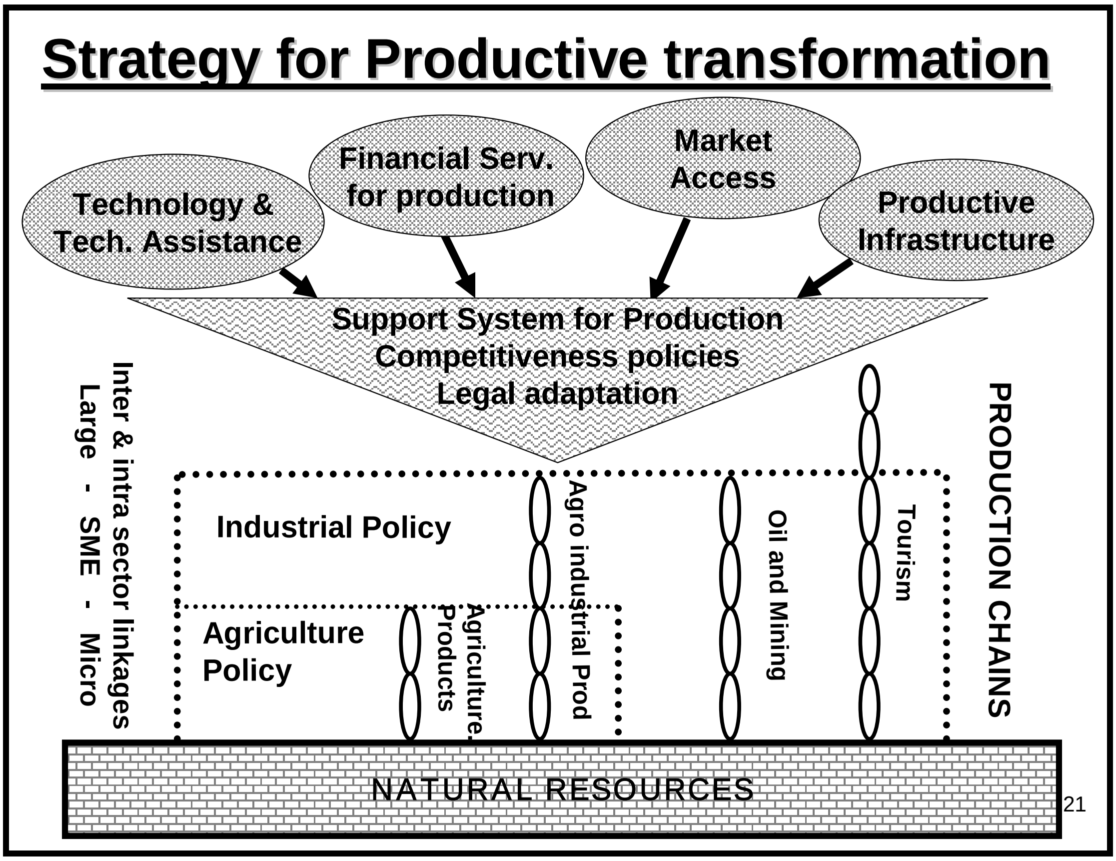
[4] The income of the 10% of the population is 25 times the income of 40% poor population, in Latin America this relation is only 15 times (Hernany 2002). The poverty is 2 thirds of the population while in Latin America is 43% (CEPAL 2002).

[5] In the researches of Dollar & Kraay (2000) and Bourguignon (2000) they consider developing countries for the calculations.

technological change for a better economic insertion of those economic agents with lower capital access like small producers, artisans and informal workers.

In Figure 1 we can see a strategic schema to enable the productive transformation. The strategy begins with four strategic policies to develop a suitable support system capable to create an environment to foster the chains. The main objective of the transformation process in this schema is to make a good use of natural resources to generate stable employment and added value in the production process. This will permit a better assimilation of technology and a better transfer of appropriate technology to the smaller producers.

Figure 1: Strategy for productive transformation



The transformation process entails the development of production chains to enable inter and intra sector linkages. The development of chains requires an adequate institutional environment to decrease the transaction costs and second to transfer appropriate technology to smaller enterprises. The Bolivian System for productivity and competitiveness identified 14 production chains, which can generate thousands of employments in the micro small and medium enterprises. This will permit a better assimilation of technology and a better transfer of appropriate technology to the smaller producers. The productive transformation entails also a change in the sector patrons regarding the participation on employment and generation of income. For example, the agricultural sector participates with 14% in the GDP and assimilates 44% of the employment while the industry generates 17% of the GDP and absorbs only the 9% of the employment. The productive transformation will change this patron for example; enhancing the agro-industrial chains to increase the productivity of the agriculture and the share of the agricultural sector in the GDP.

