Small and Medium Enterprise Development

Background

Small and medium enterprises (SMEs) and micro-enterprises constitute over 95 per cent of all enterprises and account for two thirds to one half of total non-farm employment and gross domestic product (GDP) worldwide. SMEs play pivotal roles in creating dynamic, market-oriented economic growth, employing the growing workforce in developing countries, alleviating poverty and promoting democratization.

Concept

Operational definitions of the term small and medium enterprises (SMEs) are generally based on the number of persons employed or the amount of fixed capital and vary from country to country. For our purpose, SMEs can be considered as having, say, between five to two hundred employees and are found in the formal sector (i.e., they are formally registered as a business organization).

SMEs can be distinguished from micro-enterprises, which employ a very small number of people (often only one to five), experience severe constraints regarding access to resources, and typically make up part of the informal sector, and from large enterprises, which have many employees and greater capital.

Lessons Learned

SMEs encounter many obstacles in developing countries. They confront problems relating to access to finance, counselling, information, skills, technology and markets. An additional challenge is posed by the policy and business environment in which they operate, which is changing rapidly as a result of market-oriented reforms and technological change. The lessons learned that are presented below correspond to key needs of developing countries: (a) the formulation of national SME policy frameworks and a favourable policy environment; (b) the development of service providers to support SMEs; and (c) the development of the financial sector.

Policy Environment

1. Government should facilitate, not over-regulate, SME operations.

In countries where the policy environment is restrictive, SME development will be slow, owing to obstacles to SME establishment and
registration, taxation and regulation that place a punitive burden on SMEs, unequal property and other legal rights of owners and workers, and difficult access to resources and public-sector procurement programmes.

**What to do?**

The appropriate role of government vis-à-vis SME development is to maintain competitive markets, formulate policies and legislation and build infrastructure. Areas requiring attention are: formulation of suitable laws on taxation, e.g., to avoid high taxation on imported raw materials; avoidance of ceilings on interest rates; compliance with labour and environmental requirements; and fostering the growth of a modern business infrastructure, including legal and accounting systems and financial markets.

In countries where the environment is very unfavourable, a phased approach can be useful, i.e., first, encouraging the government to abolish unfavourable policies and laws in order to move towards an approach of benign neglect that allows the sector to expand and subsequently, providing actively supportive policies.

**Example:** Many countries have implemented explicit SME development policies and strategies. In East and South Asia, economies such as Hong Kong, India and the Republic of Korea have formulated special policies to protect SMEs from imports and provided incentives to improve productivity during their early development. (Source: ILO, Small enterprise development: Policies and Programmes, Geneva, 1987.)

2. **SMEs should participate in the formulation of policies affecting them.**

Earlier government and donor support was based mostly on policy-makers’ often insufficient understanding of SME needs. Without regular consultation, the policies are often not relevant to the SMEs and do not realistically address their weaknesses and build on their strengths.

Chambers of commerce and trade associations are examples of the kinds of organizations that should be included in the policy dialogue. Chambers of commerce and trade associations exist in almost all developing countries, but participation by SMEs is typically poor, in part because they believe that these organizations have little to offer them. In such cases, reform of associations to empower the participation of the SMEs may be required. Donors should take care to avoid financial dependency when supporting private-sector membership organizations. Such organizations should seek sources of support beyond donor funding, for example, through membership fees, sponsorships, income from the sale of publications and organizing meetings and especially from services provided to members.

Other advocacy mechanisms to inform governments of SME needs and views can also be used, such as legislative hearings, workshops, and the establishment of panels and sounding boards.

Another approach is to support the development of accurate statistics on SMEs. This helps the government to identify SME operating constraints and opportunities and the impact of policy reforms and donor interventions.

**Example:** Large corporations have traditionally influenced government policy. Given the growing recognition of the economic and employment generating potential of the SME sector, the SMEs are now able to influence governments through their trade associations. The Federation of Associations of Small-scale Industries of India (FASII), which includes some 100 SME associations, is now well represented on various small-enterprise boards and policy bodies in the country. (Source: Structure and Promotion of Small-scale Industries in India, National Council of Applied Economic Research, and Friedrich Neumann Stiftung, New Delhi, 1993)

3. **Rural enterprises need infrastructure and specially adapted government policies.**

Government policy is especially important to the success of rural small enterprises, which operate under conditions that are often more unfavourable than those of urban companies.
because of the low purchasing power of the local market and the distance to urban markets and access to services. Yet as economic development proceeds, productive employment must be found for surplus agricultural labour, and local agricultural produce needs to be processed when moving from a subsistence economy.

