

ENTERPRISE DEVELOPMENT STRATEGY

Small- and Medium-Sized Enterprises

I. Introduction

- I.1 Current Challenge: Most countries in the region are undergoing reforms that are opening their economies to greater international competition. However, domestic factor markets are not adequately developed to ensure the successful adaptation of SMEs to this new competitive environment. Unlike larger firms, which can more easily absorb the transaction costs, SMEs are at a disadvantage and require specific compensatory assistance.
- I.2 Economic Role of SMEs: The importance of SMEs to longer-term economic stability, derives from their size and structure which, *under adequate conditions* i.e. well developed factors market, allow them the flexibility and ability to weather adverse economic conditions. SMEs are more labor-intensive than larger firms and, therefore, have lower capital costs associated with the creation of jobs. Consequently, SMEs play an important role in fostering income stability, growth, and employment. Modern economies operate as complex networks of firms in which a firm's competitive position depends, in part, on the efficiency of its suppliers. Therefore SME's competitiveness affects the competitive position of the economy as a whole. In addition, SMEs improve the efficiency of domestic markets and make productive use of scarce resources, such as capital, facilitating long-term economic growth.
- I.3 Features of SMEs: Their characteristics distinguish SMEs from larger firms. Large firms often have direct access to international and local capital markets, while SMEs are often excluded because of the higher intermediation costs for smaller projects. Additionally, the fixed costs of complying with regulations, a limited capacity to market products abroad, and limited access to policy makers weigh against the SME more than the larger firm. Microenterprises largely operate at a threshold which falls below the regulatory and institutional constraints that inhibit other SMEs and, in some cases, would expand if the barriers to their operations were removed. Because high transactions costs are one of the most important barriers, their reduction will promote the creation and expansion of SMEs and, in particular, encourage microenterprises to expand. For the purposes of Bank strategy, SMEs will be taken to include the smallest business units with growth potential although it is recognized that microenterprises have their own unique characteristics and have a social as well as economic role.

II. Constraints to Enterprise Development

- II.1 Notwithstanding the wide-ranging economic reforms instituted in the region, SMEs face a variety of constraints owing to the difficulty of absorbing large fixed costs, the absence of economies of scale and scope in key factors of production, and the higher unit costs of providing services to smaller firms. A set of constraints, which is not intended to be

exhaustive, is identified below. These constraints should be addressed in a Country Enterprise Development Strategy (See IV. Strategy Implementation).

II.2 Input Constraints: SMEs face a variety of constraints in factor markets.

- **Debt & Equity**: SMEs have limited access to capital markets, both locally and internationally, in part because of the perception of higher risk, informational barriers, and the higher costs of intermediation for smaller firms. As a result, SMEs often cannot obtain long-term finance in the form of term debt and equity.
- **Labor Market**: An insufficient supply of skilled workers can limit the specialization opportunities, raise costs, and reduce flexibility in managing operations.
- **Information & Technology**: SMEs have difficulties in gaining access to appropriate technologies and information on available techniques. This limits innovation and SME competitiveness. At the same time, other constraints on capital, and labor, as well as uncertainty surrounding new technologies, restrict incentives to innovation.
- **Production inputs**: SMEs face constraints in the availability of production inputs. For instance, better quality raw materials are generally exported or are available only to larger firms, and their suppliers tend to be oligopolies. Inadequate infrastructure and weak provision of basic services such as transportation, energy, urban planning and production sites represent particular impediments for SMEs

II.3 Output Constraints: Access to domestic and international markets can be constrained by factors that relate to the size of SMEs.

- **Domestic Markets**: The diminished role of the state in productive activity and renewed private investment has created new opportunities for SMEs. Nonetheless, limited access to public contracts and subcontracts, often because of cumbersome bidding procedures and/or lack of information, inhibit participation in these markets. Also, inefficient distribution channels and their control by larger firms pose important limitations to market access for SMEs.
- **International Markets**: Previously insulated from international competition, many SMEs are now faced with greater external competition and the need to expand market share. Limited international marketing experience, poor quality control and product standardization and little access to international partners, however, impede expansion into international markets.

II.4 Regulatory Constraints: Although wide ranging structural reforms have improved prospects for enterprise development, many issues remain to be addressed at the firm

level.