The productive transformation requires a clear state policy to articulate actions of the central government and the actions of the municipalities at local level in order to facilitate the access to higher levels of capital, training, and better access to appropriate technology. The productive transformation needs also explicit policies not only to promote the capacities to generate and manage productive units in the urban and rural areas, but also to generate synergies through the implementation of production chain structures.

In conclusion if the BPRS does not work properly it is because there are construction defects in its theoretical conception because of the mechanism in which it is based. It simply does not have the expected impact in economies with inequitable distribution. In reality, where policies work, weaknesses can still be identified between the main components of the strategy.

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The SME Promotion Policies in China

Zhenjing Li

1. Introduction

As a result of the economic reforms and market opening measures, small and medium-sized enterprises (SMEs) in China[1] have enjoyed remarkable development. Non-state-owned SMEs have become the main part of the Chinese economy and played an increasingly important role in the national economy and social development[2]. In China, more than 10 million SMEs[3] were registered by the end of 2003, accounting for more than 99% of the total number of enterprises. SMEs in China, have contributed to about half of the gross domestic product (GDP), about 65% of the national industrial output value, 60% of the exports and 43% of the taxation of the country. The SMEs provide 75% of the jobs in urban areas of the country and are responsible for creating most of the new urban jobs. They are also the main destination for workers laid-off from state-owned enterprises (SOEs) that re-enter the workforce[4].

Today, SMEs are getting stronger and continue to contribute to the development of the Chinese society and economy. They exert the same function as SMEs in other countries, namely promoting employment, technological innovation, training of entrepreneurs, developing international economic relationships, accelerating market competition, and maintaining economic vitality. Comparatively speaking, the special nature of Chinese SMEs manifests their specific influence on the transition of China's economic system and social structure. For example, the development of non-public-owned SMEs not only changes the enterprise ownership structure, but also lays an important foundation for the process of developing China's market economy. At present, the number of non-public-owned Chinese enterprises far exceeds the number of state-owned firms. Excluding over 20 million individually-owned enterprises, the proportion of formally registered non-state-owned legal entities grew from 26.1 to 59.5% between 1996 and 2001[5]. According to the statistics on

[1] In general, SMEs in China are defined as: small enterprises (8-100 employees), medium enterprises (101-500 employees).
[2] Wang, Yanzhong (2004): Financial difficulties and structural characteristics of SMEs in China, China & World Economy, P34-49, Vol. 12, No. 2, 2004.
[3] Excluding over 20 million individually-owned enterprises.
[4] Xinhua News, 02.06.2004.
[5] China Statistical Yearbook (1997, 2002).

industrial value-added output, in the first three months of 2003, the state-owned and collective economy fell to 30%, while the non-public owned economy jumped to 70%[6].

Despite of the rapid development and the important role in the national economy and social development, SMEs in China are still in a weak position in terms of access to information, technology, human resources, finance and markets[7]. In order to create a policy environment that encourages SMEs to accelerate expansion and enable them to compete on an equal level, the Chinese government has set two major tasks for promoting the development of SMEs, including the development of a favorable policy environment and the establishment of various systems of public service.

2. Development of a Favorable Policy Environment

Policies supporting SMEs in China are mainly categorized according to aspects such as: improving ideological climate for private sector, implementation of the SME Promotion Law, strengthening financial and tax policy support, financial credit policy and encouraging technical innovation.

2.1 Improving the Ideological Climate

In the early days of China's economic reforms, private firms faced an openly hostile political atmosphere and, as a result, were extremely limited in scale. The 14th Party Congress in 1992 saw the announcement of the socialist market economy, which implied that firms in the non-state sector would play an important role in national economic development. In September 1997, the 15th Party Congress changed the position of the private economy from the previous "supplement to the state-owned economy" to an "important component of the socialist market economy." The private economy was now expected to play an important role in meeting the diversified needs of the people, increasing employment opportunities and promoting national economic development. The 1997 Party decision was reflected in a constitutional amendment in March 1999, which ensured the state's guarantee of the legal rights and interests of the private sector. It is likely that for private enterprises, nothing is more important than the speech made by former President Jiang Zemin at the 80th anniversary meeting of the CPC: "private entrepreneurs are now one of the new social classes, and they make great contributions to socialist society

[6] China Statistical Yearbook (2004).