What to do?

Policies that ensure the equitable distribution of land and export/import regulations that are favourable to local agricultural production can have a strong impact. Rural enterprises need electrification, telecommunications, and access to the transportation infrastructure to bring their goods to market and to obtain raw materials and inputs. Extra efforts may also be required for female entrepreneurs, such as providing childcare facilities and ensuring equal rights to assets.

Example: Some prerequisites for successful rural enterprise institutions are a supportive policy environment and intensive backstopping by the executing agency, as demonstrated by the rural enterprise project in Ghana. (Source: UNDP, CEDAB, GHA/87/04)

A sectoral approach that has demonstrated success is the poultry programme of the Bangladesh Rural Advancement Committee (BRAC). This programme has reached 1.2 million people, mainly women, through training and counselling as well as the provision of veterinary supplies and bulk feed. Cost-recovery levels have been high. Success factors have been the demand-led relationships with clients and the personal ownership of the project by clients and BRAC staff. (Source: R. Hitchens and A. Gibson, CDASED, Rio, 1999)

Support Services for SMEs

4. Support services for SMEs must be market-oriented.

Previous programmes designed to provide SMEs with access to support were mostly centralized, heavily subsidized, and based on policy-makers’ insufficient understanding of SME needs. Few of these initiatives proved effective and sustainable. Recent experience demonstrates that successful business development services (BDSs) should be coordinated and run like a business.

What to do?

When designing a programme for SME support services, the following four essential success criteria for the provision of these services should be applied. These services should be:

(a) demand-led, i.e., reflecting an analysis of genuine need for the support service. This analysis is best done before designing the service and with the direct participation of small enterprises and organizations close to them.

(b) businesslike, i.e., treating end-users as customers rather than beneficiaries; employing professional management that has private sector background; and rigorous monitoring and evaluation of results followed by prompt corrective action.

(c) sustainable, i.e., provided on a fee-for-service basis (transaction-oriented), with the cost commensurate with the benefits obtained by the end-user (cost-effective), and with a continuing impact after the external support is concluded (sustainable).

(d) Outcome- and outreach-oriented, i.e., going beyond the achievement of outputs to demonstrable and replicable outcomes (survival of businesses; increase in employment, income, exports).

Example: Factors contributing to the success of the UNDP-United Nations Industrial Development Organization (UNIDO) business centres in Romania include: (a) local manpower was utilized; (b) market research and analysis of SME needs were conducted before project initiation with counselling then offered according to identified needs; (c) training and financing services were linked; (d) participation was fee-based; and (e) the programme was timed to meet a surge in the establishment of new businesses. (Source: R. Kennedy and C. Sonesson, CDASED, Rio, 1999)

5. Training should be practical.

While SME owners think they have no need, money or time for training, evidence suggests
that training often constitutes a very cost-effective intervention. General awareness training is less useful than training in specific industry skills within a sector, which is more relevant to the SME. Vocational training and programmes that focus on teaching mastery of the skills and procedures encountered by small-enterprise personnel in their day-to-day business management and operations have the greatest effect.

**What to do?**

To overcome resistance to training, it may be useful to include an advocacy or publicity component in the training programme. Basic business skills such as accounting, marketing and production management are often the main subject matter. Organizers should make sure that skilled trainers conduct the training and schedule repeat training and follow-up to see how the skills acquired through training have been applied. Universities and research institutes can also play a role in developing the human resources and technologies appropriate to small businesses.

