

SUPPORTING RURAL NON-FARM ENTERPRISES: WHAT CAN BE LEARNED FROM DONOR PROGRAMS?*

*Richard L. Meyer**

INTRODUCTION

Considerable attention has been focused on rural non-farm enterprises in recent years by donor agencies and development specialists. Micro- and small-scale enterprises have also been the subject of many recent studies. Undoubtedly, part of this interest is due to the growing realization that large-scale, modern industrialization strategies of previous decades have failed to solve the problems of underemployment and poverty (Liedholm and Mead 1987). It has been popular to view support for microenterprises as an effective way to stimulate the private sector's contribution to growth and equity objectives of developing countries. Non-governmental (NGOs) and private voluntary organizations (PVOs), in particular, have become active in support programs of credit, training and technical assistance for urban and rural small-scale enterprises.

This paper aims to present a summary of the large and growing literature about donor experience in attempting to meet employment and income objectives through assistance to the rural non-farm sector, with emphasis on micro- and small-scale enterprises. Key conclusions about these experiences are presented stressing those with implications for rural development in the Philippines, and for the research to be conducted in the Dynamics of Rural Development Research Program of the Philippine Institute for Development Studies

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*Professor, Department of Agricultural Economics and Rural Sociology, The Ohio State University.

(PIDS). Much of the literature available in this field is of two types. One type concerns the experience of the donor or international agency in providing assistance to countries through projects designed for certain target groups, enterprises or regions. Since much of this assistance involves credit, this paper focuses on the lessons learned in attempting to provide credit services to the target clientele. The second type of literature concerns an economic analysis of the group or sector being assisted. Such literature seeks to answer economic questions like the role of small-scale or rural non-farm enterprises in creating employment and generating income, the efficiency and profitability of various firm sizes, and the dynamic process of enterprise creation and growth.

A COMMENT ON DEFINITIONS

The first problem encountered in conducting a literature review encompassing several studies, countries, and authors is the wide range of definitions used to identify and study enterprises, firms and sectors. The terms "small" and "micro" are used to describe size of firm, usually measured in terms of employment or assets. The term "microenterprises" refers to the smallest-size firms, frequently employing only the owner/entrepreneur and his/her family with only a few workers. Although some small-scale firms operate on a modern industrial basis, most are generally organized as "cottage industries" with limited management specialization and division of labor (World Bank 1980). The terms small and micro also frequently imply "informality" because these firms tend to fall outside the sphere of influence, regulation and support of government. Informality gives these firms the advantage of avoiding restrictive government regulations, but can also limit their access to formal finance, and broader markets, technologies and information systems that would enable them to grow and benefit from economies of scale.

The term "non-farm enterprises" has been applied to the heterogenous set of undertakings found on and off farms but which are not included in the typical farm production study (Meyer 1991). Processing activities conducted within the farm household are often included in this definition. In addition, these enterprises cover economic activities found in villages and small towns, often closely linked to agriculture by providing inputs, or processing and marketing farm outputs. These enterprises are distributed across all firm sizes,

but much of the research has focused on those which fall within the micro- and small-size category.

The emphasis of industry studies tends to be on "manufacturing." However, the rural non-farm sector includes a vast range of service and trading enterprises, and other firms indispensable to the agricultural sector, and which provide a large amount of employment and income, especially for women, in many countries. Most donor credit programs, though, have only recently recognized the value of including non-manufacturing activities in their list of projects eligible for funding through subloans.

For the purposes of this paper, the term "rural non-farm enterprises" will be used to encompass the heterogenous set of economic activities found on and off the farm, but usually strongly linked to agriculture. They tend to be small in size, measured in assets or employees, and use largely traditional methods of production and simple forms of organization. No effort is made to specifically include "agribusinesses" in this review because the agribusiness literature often centers around larger-size firms, frequently with international linkages, and using modern production, processing and marketing techniques. Undoubtedly, large-scale agribusinesses are important in shaping the rate and nature of rural development, and in indirectly creating opportunities for smaller-scale, more traditional enterprises in the rural non-farm sector. However, they are less frequently the focus of donor assistance programs, and in some countries, there is a heated debate about the growth and equity implications of using large-scale, multinational agribusinesses as the engine of rural development. It is possible that broader-based, more equitable development will occur by stimulating the growth of smaller, more traditional enterprises and firms.

DONOR EXPERIENCES

Several reports summarizing donor experiences and recommendations concerning rural and microenterprises are now available. The purpose of this section is to highlight the key findings of several recent reports.