[7] Wang Chunzheng, vice minister of the National Development and Reform Commission (NDRC): Speech at the first China Small and Medium Enterprises Fair, 18.10.2004, Guangzhou.

through their honest labor and lawful operation, bringing together workers, farmers, intellectuals, and People's Liberation Army soldiers." The idea was that the superior among them could be absorbed into the CPC. The spirit of his speech was reflected in the 16th report of the CPC, and the party constitution was revised accordingly. This speech further promoted the social status of the owners of private enterprises, constituting another milestone in the development of private enterprises after the 5th Congress of the CPC. This idea was reflected in the "Principle of Three Representations". According to this principle, the Party represents the most advanced economic forces and elements of culture and the basic interests of a wide range of people. In this context, the most important factor seems to be the third, namely a wide range of people including private entrepreneurs. The implications of the "advanced economic forces" are also very important. The CPC has now come to realize that the most advanced economic forces and high economic productivity necessarily comes from the private sector. In 2002, the CPC opened Party membership to entrepreneurs and businesspeople. It is widely expected that in the near future, more and more private entrepreneurs will take senior positions in the Party under the "Principle of Three Representations"[8].

2.2 Implementation of the SMEs Promotion Law

The "Small and Medium-sized Enterprises Promotion Law of People's Republic of China" was adopted at the Ninth Session of the National People's Congress Standing Committee on June 29, 2002 and is effective from January 1. 2003. This law codifies the official definition of SMEs and clarifies what government support will be made available to them. It offers forty-five policy measures in eight aspects of general principles, financial support, consulting support, technical innovation, market exploration, social service, and supplementary principles[9].

2.3 Strengthening Financial and Tax Policies

China offers five financial and tax policy measures to promote the development of SMEs[10].

- *Reduction of income tax and value-added tax.* In order to reduce the tax burden for small sized enterprises, the government makes a levy of 18%[11] on the enterprises whose

[8] China's small and medium enterprises: room to grow with WTO, www.usembassy-china.org.cn/econ/smes2002.html.
[9] http://english.people.com.cn/200207/30/eng20020730_100591.shtml.
[10] Chinese version provided by National Development and Reform Commission (NDRC).
[11] The Chinese tax system (1994) defines that the normal enterprises' income tax rate is 33 %.

annual taxable income (ATI) is under RMB 30,000 (3,628 US dollars), and income tax rate of 27% on the enterprises whose ATI is under RMB 100,000 (12,092 US dollars) but above (including) RMB 30,000. The value-added tax rate is reduced from 6% to 4% with regard to small sized commercial enterprises whose ATI is under RMB 1.8 million.

- *Tax policies encouraging urban employment.* Newly established urban firms which place unemployed people surpassing 60% of their staff can be exempted from taxes for three years with the approval of responsible tax institutions. When their tax-exemption term expires, they can still enjoy preferential policy of having 50% reduction of income tax for two years. Newly established firms for service (except for advertisement, sauna, massage, network bars and oxygen bars) and trade (except for certain enterprises not involving retail), which recruit laid-off workers surpassing 30% of their staffs and sign contracts for longer than three years, can be exempted from city maintenance and construction tax, educational fee added tax and enterprise income tax for three years.

- *Tax policies for high-tech enterprises.* Enterprises in the high-tech industrial development zones of national level, if confirmed as high-tech ones, can be exempted from enterprise income tax for two years, and then enjoy a 50 % reduction.

- *Tax policies for service industries.* Newly established enterprises in communications and transportations, post and telecommunications, consulting service and information industry as well as technical service industry can be exempted from income tax during the first running year and pay 50 % income tax during the second running year. In addition, the government offers tax preference of various degrees in regard to school-run industries, newly established enterprises in undeveloped areas, and welfare enterprises which employ handicapped.

- *Financial expenditure policy.* The central and local financial authorities continuously set up various special budgets for supporting SMEs, which are mainly used to promote the service system construction for the SMEs, to launch the programs for supporting SMEs, to supplement the developmental funds of SMEs and other projects concerning promoting the development of SMEs.

2.4 Financial Credit Policy

The People's Bank of China has published four documents since 1998, putting forward a series of policies and measures involving improving financial services, adjusting the credit structure and providing diverse financial products for SMEs.

2.5 Technical Innovation Policy

The Chinese government has, in recent years, issued some policy documents, which have provided a favorable policy environment for scientists and researchers, foreign investors and returned overseas-educated students in their endeavor to start their own business. Since China set up the S&T SME Innovation Fund in 1999, the Chinese government has arranged funds to the tune of three billion RMB (363 million US dollars), and sponsored nearly 3,800 projects with an average financing of 750,000 RMB (90,689 US dollars) per project[12].