**Example:** An evaluation of a regional training project in China, India, the Philippines and Thailand noted that “...the training events included as project activities were highly effective, due ... to the practical, ‘hands-on’ approach taken...”. Trainers who have practical experience in industry generate greater benefit from training courses. Evaluations of the International Labour Organization (ILO) Start, Know and Improve Your Business programme reinforce this point. (Source: UNDP, CEDAB, RAS/86/018)

6. **Advisory services are best provided by the local private sector.**

SMEs need advice on specific business and technical problems. This requires the development of a professional services sector. Private-sector service providers are best equipped to handle this task in the long term, often because they are more focused on efficiency and have a better knowledge of private-sector realities and needs. Local consultants are best positioned to understand local needs, communicate effectively with small businesses and provide cost-effective services. For rural enterprises, the support services need to be adapted to their special needs.

**What to do?**

The government and donors should encourage the growth of private-sector providers. In many countries in Asia and Latin America, service providers are more geared towards larger companies and need support to reorient themselves to the experience of small business, for example, through subsidizing SME clients who otherwise could not afford their services. To succeed, advisory services must be accompanied by the recognition by enterprises that knowledge-intensive services can be useful and by a willingness to pay for them. For rural enterprises in particular, programmes can make use of non-governmental and appropriate parastatal organizations as channels for training and counselling. Such organizations can be particularly useful in undertaking focused, sector-specific and on-location programmes. Such programmes have proven more effective than multi-purpose ones.

**Example:** The barefoot-consultants scheme based in Pune, India, helps to develop the capacity of local consultants to solve local small-town problems. The consultants are brought to Pune for business improvement training, then go to small towns to provide advisory services, returning periodically to Pune for follow-up training. (Source: R. Lalkaka, 1997)

7. **Cost recovery for services should be actively pursued, but some subsidization is nearly always required.**

Levels of cost recovery vary greatly, typically ranging from near full recovery for some marketing and training services to low recovery for high-level advisory services and information. Because advisory services are relatively expensive, highly subsidized counselling programmes are not sustainable. Subsidization has been common.

**What to do?**
In most developing countries, some degree of subsidization will remain a requirement for a large number of services and SMEs. Before establishing a service, the market should be analysed to ascertain the demand and ability to pay. Even where government or donor subsidies are used, a fee should be charged, increasing gradually as the service proves to be useful. Most important, the use of subsidies should be carefully documented and measured in relation to the provision of services in order to determine positive trends towards self-reliance.

**Examples:** Assessments of the ILO-Netherlands initiated, FIT programmes in Africa indicate that channeling selected services through for-profit providers can be effective. Rather than encouraging institutions to provide a broad range of general services, the focus should be on targeted and innovative services since this allows for specializations that are tailored to SME needs. (Source: J. Tanburn, CDASED, Rio, 1999)

Small businesses are usually reluctant to share information and to pay for information services, as the experience of the United Nations Fund for Science and Technology for Development (UNFSTD) with the Technological Information Promotion System (TIPS) programme illustrated. However, once the utility and quality of a service are established, SMEs become more willing to pay for information. (Source: R. Lalkaka).

8. **Subsidizing demand for services can be more effective than subsidizing supply.**

Donors have often supported a limited number of service providers directly. Such schemes frequently become support to the provider rather than support to the SMEs. Sustainability is compromised because the service provider becomes dependent on donor funding and lacks sufficient incentives to respond to the SME needs.

What to do?

Development cooperation should focus on stimulating markets for business services and not on subsidizing specific service providers. Programmes should avoid concentrating their efforts on building up one support provider, instead encouraging the support and use of several providers. Services can be made more affordable and effective by letting SMEs themselves choose among service providers in a competitive market place, for example, by providing funds directly to the SME through a voucher scheme.

**Example:** The Paraguayan experience with vouchers as a means of developing a market for training services is of interest. Public funds are used to issue vouchers to SMEs covering about 50 per cent of the cost of training from accredited providers, with the SMEs themselves covering the remainder. Evaluations of the scheme have been positive, particularly since it empowers the SME by putting the subsidy in its hands. It also helps to develop the market. (Source: L. Goldmark, CDASED, Rio, 1999)

9. Where State-sponsored advisory services are deemed necessary, they should retain organizational independence.

Where private service providers are still being developed (as in some African and restructuring economies), public sector institutions may have to meet the support needs on an interim basis. The organizational independence of the service provider can help to make the service provider more effective and businesslike and facilitate cost recovery.

What to do?