- **Taxation & Tariffs:** Complicated and inefficient tax codes that include cascading sales taxes and stamp taxes are least favorable to SMEs and artificially promote larger-scale firms and microenterprises. At the same time, the tariff and non-tariff barriers which favor larger firms that play a role in policy making, are often biased against SMEs.
- **Legal:** High start-up costs for firms, including licensing and registration requirements, can impose excessive and unnecessary burdens on SMEs. The high cost of settling legal claims and excessive delays in court proceedings adversely affect SME operations. The absence of antitrust legislation favors larger firms, while the lack of protection for property rights limits SME access to foreign technologies.
- **Capital Movements:** Even though most countries have significantly relaxed restrictions to capital movements, bureaucratic complications and distortions in the foreign exchange markets remain. These tend to affect SMEs most strongly because they lack the wherewithal of large firms.
- **Labor Markets:** Inflexible labor codes and other indirect labor costs bear most heavily on SMEs, raising their cost of doing business and depriving them of the flexibility to adapt.

II.5 Management Constraints: The lack of economies of scale and competition for one of the most scarce resources, management know-how, place significant constraints on SME development.

- **Management skills and training:** Even though SMEs tend to attract motivated managers, they can hardly compete with larger firms. The scarcity of management talent, prevalent in most countries of the region, has a magnified impact on SMEs.
- **Consulting Services:** The lack of support services or their relatively higher unit cost can hamper SME efforts to improve their management because consulting firms often are not equipped with appropriate cost effective management solutions for the scale of SMEs. Furthermore, the scarce awareness, absence of information and/or time to take advantage of existing services results in weak demand for them.

II.6 Institutional Constraints: The lack of cohesiveness and the wide range of SME interests limits their capacity to defend their collective interests and their effective participation in civil society.

- **Association and collective action:** Associations providing a voice for the interests of SMEs in the policy-making process have had a limited role compared to those of larger firms. Many of the entrepreneurs associations have yet to complete the transition of their goals from protectionism to competitiveness. Additionally, the potential economies of collaborative arrangements in production and sale among SMEs have not been adequately explored.

III. The Bank's Strategy

III.1 The goal of Bank strategy is to support the competitiveness of SMEs so that they may contribute to long-term growth and employment. This will be accomplished through support for enhancing the private delivery of goods and services. To achieve this objective, it is proposed that Bank actions related to the Enterprise Development Strategy for Small- and Medium-Size Enterprises be directed at helping the SMEs to help themselves, to move from protection to competition. It is believed that programs that employ this approach will be sustainable over time and will promote economic development to a greater degree than the provision of handouts. Nevertheless, it must be recognized that factor markets are still underdeveloped and that such an approach does not rule out the use of subsidized access to services required by SMEs, where the lack of effective demand and/or high transaction costs prevent their provision by the market. In these cases, however, direct support should be limited in scope, transparent in its application, and targeted to an identified need.

III.2 The Bank's strategy should focus on the following two main areas:

- **Creation of a level playing field:** In order to promote the development and growth of SMEs the institutional and regulatory barriers which are biased against them should be reduced. The key policy areas are in input markets (capital, labor availability and qualifications, technology, production inputs), output markets (pricing, anti-competitive policies, access to market information), and regulations (tax, tariffs, procurement, legal, capital movements).

- **Compensation for unfavorable position:**

Lowering transactions costs of business: To the extent that it is practical, Bank programs should lower financial and economic transaction costs. It is recognized that the fixed costs of doing business are less easily absorbed by smaller firms than by large ones. Therefore, efforts to reduce bureaucratic procedures, enhance access to credit, eliminate unnecessarily restrictive labor practices, and expand the availability of market-related information will benefit SMEs to a greater degree.

Targeted programs: Eliminating institutional biases and lowering transactions costs are necessary, but not sufficient steps to promote SMEs. In cases were

SMEs do not have access to the necessary inputs because of the failure of the market to provide them, the Bank can promote the provision of services and information through local and international institutions that fill these gaps. The provision of services should not be on a full-grant basis, but rather on a cost-sharing basis, i.e., with partial grants, contingent recovery or favorable loan tenor for the access to business services, in order to encourage the development of the market for these services.

Transfer of techniques and institution building: The sustainability of the Enterprise Development Strategy will depend on the successful transfer of the techniques and capacity to support SME development to the regional actors (both member governments and agencies, and the private sector). In support of this transfer, the Bank should seek to establish linkages among the actors -- with a special focus on those in the private sector -- to encourage the interchange of policy lessons and experiences (within and between countries), develop the necessary local research and policy analysis on SME issues and encourage a policy dialogue on relevant issues.