3. Establishment of Public Services

The establishment of public services includes mainly two measures: establishing the credit guarantee system and creating hi-tech SME incubators.

3.1 Establishing the Credit Guarantee System

Recognizing the limited financial opportunities available to SMEs, the central government created a network of credit guarantee agencies in June 1999 and asked the former State Economic and Trade Commission's (SETC) SME office to oversee them, until the 2003 government restructuring, when responsibility was shifted to the National Development and Reform Commission (NDRC) new SME office. In order to encourage and stimulate the development of credit guarantee institutions for SMEs, the State Administration of Taxation released the Notice on Exemption of Business Tax for SME Credit Guarantee and Re-Guarantee Institutions in April, 2001, offering preferential policy for non-profitable SME credit guarantee and re-guarantee institutions in the scope of nationwide pilot projects, which could be exempted business tax for three years with regard to their income from guarantee business. On February 23, 2004, the NDRC and the State Administration of Taxation together issued a notice on issues concerning Exemption of Business Tax from SME Credit Guarantee Institutions, so that the enlarged applicable scope of the policy would further promote the development of SME credit guarantee institutions. In order to strengthen

[12] www.china.org.cn/e-news/news03-02-20.htm.

the administration of guarantee institutions and avoid operational risks, the Ministry of Finance issued Interim Measures for Risk Management of SME Financing Guarantee Institutions in March 2001, which clearly defined the rules for financing guarantee institutions involving their organizational forms, business limits, running principles, guarantee fee charge, and reserves for responsibilities as well as withdrawing guarantee funds etc, so that promoted the active and stable development of SME guarantee system. By the end of 2003, more than 1200 institutions for SMEs credit guarantee have been established nationwide and over 31 billion RMB (3.73 billion US dollars) guarantee funds have been raised, which is enough for guaranteeing SMEs to get 180-200 billion RMB (22-24 billion US dollars) loans[13].

3.2 Creating Hi-Tech SME Incubators

Significant progress has been made in building national hi-tech zones, S&T business incubators, returnee start-up parks, university science parks, as well as specialized incubators for software, IC design, biotechnology, optical-electronic technology, and new materials. By the end of 2003, China has more than 30,000 hi-tech SMEs in its 53 national level hi-tech zones, which generated a total of 1.3 trillion RMB (157 billion US dollars) in industrial output and created nearly four million jobs. All the 53 national hi-tech zones have an average growth rate exceeding 60% in their major economic indices. Their industrial added value increased at a rate of 35.2% per year from 1998 to 2003, three times the average of China's manufacturing industry during the same period. Moreover, China has more than 460 S&T business incubators, ranking second in the world. These incubators are now providing service to 15,000 companies and over 4,000 have already graduated. 865 productivity promotion centers in China cater to nearly 80,000 companies, which altogether provide 480,000 jobs. A great number of vibrant S&T companies are booming rapidly in China, including over 100,000 non-state-owned S&T businesses, which earn a total income approximating 1.9 trillion RMB (229 billion US dollars) or 340,000 RMB (41,112 US dollars) per capita per year, and employing 6.5 million people[14].

4. Further Policy Perspectives

Even though the Chinese government is attaching unprecedented importance to the development of SMEs and has made great efforts to promote them, SMEs in China still face a lot of challenges and obstacles, therefore great efforts should still be made in China.

[13] www.chinadaily.com.cn/en/doc/2003-12/29/content_294286.htm.
[14] www.chinadaily.com.cn/en/doc/2003-12/29/content_294286.htm.

4.1 Improvement of the Financial Market

Many aspects of the Chinese financial market should be improved for the SMEs: First, the state-owned commercial banks continue giving priority to large state-owned enterprises because of their implicit government guarantees. Some SMEs do in fact turn to the banking system for at least a small portion of their lending needs. In these cases, SME managers typically use their housing as collateral. As a result of the banking system's continuing preference for lending to large state-owned firms, SMEs usually raise money through indirect financing, primarily from family members or from their local communities. Secondly, SMEs generally do not receive central government approval to list on China's domestic stock exchanges, which are still dominated by politically connected state-owned firms. The new established second board for smaller, more dynamic firms is too small. Finally, the Chinese venture capital market is undeveloped. The Chinese Company Law implemented in 1993 did not take venture capital companies into consideration, thus restricting the investment of venture capital. Moreover, China’s bank structure lacks small banks, especially private banks. Small banks, with their comparatively small size of capital, could target SMEs, since large banks with abundant funds usually target large enterprises that need huge amounts of capital. Even if large banks intend to serve SMEs because of outside pressures, they may not be able to do so well[15].