United States Agency for International Development (USAID)

In many ways, AID has been a leader among the donors in support programs for micro and small enterprises. The early PISCES project

evaluated several attempts to provide assistance to these enterprises. Later, the ARIES project and now the GEMINI project continue that tradition. AID has also been important in supporting research about small enterprises and the rural non-farm sector. Carl Liedholm and colleagues at Michigan State University have conducted research in this field with AID support since the 1970s. The Harvard Institute for International Development has a long history of research on the financial sector of Indonesia, some of it supported by AID, that has helped reveal how financial reforms in that country have helped the small-scale sector. In 1988 and 1989, AID undertook and published the results of a major stocktaking of its experience in microenterprise development (Boomgard 1989).

Liedholm and Mead prepared a paper in 1987 that represented a comprehensive synthesis of MSU research findings up to that date. The conclusions were largely drawn from in-depth studies conducted in selected survey areas in six countries: Sierra Leone - 1974-1975; Bangladesh - 1978; Jamaica - 1978; Honduras - 1979; Thailand - 1979; and Egypt - 1981. The small-scale industries in the study included those establishments with fewer than 50 workers engaged in manufacturing activities or related repair work.

The analysis of the sampled firms revealed that they collectively account for the bulk of industrial employment, are located in rural areas (localities with less than 20,000 inhabitants), most are very small employing fewer than five persons, virtually all are privately owned and are organized as sole proprietorships, and the proprietors and family workers make up most of the labor force. The amount of capital used by these firms is modest, but larger than that called for petty trading or unskilled service activities. Most of the funds for establishing or expanding these firms comes from personal savings, relatives or retained earnings. Only a small amount comes from formal financial sources or governments. The economic activities of these small-scale firms appear to be increasing in absolute terms along with the employment absorbed by the small-scale private sector.

The factors influencing the demand for and supply of goods and services produced by the small-scale industries were examined. Recent studies have revealed a strong positive relationship between demand and growth of household income, debunking the popular belief that small-scale firms produce inferior goods. A second source of demand is found in the strong backward and forward linkages with the rest of the domestic economy, especially agriculture and large-

scale industry. On the other hand, government and foreign demand was limited for most firms.

With respect to supply, most studies show that small-scale industries are efficient users of capital by generating more employment per unit of capital than large-scale firms. Output per unit of capital of small firms also tends to exceed that of large firms. Studies of the social benefit cost ratio of small versus large firms in Sierra Leone, Honduras, and Jamaica showed that they were greater than one and larger for small firms in 10 out of 12 industry groups analyzed, but wide variations in efficiency among the small firms appeared. The small firms that are most likely to be economically efficient were found to have the propensity to: (1) use workers; (2) operate in workshops away from the home; (3) operate in localities with more than 2,000 inhabitants; and (4) be involved in product lines/activities with better economic prospects, such as tiles, furniture, baking and repair activities. An important finding is that one-person firms were frequently on the margin of economic viability.

Liedholm and Mead (1987) concluded that small-scale firms can be enhanced by policy changes that reduce the bias against small firms, especially those controls that restrict interest rates and encourage lenders to ration scarce funds to traditional larger-scale clients. Policies promoting small-scale farming are also a powerful stimulus.

Projects rather than policy reforms, however, have been the primary method used by government and donors to support small enterprises. Relatively few entrepreneurs receive this assistance, however. Special credit programs designed to assist small- and medium-size firms often end up providing little credit to the smallest firms. But the AID stocktaking concluded that some programs can reach the smallest firms on a self-sustaining basis with minimal subsidies. Liedholm and Mead argue that the most successful programs that provide non-financial assistance are those that attempt to supply a "single missing ingredient," but that position has been disputed by Boomgard. They also assert that projects assisting existing firms are more likely to be successful than those trying to establish new ones. Similar to the World Bank experience, they contend that successful projects tend to be built on proven existing institutions.

The stocktaking evaluation represented a major effort by AID to evaluate what was learned about what works and what doesn't work

in its microenterprise projects (Boomgard 1989).¹ It focused on identifying projects and programs with proven effectiveness in generating and sustaining developmental benefits, and in analyzing the factors responsible for their success. (Throughout the study, microenterprises were defined as firms that employ 10 or fewer full-time workers.)

By the mid-1980s, AID was involved in at least 87 active microenterprise projects or programs in 35 countries. A purposeful sample of 32 projects and programs located in 20 countries was selected for detailed study in the stocktaking. They were selected because they targeted assistance to microenterprises, and some analysis of beneficiary impact was available. In almost all cases, the project or program studied either began operations in the 1980s or AID's involvement started at that time. Data were obtained from existing evaluations and site visits to 10 countries. Seven programs were selected from Asia, including the large-scale Indonesian BKK program, 11 from Africa, and 23 from Latin America. They are being implemented by PVOs, government agencies and credit unions. Some programs provide only credit to their beneficiaries, while others also offer training and technical assistance.