Governments and donors may have a limited role in jump-starting the market for advisory services to SMEs. Technical cooperation projects can be designed to transform government service agencies into contract consulting and research mechanisms.
Examples: This is illustrated by evaluations of the Kenya Management Assistance Programme (K-MAP). Although government-sponsored, it is relatively autonomous and works effectively with national and international businesses to assist entrepreneurs through counselling, training and access to finance to start and grow their ventures. (Source: J. Tanburn, 1999)

In African countries with an inadequate business infrastructure, the problems of starting and sustaining enterprises are especially severe and call for specific measures. Enterprise Support Services for Africa (ESSA), for example, matches SMEs to consultants. Factors that contribute to its success are (a) the careful selection of companies, (b) participatory approaches in developing consulting assignments, and (c) follow-up in extracting benefits from consulting support. The assessment also highlights the differences in services needed by micro-enterprises and small enterprises. SMEs require services oriented towards growth by helping the SME become more organized and professional. Micro-enterprises often need active follow-up and support beyond normal business development services (e.g., in literacy), and the services are more basic, focusing on survival. (Source: M. Lynch and Young-Gyampo, CDASED, Rio, 1999)

10. Dissemination of information can help develop the markets.

Small enterprises in developing countries suffer from a lack of information on available support and market signals, including those for local and export markets. This may lead to errors in judgement about which products to supply and pricing, causing economic loss. More efficient flows of information lead to more efficient and equitable markets.

What to do?

Governments and donors should foster the flow of information on government regulations and programmes, current market prices, good business practices, and opportunities for small enterprises to learn from and help others. This can be done through publications, trade fairs, and the Internet, for example. Electronic information and communication services can be of value to SMEs in countries with the requisite infrastructure. In countries without electronic infrastructure, more traditional means such as radio broadcasts on market prices, production, sales, and market opportunities may be useful.

Examples: The Serviço de Apoio às Micro e Pequenas Empresas (SEBRAE) in Brazil has established a nationwide network of computer/telephone counters that provide first-level information to callers on starting a business, trade opportunities, accessing business services and finance. The United Nations Conference on Trade and Development (UNCTAD) Trade Point programme, covering 124 countries, facilitates the participation of SMEs in international trade through tools that increase knowledge of trade procedures and help to access trade opportunities electronically. (Source: UNCTAD, 1999)

11. Commercial collaboration between enterprises should be encouraged.

Providing goods and services only to the end consumer will limit the growth of SMEs. Where larger enterprises use the SMEs as suppliers, the market of the SMEs will expand and the larger companies also gain by the presence of a reliable local supply. Market collaboration and sales between large and small enterprises are signs of the maturation of the business sector.

What to do?

Commercial collaboration includes economic relationships such as subcontracting, franchising, licensing and industrial clustering (i.e., the coming together of entrepreneurs in geographic proximity for collective efforts to improve competitiveness). It is also reinforced by non-economic relationships such as trade associations and chambers of commerce. Large enterprises can provide support through mentoring and by sourcing components and services from SMEs. Local government and donor organizations can be the most helpful after an industrial clustering process has gained momentum by providing infrastructure and services. Successful linkages
must be in the economic interest of all the concerned parties; those that are not market-driven are unlikely to succeed.

Example: In the hosiery cluster in Tirupur, a small city in India, vigorous support agencies for design, marketing, export and containerization have developed. (Source: M. Gulati, 1997)

12. The technical skills required of SMEs are changing to deal with computerization and globalization.

Previous technical assistance projects would often focus on building technical production skills in the sector of the SME. The future needs of the advanced developing countries are changing. The globalization of the economy is making it more important to be able to deliver customized products at short notice and respond to design changes in a quick, flexible manner. In countries such as China, large numbers of SMEs are being forced to close because they cannot meet basic environmental protection standards.

What to do?

This situation requires the progressive mastery of new, more sophisticated technologies. E-commerce provides opportunities for SMEs to participate in the global supply chain. With respect to pollution abatement, technical assistance and training in technological standards should help mitigate such problems before they affect the growth of the SME sector.