4.2 Improvement of the Credit Guarantee System

China's nascent credit guarantee system is a step in the right direction, especially until the banking system makes lending decisions on a strictly commercial basis. Nonetheless, a study by the State Council's Development Research Center found that some credit guarantee companies preferred supporting larger firms over smaller ones, viewing the latter as too risky. The study also concluded that banks have been able to shift nearly the entire liability burden onto the credit guarantee companies, thereby undermining one of the central government's goals of strengthening the credit risk assessment ability of the country's state-owned banks. This situation should be further discussed and improved.

4.3 Reduction of Levies and Fees

Some SME proprietors respond to China's uncertain regulatory environment by not fully expanding their businesses. They know that being "too successful" could draw the attention

[15] Chen, Naixing (2004): 10 Reasons Why smaller firms Suffer, www.bjreview.com.cn/200404/Business-200404(A).htm.

of local government officials who then might impose high levies and fees. In this context, the long tradition of family-based businesses also works to limit the development of SMEs. Many of these firms are unwilling to transform themselves into larger corporate entities because that would require entrusting non-family members with the firm's valuable information and resources. Not surprisingly, SMEs are not eager to shoulder more of the national tax burden, which is still primarily carried by the state-owned sector. The irony for SMEs is that by not paying more taxes to the central government, they are not able to buy the center's "protection" from predatory local officials[16].

4.4 Reform of the Import and Export Administrative System

China's accession to the World Trade Organization has further promoted China's economic globalization. However, a rigorous export approval process and stagnant foreign trade administrative system reform restrain China's economic integration with the world. China's program to go global should be marked by the ability of SMEs to trade freely in the international market. Right now, only a small number of large enterprises in China are able to enter the world market. The foreign trade approval system should be changed into a registration system to facilitate the entry of SMEs into the international market.

4.5 Changing the Government's Role

When moving from a planned economy to a market-oriented one, the government also needs to revamp their roles accordingly. The unlimited power of government has, to some extent, hindered the development of market economy as well as the SMEs. Government should stop intervening in business operations and management and leave from the market. To carry out this shift, China should perfect its legal system and the government must perform administrative practices in accordance with the rule of law[17].

4.6 Promotion of Non-governmental SME Organizations

Some of the current functions that the government is responsible for should be undertaken by SME organizations. These organizations should be established regarding the needs of SMEs. Most of the current SME organizations are merely transformed governmental organs

[16] China's small and medium enterprises: room to grow with WTO, www.usembassy-china.org.cn/econ/smes2002.html.
[17] Chen, Naixing (2004): 10 Reasons Why smaller firms Suffer, www.bjreview.com.cn/200404/Business-200404(A).htm.

that cannot work independently. Non-governmental SME organizations should be strongly promoted.

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"Link to upgrade" – A proposal for Reinforcing the Connection between Pro-Growth and the Pro-Poor Growth Strategies in the Private Sector Development Approach of German Development Cooperation

Utz Dornberger

Poor people depend on an appropriate level of education and competence as well as investment capital in order to take advantage of the growth potentials that result from the demands of the modern industrial sectors and their employees. Consequently, to develop these competences and resources many donor organizations concentrate on measures promoting capacity building in micro and small enterprises and providing BDS as well as financial services. This article discusses a strategy for focusing these measures more on the development of sustainable business linkages[1] between informal sectors and modern industrial sectors to generate direct growth effects to the benefit of the poor.

1. Linkages between the Informal Sector and Modern Industrial Sectors

Most people in Africa, Latin America as well as in many parts of Asia must resort to the informal sector in order to ensure their sustenance. Kappel[2] discusses the division of the informal sector into three basic sub-sectors:

- The subsistence sector absorbs the slack labor and has a very low productivity. It is the sector of the poorest of the poor.
- The traditional informal sector is characterized by low capital intensity, does not employ wage workers permanently and there is an absence of labor contracts. The factor endowment shows the dominance of labor-intensive production activities. The working capital is in most cases constituted by family savings.
- A modern informal sector that emerges based on activities in small-scale industrial and service sectors. The borders to the formal sector are unclear. According to the local