Three distinct approaches to enterprise development were identified in the study. The *enterprise formation approach* attempts to help highly disadvantaged groups or individuals from the survival economy develop viable businesses. Programs following this approach often serve a relatively large proportion of new entrepreneurs and a comprehensive range of services focused on the creation of rudimentary business skills, resulting mostly in income generation rather than in new employment.

The *enterprise expansion approach* tries to improve the performance of existing microenterprises. Essentially minimalist, it emphasizes small improvements for many firms, often providing only credit. The graduation of firms into small enterprises is largely left to natural selection rather than project effort.

The *enterprise transformation approach* actively tries to graduate entrepreneurs from micro to small enterprises, often by providing an integrated mix of credit, training, and technical assistance. The firms assisted are typically somewhat larger than those involved in the other approaches; thus, employment generation plays a relatively

1. This section draws heavily from my earlier review of the Boomgard report. Another synthesis of the stocktaking evaluation was published by Levitsky (1990).

larger role. Both the formation and transformation approaches are transformation-oriented, and place heavy emphasis on technical assistance and training. The expansion approach, on the other hand, tries to support existing enterprises, and this accounts for the minimalist-credit orientation.

Six of the sampled projects and programs were found to stress enterprise formation, 22 enterprise expansion, and 14 enterprise transformation. Because of multiple subprojects, the total number exceeds the total sample size. A relatively small number of programs in Latin America emphasize enterprise formation, while a relatively large proportion in Asia and the Near East fall in the expansion category. The sampled programs were evaluated on three criteria: beneficiary impact, cost-effectiveness, and institutional sustainability. The last criterion considered the three dimensions of financial, organizational and environmental sustainability.

The principal results of the evaluation are summarized in Table 1. The enterprise expansion data are presented in columns three, four and five. Column three gives the results of these programs treated together. Since the group is heterogeneous, the results of the six programs which operated primarily as financial institutions are presented separately in column four, and the results of the remaining programs are summarized in column five. In several cases data are missing, and in other cases, a wide variance among the programs within a particular group is present. Therefore, some of the differences in mean values appear large but are not statistically significant, as noted in column seven.

Most microenterprise programs serve only a few hundred clients, with the exception of financial institutions that serve thousands. Women represent a significant share of total beneficiaries in all programs. The formation and transformation programs tend to serve a larger percentage of manufacturing firms compared to other types, but the differences are not significant. Given the large allocation for training and technical assistance, average program costs are also higher, but not significant.

The average loan size in transformation programs exceeded \$3,000 compared to approximately \$500-700 in the other programs. This finding suggests that attempts to graduate microenterprises to small-scale firms require change in the firm large enough to justify a relatively large loan. Loan size can be determined by comparing average loan size relative to GDP per capita. The transformation programs provide loans that average 10 times the average GDP per

Table 1
KEY RESEARCH FINDINGS

Item	Enterprise Expansion					Statistically Significant*
	Enterprise Formation	Total	Financial Institution	Microenterprise Program	Enterprise Transformation	
Average years in operation	3.7	4.0	7.3	2.7	2.3	Yes
Average number of annual beneficiaries	328	87871	393172	642	264	Yes
Average percentage of women beneficiaries	59	43	41	43	27	No
Average percentage of beneficiaries in manufacturing	54	40	23	44	60	No
Average program cost per beneficiary (\$)	948	575	N.R.	575	2549	No
Average loan size (\$)	508	705	676	714	3261	Yes
Average loan to GDP per capita	1.3	1.2	2.2	0.9	10.2	Yes
Average percentage of fixed assets loans	25	20	9	26	45	No
Average program cost per dollar lent (\$)	3.24	0.46	0.51	0.43	1.08	Yes
Average real interest rate	3	23	17	25	0	No
Percent of loan funds in arrears (\$)	24	17	22	16	18	No

*Statistically significant at 5 percent level.

capita, while other programs offer loans roughly one to two times GDP per capita.

Most programs supply 25 to 45 percent of their loans to finance fixed assets. The financial institutions in the expansion programs, however, provide mostly working capital which is consistent with their objective of helping clients make marginal improvements in their businesses. By lending mostly working capital, these institutions also face less stringent staff requirements, making it easier to operate large-scale institutions reaching thousands of clients.