Examples: UNDP-initiated programmes are bringing information and communications technologies to rural communities in Egypt. The Small Industries Development Bank of India is running Skill-cum-Technology Upgradation Programmes on quality control and computer applications with a 35 per cent cost recovery rate. UNCTAD has introduced Centres for Innovation and Enterprise Development in selected African countries to assist SMEs in defining their problems and sourcing the technological solutions for them. (Source: UNCTAD, 1999)

Developing the Financial Sector

13. The development of a national financial sector is a requirement for SME growth.

Lack of access to finance can usually be found at the top of any list of the problems of small businesses. Businesses generally start with their own resources and are undercapitalized. This is a major factor in their failure. In developing countries, the financing institutions are usually not able to meet the SME needs for seed money and investment capital as a result of the high transaction costs and perceived risks, the lack of collateral and financial data, and negative bank experience in dealing with small asset-backed borrowing. Problems are exacerbated in unstable, high-inflation environments.

What to do?

In less developed financial markets, programmes may assist in strengthening local institutions through training and intercountry exchanges of experience in preparing bankable projects, testing innovative services such as credit guarantee schemes, and extending the group lending model based on peer guarantees to the needs of small businesses while avoiding subsidized lending, which distorts financial markets.

In developing countries, it is especially important to link finance to non-financial support services. As shown by UN agencies such as ILO and UNIDO, donor programmes can help in developing capacities to prepare business plans for accessing credit and facilitating the process.

In the more advanced industrializing countries, there may be potential for exploring equity financing through second-tier stock markets. The venture capital mode can be extended by the formulation of regulations and tax structures facilitating initial public offerings and the use of electronic networks for matching capital sources to enterprises. Other debt-financing mechanisms such as credit guarantee schemes, leasing and
factoring have shown considerable potential and need to be developed further.

**Examples:** The UNDP-initiated Enterprise Africa programme plays a two-way facilitation role: helping its member companies to become creditworthy borrowers and helping the financial institutions to develop relationships with the entrepreneurs.

The Kenyan Rural Enterprise Programme (K-ep) is now applying its micro-finance lessons to commercial SME lending. The use of collective lending can be adapted where, for example, one company may guarantee for another when they are interdependent through the supply chain. (Source: UNCTAD, 1999)

The UNDP-supported Social Fund for Development, Egypt, has attracted substantial donor support and delivered good results by combining financial services with technical assistance, now moving towards self-supporting operations. (Source: UNDP, CEDAB, EGY/92/007)

**Programme Design and Implementation**

The need for the small enterprise sector is increasing just as government and donor budgets are declining. This calls for better use of technical and financial resources, improved preparation and implementation of SME support programmes, enhanced monitoring and quantitative assessments of results. Donor assistance can be useful at both the macro and micro level: (a) support to governments on macro-level SME development strategies and policies can be cost-effective; and (b) donor-sponsored programmes can often make significant contributions at the micro level in countries where small businesses face basic issues of survival, working directly in sectors or even with groups of enterprises.

14. **Invest more efforts in initial preparation.**

More intensive initial work is essential. Hasty and flawed programme design is a significant cause of unsuccessful results in many SME development programmes because the complexity of this sector has not been taken into account.

**What to do?**

For direct-support programmes or projects, a pre-launch market analysis should be conducted either of services to the SMEs or of the potential market of the SMEs receiving support, depending on the objectives of the project. The above-mentioned four principles (services should be demand-led, businesslike, sustainable, and outcome- and outreach-oriented) should be applied when designing support-service projects. Mechanisms must be established to ensure sustainability, such as a cost recovery schedule or an assessment of the repayment potential of loans. A risk assessment of the effects of the negative policy environment can also be useful when providing direct support to SMEs.

For policy interventions, more time should be spent on building the political commitment required for the project to succeed, for example, through workshops with the government and the private sector.