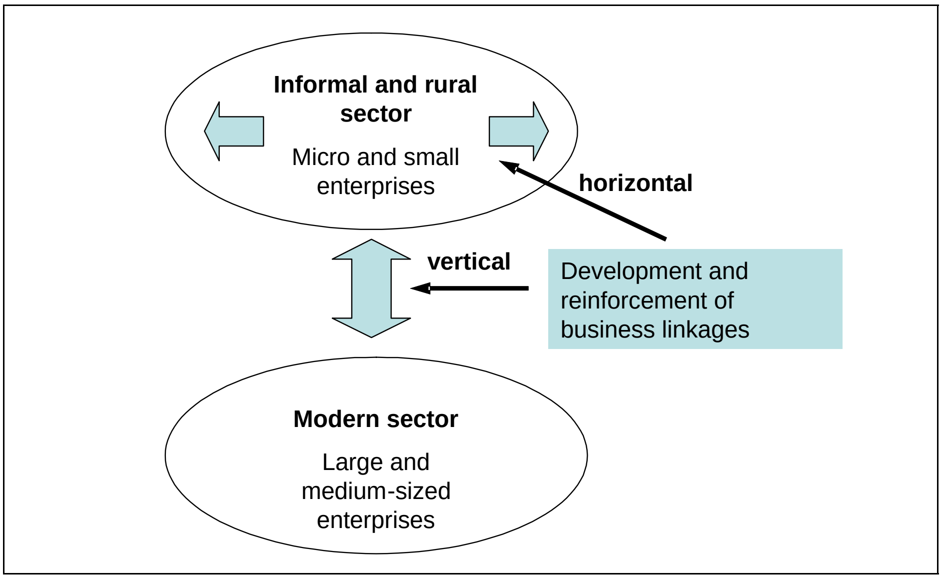
[1] Groups of interacting companies build networks, which produce related goods and services. Business Linkages describes the existing economic relations between the enterprises in the network. Business Linkages can be characterised by different dimensions. They can be differentiated according to their direction: vertical along a value chain or horizontal between enterprises at the same stage. Furthermore, one can distinguish between the relevant actors: linkages between large corporation and SMEs (subcontracting) or linkages between SMEs (industrial districts and cluster).

[2] Kappel, 2003.

situation, the firms decide if they abandon the informality. This sector is ruled by small and medium-sized firms that because of their relationships to modern industrial sectors offer upgrading potential.

This differentiated analysis of the informal sector shows that this sector comprises, specific groups of firms with growth potential can be recognized. Their growth depends strongly on the direct cooperation with large and medium-sized enterprises (in most cases through subcontracting).
The development of business linkages between the informal and the formal sector, or in other words between the micro and the small-enterprises on the one side and the modern large and medium-sized companies on the other, represents a crucial starting point for private sector promotion strategies with direct Pro-Poor Growth (PPG) effects. The focus should be on identifying of micro and small-enterprises with higher growth potentials which act as suppliers for large and medium-sized companies and which would be able to exploit their growth potential. Growth is very important in pursuing this kind of productivity, and it may be achieved through market integration and a stronger integration of agricultural producers into national and global value chains, for example through further development of the local and national industrial food production (with repercussions in the form of agricultural demand-led industrialization) and export markets (e.g. fish, coffee, flowers, vegetables). These linkages could stimulate the dynamic economic development which is necessary in the rural areas more effectively than traditional instruments. The strengthening of business linkages should therefore be prioritized in the Private Sector Development (PSD) Strategy of the German development cooperation (Figure 1).

Figure 1: PSD Strategy focus on business linkages



The following arguments support the approach of promoting business linkages in the PSD strategy of German development cooperation:

- The scientific discussion and its underlying empirical analysis show that a direct PPG could be stimulated in addition to implementing redistribution strategies especially through an economic upgrade of micro and small-enterprises. The integration of these enterprises in local and global value chains through the promotion of business linkages (supplier relationships, co-operations, etc…) forms the vital basis for such an upgrading process.
- The strengthening of business linkages also facilitates the linking of pro-growth and the pro-poor-growth strategies. The contribution of the German development cooperation in developing countries could complement the activities of large donor organizations (World Bank, IFC, and the regional development banks) as well as national efforts of the developing countries, since their activities focus more strongly on the promotion of modern, internationally competitive industrial sectors. At the same time the German donor organization could focus on the integration of micro and small enterprise into these modern sectors. Furthermore, the implementation of this strategy would allow micro and small enterprises to develop services that satisfy the increasing demand for well-paid employees in the modern industrial sectors.
- The German economic promotion agencies possess excellent know-how for the creation and development of business linkages. Currently the integration of small and medium-sized suppliers in global value chains of large multinational corporations in the automotive, chemical and electronics sectors is an important success factor of German SMEs. In this area, it is possible to recruit experienced and competent partners, whose knowledge is unparalleled even on an international level.