The data in the bottom three lines of Table 1 give some indication of the comparative cost-effectiveness and financial sustainability of the programs. Because of the modest services provided and their large-scale operations, the average program cost is lowest for the expansion programs — at just under 50 cents for every dollar lent. Transformation programs on average cost double that amount, while formation programs cost six times more. One good indication of a program's ability to recover costs is reflected in the interest rate charged on loans. The expansion programs charge real interest rates that average up to 25 percent, while the other programs have a large subsidy element because they only charge 0-3 percent. Even the relatively high rates in the expansion programs do not cover program costs.

The challenge to recover costs is further complicated by loan delinquency and default. The programs report loan arrearages ranging from 16 to 24 percent on average. If only half of these actually results in losses, loan losses of 8 to 12 percent are too high for most programs to sustain without continuous infusions of outside funds. The expansion programs come closest to meeting self-sufficiency, but generally the other programs are far from it. Financial self-sustainability is closest to being achieved in the best-managed programs which limit their assistance to low-cost financial services, like the BKK and KUPEDDES programs in Indonesia. Importantly, it was observed that credit programs that strive to become self-sustaining, even when the goal is unattainable, generally perform better than those that expect continuing external support. Organizations that think of themselves as businesses that live or die on the basis of earnings behave differently had they not been subjected to this market test.

The evaluation concludes that direct assistance programs aiming to improve the performance of microenterprises without attempting to transform them into more complex businesses have a better record

of achievement than the more ambitious transformation programs. They typically provide small working capital loans with efficient screening, rapid disbursement, and a reasonable assurance of the availability of larger loans upon repayment. The beneficiaries are poor, but not the poorest of the poor. The benefits of the programs are modest for each client, but they increase the income of many clients rather than create large amounts of employment. The organizations implementing these programs adopt a business-like attitude toward achieving a large volume of lending and operate in a market area large enough to achieve economies of size. The evaluation also identifies important qualitative factors affecting institutional performance, such as a clear mission, strong leadership, well-trained and dedicated staff, good management information systems, and ability to adapt to changing circumstances.

The stocktaking results present a dilemma for microenterprise support programs. On the one hand, programs may reach a large number of participants on a self-sustaining basis if they limit their support to small working capital loans. But this limited service may not meet the total needs of many enterprises. On the other hand, it is more difficult to achieve self-sufficiency if programs attempt to provide expensive training and technical assistance services for their clients. Furthermore, graduation from special microenterprise programs is difficult. Therefore, an alternative is to graduate entire microenterprise programs into credit retailers for larger-size loans for longer-term purposes.

In spite of the mixed results achieved in these programs and projects, the report recommends that AID continue to fund microenterprise support projects. One reason is related to AID's interest in stimulating policy change. The overall business and economic environment in a country has a strong influence on the opportunities available for profitable business ventures. By promoting successful microenterprise interventions, AID can become involved in policy dialogue concerning the need for and desirability of policy reforms. AID can also be a strong advocate for the small business community. Implementing projects provides a practical way to accumulate information and influence decisions, in addition to supporting research or including conditionality in foreign aid programs.

A second benefit of AID support of microenterprise projects concerns the development of financial markets. The report argues that formal financial institutions resist lending to the small-scale

sector not so much because of perceived risk but due to huge transaction costs. Innovations to reduce these costs that are introduced, tested and perfected in projects may open up formal lending to successful small-scale entrepreneurs. These innovations may also lead to the development of new lending institutions willing to serve a small-scale clientele.

European Investment Bank (EIB)

The European Investment Bank (EIB) completed a review of its lending program for small-scale enterprises in 1989. The results were reported in APRODI (1989), EIB (1989) and by Carter et al. (1990). Except as noted, this synthesis is drawn from Carter et al.

Since 1976, the EIB has financed projects in 66 ACP (Asian, Caribbean and Pacific) countries with its own resources raised in international capital markets, and with risk capital provided by the EC countries. Frequently, own resources are used for on-lending, while risk capital is used for equity participation or studies. About 22 of its operations have been channelled through local financial institutions, generally development finance corporations (DFCs). In the 12-year period ending in 1988, US\$363 million had been committed of which nearly 60 percent went to 660 SME projects. Two-thirds of the funds came from own resources and one-third from risk capital. A total of 42 countries participated (27 African, 11 Caribbean, and 4 Pacific), of which 16 were classified as poor (with per capita incomes of less than \$450). Operations in the lower-income countries have benefitted most from risk capital.