IV. Strategy Implementation

- IV.1 Country Enterprise Development Strategy: In light of the diversity of instruments needed and the range of actions already undertaken by the Bank in each country, it is proposed that a coordinated and coherent effort be made to integrate those efforts and to take advantage of the unique opportunities and synergies offered by the joint actions of the Bank's various institutions. The Multilateral Investment Fund (MIF), the Inter-American Investment Corporation (IIC), and the Bank, working as a group, under the leadership of the regional departments and the technical support of the central units, will develop, a **Country Enterprise Development Strategy** (EDS), within the framework of the Country Programming process. This strategy will be consistent with the principles outlined above and will be based on a thorough analysis of the Bank's ongoing country activities, the country strategy for SME, the actions and programs of other donors, the existence of regional integration programs and the operating environment for enterprises that identifies the areas in need of intervention. It will consist of a strategy statement to guide Bank's activities and a **comprehensive (multiyear) package of actions**, which may include new operations, the adaptation and integration of existing ones or a combination of both and all the policy and institutional measures necessary to enhance SME development. It will clearly identify the various roles for the different members of the Bank Group.
- IV.2 EDS preparation. Individual country strategies will be prepared by the Regional Departments, inasmuch as possible, as part of the regular Bank's programming process, otherwise as stand-alone strategies, and will be approved by the Programming Committee. Bank's activities in support of SMEs will be monitored by a Private Sector

Committee, presided by the Bank's President. To support the preparation of the EDS, the Social Programs and Sustainable Development Department will provide assistance, as requested, in preparing the first strategies. Additionally, based on country case studies, best practices will be identified and benchmark performance indicators provided for use in program design. Also, research will be carried out on innovative tools to support enterprise development. The results of these studies will be disseminated through seminars, working papers and informal meetings among Bank Group staff. An important element in strategy implementation will be the sharing of experiences.

V. Instruments for Strategy Implementation

- V.1 The Bank has provided an array of instruments to support enterprise development in the region directly and indirectly. In the early 1960s, the Bank provided direct loans to private enterprises, while more recent programs promoting macroeconomic stability and appropriate microeconomic incentives are now yielding benefits in renewed private sector-led growth. In many member countries, now that structural adjustment has laid the groundwork for market-oriented policies, **the Bank must increasingly focus on firm-level issues that affect competitiveness**. Already the liberalization of trade and reduced role of the state in productive activities have created opportunities and challenges for SMEs by reducing state control and expanding access to foreign exchange and imported inputs, while increasing import competition.
- V.2 To meet this challenging business environment, the Bank Group has developed or will develop instruments that can be used to address each of the areas of action that will be identified in the EDS. The following list is **only illustrative** of the type of actions that the EDS will contain. The analyses proposed above will suggest the instruments to be designed according to the specific needs identified in each country and experience will lead to new ways of addressing the problems (the classification of instruments is also illustrative, as a given instrument may cover both aims).

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Sample of Instruments for Strategy Implementation

• **Creation of a level playing field:**

Investment sector reform type loans or loan components and Bank Group Technical Cooperation:

Reform of regulatory environment
Alternative methods for settlement of disputes
Strengthening of financial and capital markets
Development of relevant SME skills in financial institutions
Labor market reform

• **Compensation for unfavorable position:**

Bank Group Loans, Equity Investments and Technical Cooperation:

Nonsubsidized intermediated credit
Promotion of business organizations
Support for guarantee funds
Management support
Site development
Technological development
Equity funds for financial and productive enterprises
Export promotion/market intelligence
Development and harmonization of regulations between countries (quality, environmental, etc.)
Worker training programs
Management training programs
Leadership Development
Direct loans and equity investments
Promotion of joint ventures (e.g. Programa Bolívar)
Business development centers
Expansion of equity ownership base of SMEs

VI. Responsibilities for Strategy Implementation

- VI.1 Over the years 1995-1996 the Bank will prepare a number of pilot EDSs in each region. The Regional Departments will identify countries that can most benefit from the preparation of EDSs and will consult with the authorities on their interest for an Enterprise Development Program, as a consolidation of actions and strategies in the sector.
- VI.2 The preparation of the documents will be carried out by a working group lead by the Regional Departments and will include support from central units, to assist in coordinating these activities among the regions, and as needed, will include the participation of IIC, MIF and PRI. The support from the central unit will include, among others, the preparation of methodologies, dissemination of best practices, benchmark development and support for results evaluation and for the preparation of country and Bank's strategies.

VI.3 Once the SME program of actions has been agreed upon with the country, the implementation will follow the Bank's existing procedures, with the participation of IIC and MIF in their respective operations, under the coordination of the regional departments.