2. Strategies for the Promotion of Business Linkages

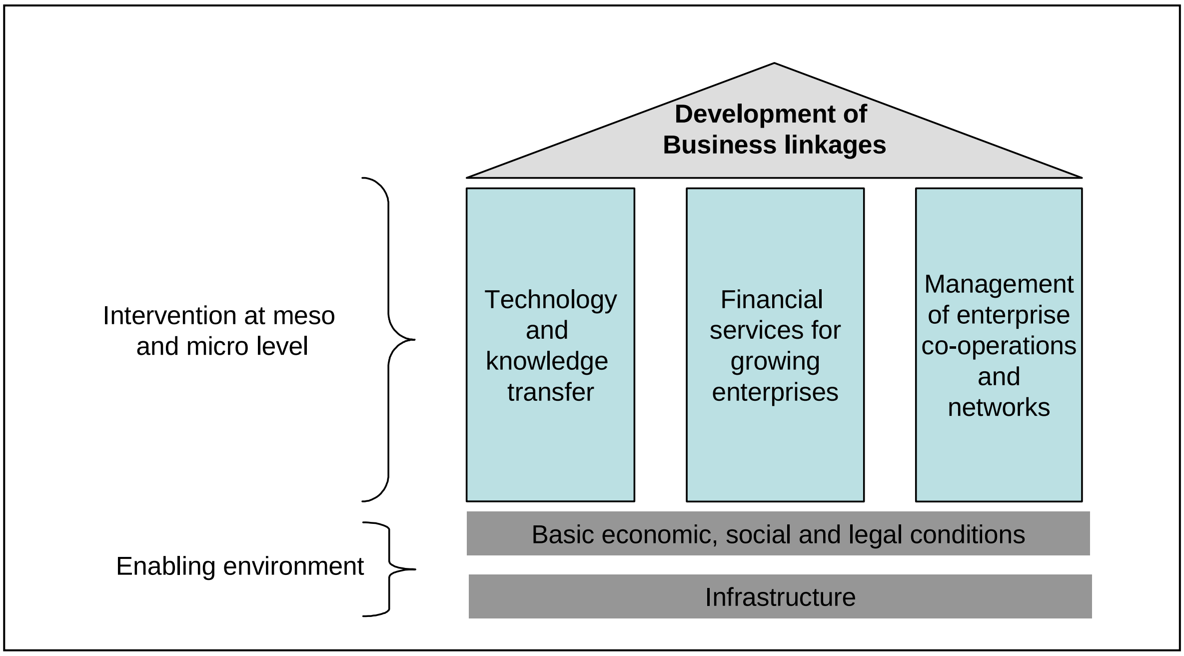
Donor organizations wanting to promote the upgrading and growth potential of micro- and small enterprises within the scope of their PSD strategy consider the development of business linkages between such enterprises and the modern industrial sectors as their central point of intervention. A short analysis of the different approaches to promoting business shows that these organizations mainly concentrate on:

- The development of horizontal and vertical business linkages through BDS allocation, reinforcing the managerial network and coaching multi-stakeholder processes (especially the activities of the UNIDO and the Inter-American Development Bank)

- The financing of technical support for the development of vertical business linkages on a cost sharing basis (e.g. Business Linkage Challenge Fund of the DFID)
- The technical support for the implementation of international standards in SMEs as a basic condition for their integration in global value chains

Based on these experiences and scientific discussions it is possible to draw a model describing the necessary intervention stages for promoting vertical and horizontal business linkages with the explicit inclusion of micro and small-enterprises.

Figure 2: Intervention stages for promoting business linkages



The development of an enabling environment based on appropriate, basic social, legal and economic basic conditions as well as on an effective technical infrastructure is considered to be a fundamental pre-condition for the success of private sector development programs. An explicit business linkages promotion strategy should contain the following elements:

- Promotion of technology and knowledge transfer to the micro and small-enterprises
- Allocation of new financial instruments for supporting the growth phases of micro and small-enterprises
- Development of enterprise cooperation and networks

The German development cooperation has a number of PSD instruments at its disposal. The following chapter presents some ideas for a reorientation of these instruments to support business linkages in developing countries more intensively.