The average size of subloan in these projects was substantially larger than that of AID projects at \$322,000, but a third was for less than \$165,000. The average size tended to be bigger in larger countries. The real average size has been falling over time suggesting that the DFCs are becoming more effective at reaching smaller entrepreneurs. Sixty percent of the enterprises financed employed less than 50 workers, and 40 percent had annual expected sales of less than \$850,000 per year. Since most DFCs are prevented from funding publicly-owned enterprises, most enterprises are owned by local businessmen, and more than half by a single family.

About 60 percent of the subloans went to the bankrolling of new projects, 26 percent expansion of existing enterprises, and 14 percent rehabilitation and modernization of enterprises. About two-thirds were for import substitution, 17 percent export projects, and 19

percent services. Foodstuff, tourism and textiles received the largest total allocations. The majority of projects were close to a debt/equity ratio of 2:1, but equity contributions were higher for new projects. The ex-ante economic rate of return was estimated at over 20 percent for 77 percent of the subloans, and between 11 and 20 percent for 20 percent, indicating that expected returns are quite high. The projects in total were expected to directly create 28,000 jobs at a \$28,000-average cost per job created.

A post-implementation review was undertaken by having the DFCs respond to a questionnaire for a random sample of 120 projects. Interpretation of the results requires caution because the DFCs might have given more favorable responses than are justified, and the impact of structural adjustment recently undertaken in some countries may produce greater financial problems for some projects in the future than reported here.

The review showed a weak correlation between the ex-ante rate of return and project success, and projects tending to do well if they get off to a good start. Excluding projects for which a company had not yet been established, at the time of the survey about half of the borrowers operated profitably, a third operated at a loss, and the remainder were in receivership or liquidation. These proportions were not significantly different across the three regions. The most commonly cited reason (45 percent) for difficulty or failure was market problems, which were particularly dominant in the Caribbean. Technical and management problems were listed next, and a shortage of foreign exchange ranked third. The results suggest that market forecasts of borrowers tend to be overly optimistic, and the difficult economic circumstances in many ACP countries are manifest in weak markets rather than foreign exchange shortages for entrepreneurs. Data on project capacity utilization also reflected over-optimism in project appraisals. The average capacity utilization was about two-thirds, but was significantly higher (70 percent) for expansion projects, and lower (55 percent) for new projects.

The more successful projects as measured by company profitability were generally of two types: export oriented using local raw materials, and domestic oriented utilizing imported raw materials. Capacity utilization was highest in the former. Structural adjustment which changed relative prices in favor of domestic inputs appears to have benefitted export-oriented firms. Conversely, the domestic-oriented firms using imported inputs may have been benefitted by

high levels of protection, something that could be a difficulty in the future given the structural adjustment that is called for.

The financial structure of a project was not an important source of project failure, and many industries were able to bear foreign exchange risks without prejudicing their financial stability. About a third of the projects had been in arrears on their loan payment to the DFC, and about a third had rescheduled their loans. On the other hand, nearly 90 percent of the profitable SMEs never experienced problems with debt service.

The evaluation highlighted the importance of the quality of the assistance given by the DFCs to local entrepreneurs (EID). The on-lending rates of many institutions have often been too low relative to inflation and the margins required for sustainability. This problem plus their internal weaknesses in appraisal and supervision contribute to the financial difficulties of many DFCs. When subloans encountered problems, the DFCs have rarely been in a position to provide anything other than purely financial solutions.

The evaluation also noted the need for greater stability of economic policies if SMEs are to prosper. Greater use of the commercial banking system in projects was also advocated to help develop local financial markets and financial intermediation. The EID was encouraged to provide greater support for technical assistance in its projects, to allow lending rates to be determined by market forces, and, contrary to the views of several other donor agencies, to more effectively target economic sectors, scale of enterprises, and sizes of subloans.

International Labor Office (ILO)

The ILO recently completed its second progress report summarizing activities undertaken within the World Employment Program in the field of rural small industries and non-farm activities (ILO 1990). These include research; advisory services to governments; design and implementation of technical cooperation projects; evaluation of projects, programs, and policies; and collection and dissemination of information. The report contains a summary of the evaluations of the impact of their projects on rural small industrial enterprises (RSIE). The review conducted by the ILO, UNDP, UNIDO and the government of the Netherlands between 1985 and 1987 appears to have had a major impact on ILO views. This

assessment produced several recommendations, of which some of the most relevant ones follow:

1. *Macroeconomic policies.* Macro policies that favor growth of rural income should be given priority in RSIE development strategies, and must preferably precede supply-side support measures. Likewise, the development of an agricultural surplus is a precondition for stimulating RSIE. Donors and agencies should focus on persuading countries to adopt appropriate macro policies or insist on these policies as a precondition for supply-side assistance.
2. *RSIE support programs.* Supply-side support to enterprises is most effective if the demand environment is favorable and consists of partial input "missing ingredient" support to existing RSIE. Subcontracting from larger to smaller industries should be promoted through special training and extension programs. General-purpose small industries development agencies should concentrate on those functions they perform most effectively. Credit must be made available in as decentralized a form as possible, and the role of non-bank financial intermediaries should be enlarged. Mobile training units ought to be stimulated for technical upgrading programs. Greater use should be made of NGOs and PVOs as agents of change. Existing institutions should be used to implement projects rather than setting up new ones. Technical cooperation designed to strengthen RSIE institutions must first carefully screen them for their effectiveness.
3. *Donor coordination.* Donors and agencies have to harmonize their external assistance procedures and coordinate their field activities in support of RSIE.

It is obvious from this synthesis that the ILO has been heavily influenced by the idea that macroeconomic policies must be set right before RSIE projects can be effective. There are no suggestions presented, however, as to how changes in policies might have a differential impact on certain types and sizes of firms, and therefore influence the effectiveness of RSIE projects. As noted in the EIB evaluation, policy reforms will likely improve economic prospects for some small firms, while making it more difficult for others. This fact will have an impact on projects that target specific firms.

United Nations Capital Development Fund (UNCDF)

A review was conducted of the credit components of projects funded by the United Nations Capital Development Fund (Jackelen 1989). From 1966 to December 1987, the UNCDF obligated \$112 million in 93 projects with credit components in 17 countries, mostly Asian and African. The credit components amounted to \$31 million channelled through a variety of delivery mechanisms. Eighty-three of the 93 projects concentrated in agriculture, industry and irrigation.

Fifteen projects representing 30 percent of all budgeted credit components were selected for a detailed desk review. Three types of credit delivery mechanisms were used in these projects: Type A - financial institutions; Type B - grassroots institutions including cooperatives, village associations and communities; and Type C - a mix of financial and non-financial institutions. Two small industry projects in Burundi and Yemen fell into the Type A category. These projects encountered problems of the type frequently alleged to prevent financial institutions from making small industry loans. To name some: security requirements were high even when the project specifically exempted them, transaction costs were high for small loans, the loan approval process was time-consuming, and the financial institutions have little capacity for outreach and supervision of loans made. Recovery rates were low not necessarily because of financial difficulties of the entrepreneurs; but due to the perception of loans being "soft."

Two small industry projects in The Gambia and Bangladesh fell into the Type C category. In both cases, a bank was used to provide loans, while a government extension service offered direct assistance to borrowers. Moreover, both projects were poorly implemented because of a lack of clear definition of responsibilities, ineffective field staff and absence of a well-developed staff training program, the banks' inadequate accounting systems that provide timely information on problem cases, and the projects' not being designed to develop sufficient delivery mechanisms to accomplish their goals.

The evaluation concluded that the sampled projects, regardless of type or sector of operations, shared a number of weaknesses. These included the following: lack of clear definition about the role of the credit or revolving funds provided by the UNCDF to the project; interest rates too low to cover costs; neglect of savings mobilization and good accounting and management information systems; inability to properly assess the capabilities of the participating institutions prior

to project start-up; lack of effective technical assistance for these institutions, especially in the critical linkage between the delivery institution(s) and the borrowers; and failure to incorporate traditional informal credit customs and practices into the projects.

Despite the evaluation's unfavorable conclusions about UNCDF credit projects, it recommends that credit projects continue to be part of UNCDF programs. Various recommendations are made about how to make them more effective. Little is said, however, about the nature of the economic activities to be funded and the problems that projects can expect to encounter when serving low-income people who are the clientele of UNCDF programs.

United Nations Development Program (UNDP)

An evaluation of credit programs of the UNDP is reported in Ashe and Cosslett. A review was conducted of 750 projects approved by the UNDP between January 1987 and mid-April 1988 to determine those which were related to credit. Fifty-one of these projects (7.1 percent) were either related to or contained credit. The detailed breakdown follows:

1. 33 Type I projects with a credit component;
2. 8 Type II projects in which the UNDP provides technical cooperation to UNCDF projects that contain credit;
3. 3 Type III projects in which the UNDP provides technical cooperation for credit funds provided by international development banks; and
4. 7 Type IV projects in which the UNDP provides technical cooperation to credit operations in the banking sectors of developing countries.

A total of \$62.6 million, or 6.8 percent of UNDP funds, went to these projects. Projects in Africa and Latin America/Caribbean received most of the funds in all categories of project types.