15. **Involve the private sector in design and implementation.**

Technical assistance programmes are often designed by donors and the government or by consultants working for the public sector. Since public-sector civil servants are not the best placed to advise the private sector on how to develop itself, it is crucial to involve the private sector in formulation and implementation. This not only includes consultation with the intended beneficiaries but also using experts from the private sector and prominent business leaders as sounding boards and as sources for technical advice at the design stage and during implementation. Greater use of national private sector experts, United Nations Volunteers (UNVs) and United Nations Short-term Advisory Resources (UNISTAR), with the selective use of international experts, contributes to this involvement and may enhance cost-effectiveness and impact.
16. **Design and implement programmes with other donors and partners.**

SME development requires action on many fronts: developing policy that supports the financial sector, providing credit lines and services, developing skills and building capacity. The volume of work is too large for one intervention to have significant effect and should be shared and coordinated among donors. Linkages among programmes and projects within a country and cooperation among the main UN agencies in the SME field (ILO, International Trade Centre (ITC), UNCTAD, UNIDO) as well as bilateral programmes can enhance effectiveness and minimize needless duplication, for example, through theme groups and/or continuous dialogue in the field and at headquarters. The UN Resources Handbook on SME Development, prepared by the UNDP Private Sector Development Programme (PSDP), can give UN country offices and governments a clearer picture of the key services and tools available.

17. **Be strategic in choosing what to support, especially in relation to credit.**

Owing to the varied types of support needed for SME development, donors should make a strategic choice as to where and when to provide support. For example, all SMEs in developing countries, especially in Africa, suffer from the lack of a fully functioning financial sector. This often leads to poorly designed credit components in projects, which at best can serve as a band-aid to the situation. In these cases, it is often best to seek alliances with other donors to work on a comprehensive programme to develop the financial sector and especially the financial entities that are able to lend to SMEs. Also, given the UNDP financial situation and regulations and rules, the organization is not the best placed to provide credit lines for SMEs and may therefore have to play a catalytic or supportive role. Addressing SME policy issues together with the government and the private sector represent another potential area for support that has not been fully exploited to date.

18. **Be realistic in estimating project duration, resources needed and expected results.**

Typical UNDP-funded SME projects have a life of two to three years, which is a short time in which to effect lasting change. Estimates of both the time and money to be deployed must be realistic. This is particularly the case where the project requires the transfer of the skills and technology for a new product or for improving existing operations. These normally require a longer period of support, gradually decreasing as national capacities are being built and cost recovery increases. Alternatively, it might be necessary to limit support to catalytic and seed-money interventions.

19. **Select carefully the local support institutions for collaboration.**

Direct-support projects located within government institutions have often experienced problems in reaching out to SMEs and ensuring sustainability. Careful attention should be given to selecting which institution will manage the project, and which support agencies and finance institutions to work with the capacities these entities possess to make the project a success should also be identified. Characteristics of potentially good collaborators are good quality of services and outreach, client orientation, an appropriate pricing policy, self-sufficiency, and organizational independence. Where possible, private sector companies could be used as contractors for project activities. Project management can often best be achieved by building local, private sector capabilities via, for example, an advisory board able to instruct the project in providing loans, grants and support.
UNDP Evaluations Consulted in the Central Evaluation Database (CEDAB)


Selected Readings


Contact Institutions

Committee of Donor Agencies for Small Enterprise Development
http://www.ilo.org/public/english/employment/ent/sed/bds/donor/index.htm or
www.bellanet.org/sed/performance
- Go to www.ilo.org, Then click on Department home page, click on Small enterprise development,
  click on Business development services, click on Committee of donor agencies.

ILO
http://www.ilo.org/public/english/employment/ent/sed/ or contact isep@ilo.org
- Go to www.ilo.org, Then click on Department home page, click on Enterprise.

ITC
www.intracen.org

UNCTAD
- Go to www.unctad.org, Under Project subsites, click on Division on investment, technology and
  enterprise development, click on Enterprise development, click on Empretec.

UNDP
www.undp.org/psdp/eed/eed_index.html
- Go to www.undp.org/psdp, Then click on Overview, click on Entrepreneurship and enterprise
development.

United Nations Educational, Scientific and Cultural Organization (UNESCO)
www.unesco.org

UNIDO
www.unido.org and www.unido.org/doc/what.htmls
- Go to www.unido.org, Then click on What we do, click on SME policy framework.

World Association of Small and Medium Enterprises (WASME), WASME c-20B Green Park Extension,
New Delhi 110016, India, Fax: 91-11-6852170

World Bank
- Go to www.worldbank.org, Then click on Topics and sectors, click on private sector development.