3. Partnerships with large and medium-sized enterprises in developing countries

The main purpose of this promotion instrument is to support large and medium-sized enterprises in the formation and reinforcement of suppliers' networks composed of micro and small enterprises. The focus should be on the technology and knowledge transfer from large and medium-sized companies, in order to increase the productivity of micro and small-enterprises through the implementation of higher production and technology standards.

An appropriate incentive program for large and medium-sized companies from developing countries could be put together within the framework of the already existing Public Private Partnership (PPP) promotion program. The following aspects could be mentioned in favor of a more intensive integration of local enterprises from developing countries in the PPP program.

- Many large and medium-sized enterprises in developing countries already have local supplier networks. They are interested in building long-term relationships, since these represent an important factor of enterprise competitiveness. The support from the PPP-Program of the German development cooperation could facilitate the integration of several micro and small-enterprises and simultaneously motivate the local corporations to invest in improving the competitiveness of their suppliers.

- In many countries, the different players offering business services in the market, such as national institutions, para-statal organizations and private service suppliers operate in an isolated way and their services for micro and small-enterprises with growth potential are underdeveloped. In addition to the existing approaches for constructing or reinforcing the traditional BDS providers, it would be possible to support non-classic actors in the BDS sphere, such as private medium or large corporations, in their activities building supplier networks of micro and small-enterprises. Within the scope of BDS, such private corporations could be capable of concluding agreements for a reinforcement of the technological platform, as well as improving the product quality and the supplying capabilities of their micro and small suppliers.

- The regional offices of the German development cooperation would be presented with a flexible and applicable instrument for the private sector's promotion. Consequently, it would be able to act independently of governmental agreements for the benefit of local development. The "new" PPP-Program would present flexible, additional instruments complementing the existing PSD projects. It would enable the regional offices of the German development cooperation to evaluate and control projects carried out by local enterprises within the scope of the PPP-Program.

4. Promotion of Networking and Cooperation Management

It is often overlooked that economic development takes place along the lines of complex systems, which are based on the division of labor. These systems and their players are subject of permanent changes. The driving forces in these systems result from the changing requirements of market and competition. Successful are chiefly those economies, regions and enterprises that constantly adapt their production and know-how to new challenges on a knowledge basis and that specialize in utilizing the resources they have access to in the best possible manner. If one takes enterprise size as an indicator for market process specialization, the deficits of a still immature economy become obvious. In comparison to the traditional western economies, participation of very small enterprises in such economies is average while large enterprises and corporations are clearly underrepresented. Large companies are more effective than smaller ones in dominating international markets or developing new markets. They can be decisive cluster drivers in their regions and they benefit from permanent exchange with the scientific community during research processes – crucial structural elements that are missing in the economies of the developing nations.

Cooperation and networking facilitates the development of efficient production techniques from an existing entrepreneurial structure. Intensive cooperation between regional enterprises and institutions could create a number of pre-conditions that help in reducing the transaction costs derived from the cooperation and that make it possible to benefit from the advantages of scope and scale. The development of certain production techniques may gradually compensate for the systemic disadvantages resulting from an enterprises' size. Many promotion programs strengthening the cooperation among companies were successfully implemented in Germany during the last 15 years (e.g. BioRegio, Innoregio, and Netzwerkmanagement Ost). It is imperative for the development of cooperation to take advantage of the experience gathered in this process, especially for promoting supplier networks composed of micro and small-enterprises in developing countries.

5. Financing Growth

The German development cooperation is one of the most competent promoters of micro-credit institutions worldwide. A significant deficit of many micro-credit offers is their limited contribution to the growth of productive economic sectors.[3] The principal micro-credit business clients in many developing countries are dealers and service providers, which, due to their business models, are capable of paying the comparably high interest rates in short periods of time.

Micro-credit programs should have a stronger focus on the financing of micro and small-enterprises of productive economic sectors. This would necessitate an adjustment of micro-credit offers to the requirements of this kind of firms as regards lower interest rates, longer terms and higher credit volumes. In order to improve the risk-management of this certainly risky type of credit, micro-credit institutions could tie the disbursement of credit to the existence of corresponding business linkages between their clients, micro and small-enterprises and clients from modern industrial sectors.

Summarizing, it must be said that Figure 2 demonstrates that none of the presented promotion instruments can be judged individually. These instruments can only prove their potential in certain combinations. The business environment in a developing or transformation country influences the choice of combination of instruments as well as the prominence of individual promotion measures.

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[3] For an empirical evaluation see e.g. Sharif & Wood, 2002; Sinha, 2003; ICMC et al., 2000.

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