For the Type I and II projects, 44 percent were directed at microenterprises, 34 percent served farmers, seven percent assisted fishermen, and two percent provided credit to aid housing construction. Poor people were predominantly the intended beneficiaries of 70 percent of the projects. The majority of the credit components were in the form of revolving funds, and the second-most common type were guarantee funds. The project documents carried

minimal information about the design of credit components, operational costs or project efficiency, cash flow, loan payment, probable project impact, or demand for funds. Sixty-one percent of the projects lacked information on the likely number of borrowers to be served, 85 percent had insufficient data on estimated loan size, 76 percent did not specify length of loan, and 83 percent failed to indicate interest rates to be charged. With such a dearth of data, it was impossible to estimate the sustainability of most projects.

To assess UNDP experience with project implementation, 16 credit projects were selected for a review of their evaluations and project files. More than half of the projects were executed by FAO in agriculture, forestry and fisheries, which explains the limited information on rural non-farm or microenterprises per se. In fact, all the project evaluations were so sketchy that important basic information, such as amount of funds disbursed and average loan size, was not provided. Sustainability was a key problem identified in the evaluations. In some cases the loan fund was not sustainable due to inflation and poor loan recovery. Secondly, institutions that are able and willing to provide credit to the poor on a long-term, ongoing basis were not created. Thirdly, there were no sustainable increases in capital for loan programs provided either from domestic or donor sources.

This evaluation also contains a set of guidelines for the design and implementation of effective credit projects. The guidelines argue among other things that credit projects will be most successful if the borrower is a member of a solidarity group or other group guarantee, has a need for short-term credit, and employs two persons or less. These recommendations, therefore, imply a minimalist, non-targeted, solitary-based approach to microenterprise lending. No attempt was made in this evaluation to define the type of borrowers or sectors that are likely to be successful over the long term.

World Bank

A comprehensive review of 15 years of World Bank experience in lending to small and medium enterprises (SMEs) was recently completed by Webster (1990).² The general objectives of these projects include the strengthening of the financial and technical

2. A summary of the report is also available in the 1990 journal article cited in the bibliography. Both the original report and the summary were consulted in preparing this synthesis.

institutions that serve SMEs, job creation, and correction of financial market imperfections that constrain small borrower access to credit. The review evaluated 70 World Bank projects in 36 countries representing \$3.2 billion in loans covering the fiscal years 1973 (when Bank SME lending was initiated) through 1989 (when 33 of the projects were completed).³

The study emphasized the building of viable and sustainable financial and technical assistance programs serving SMEs, and not the financial and industrial policy reforms or project impact at the firm level.

Projects in the Asian and Latin American regions each represented about one-third of the volume of loans made, but the African region had the largest number of total projects (21 out of 70), and is the region where World Bank SME operations are increasing. Almost 60 percent of the funds disbursed in the 33 completed projects went to firms engaged in metal products, food processing, and textiles and garments. The average subloan size for the completed projects was \$35,000, but within a project lies a wide range of subloan sizes. The fact that actual subloan sizes were far below the maximum allowable size is interpreted as evident of this reality: retail banks will not always make the largest loans authorized in a project. Projects in Asia and Latin America have been able to reach smaller borrowers than in other regions because the pool of eligible borrowers is larger, commercial banks have been used more frequently than development banks and they tend to make smaller loans, and the cost of doing business is lower, relative to the African region.

The completed projects created an estimated 600,000 jobs with approximately half of this total represented in just two projects in Indonesia. The average cost per job created was \$4,675. Many Asian projects performed well in creating a large number of jobs at an average cost of \$3,171, compared with \$9,850 in Africa. The African projects appeared to involve relatively more subloans to purchase capital equipment rather than use existing equipment or increase the number of people employed as is commonly practiced in Asia.

The projects were evaluated on three criteria: the loans were small, the number of jobs created surpassed expectations, and the institutions were substantially improved through the project. For

3. There are some discrepancies in the amount of SME lending reported by the World Bank. Webster claims the SME lending since 1980 has been relatively constant averaging about \$200 million annually. Dessing, however, asserts that 42.3 percent of the \$11 billion lent by the Bank to the private sector was channeled to SMEs from 1983 to 1988. This would imply \$800-900 million lent every year.

completed projects, 55 percent (18 of 33) achieved or surpassed at least two of the three primary objectives, 12 percent attained one objective, and 33 percent failed to reach any of the primary goals.⁴

The more successful projects had many of the following characteristics:

1. Presence of favorable pre-existing country conditions, such as:
 - (a) strong demand for services provided by the project;
 - (b) effective institutions and individuals;
 - (c) sufficient leadership and commitment to the goals of the project; and
 - (d) political, economic and regulatory environments stable enough to allow project completion without frequent and substantial shifts in policies and institutional leadership.
2. Selection of the strongest available institutions to implement projects, which sometimes required resisting governmental pressures to utilize poorly functioning public agencies.
3. Good project designs matching local demand for services with existing operations and capabilities of implementing institutions. The better projects shared these design characteristics:
 - (a) extensively prepared with in-depth analysis of the most promising sub-sectors to promote;
 - (b) demand for credit and technical assistance was judged fairly accurately;
 - (c) delivery systems were designed to fit within existing institutional operations; and
 - (d) program size and complexity were consistent with institutional ability.
4. Capable individuals held key leadership and management positions in the project delivery system.

The sustainability of credit and technical assistance programs was evaluated by assessing subloan repayment rates, the degree to

4. The first World Bank SME project in the Philippines was classified in the second group, while the second project fell into the first group.

which institutions incorporated SME services into their normal operations, and the record of repeat projects in given countries. The average repayment rate was 80 percent (highest of 92 percent in Latin America, and lowest of 61 percent in Africa). Eight of the 33 completed projects had subloan repayment rates of 90 percent or more, 15 had rates of 70 to 90 percent, and 10 had rates below 70 percent. A positive correlation was found between high repayment rates and per capita GNP, but little correlation between repayment and overall macroeconomic and regulatory conditions, and business environment. A consistent feature of successful projects was the retail banks' ability to select viable subprojects, disburse funds efficiently, and supervise projects.

World Bank SME credit projects employ lines of credit for borrowers channeled through the formal banking system, either directly to a single intermediary or through a second-tier system to retail banks. Forty-two of the projects employed apex credit delivery systems, 12 involved disbursements by development finance institutions, and 16 used alternative arrangements. The projects using apex credit systems, typically involving a mix of commercial banks and development finance institutions, were more effective as measured by smaller subloan sizes, higher job creation rates with lower costs, and higher subloan repayment rates. Public finance institutions with a general industrial finance mandate performed poorly as single intermediaries in SME loans, particularly in Africa. Subloan sizes have been relatively high, job creation low, and repayment rates likewise low. The major factors that have contributed to the typical problems of DFIs include weak and frequently shifting leadership, government interference, overall inadequacy and inefficiency, and failure to develop operational strategies consistent with small borrowers.

Most project components designed to provide technical assistance (TA) for entrepreneurs have failed to meet objectives in quantity and quality of services delivered. Poor project design, inadequate preparation and supervision by the World Bank, and poor implementation by government and public institutions were identified as reasons for these poor results. The more successful projects had fewer TA components, specific to a select group of beneficiaries, were built on an existing successful program, and provided services delivered to groups of persons with similar occupations.

Recent World Bank SME projects, many of which are in Africa, have been designed to

1. promote greater involvement of the private sector in delivering technical assistance to SMEs;
2. broaden microenterprise access to credit and TA;
3. promote female entrepreneurs; and
4. increase the overall number of entrepreneurs.

They offer the potential of reaching smaller, and perhaps previously underserved groups through especially designed programs, but the weak institutional capacity of many institutions selected for project implementation is a real concern. The reliance on NGOs in many projects may be problematic, given their typical small size relative to huge World Bank projects.

A World Bank report by Dessing (1990) specifically analyzes the challenge of supporting microenterprise in Sub-Saharan Africa. The report summarizes the literature on various types of programs to assist microenterprises. The author describes the two main strategies for supporting microenterprises: top-down indirect approach, and bottom-up direct approach. The first seeks to improve the business environment by changing microeconomic variables such as prices, government regulations and policies, and by building up the physical infrastructure. This "getting-the-prices-right" strategy is consistent with a laissez-faire doctrine of government, and relies on people's creativity and initiative to respond to new opportunities and incentives. The second approach aims to support microenterprises directly and assumes a more active involvement of the people in structural adjustments. This support often takes the form of credit, training and technical assistance.

Dessing advocates a third approach which combines the so-called process and minimalist approaches. Emphasis is placed on improving access to credit because entrepreneurs frequently report it as the most notable constraint. Moreover, several minimalist credit programs have been successful at reaching a large number of borrowers, especially the Grameen Bank in Bangladesh and the BKK in Indonesia. She advocates an approach in which NGOs, PVOs, business associations and government organizations as second-tier intermediaries are linked with the formal banking system. The

second-tier intermediary may eventually evolve or graduate into a formal institution (or bank), whereas the concept of graduating the microentrepreneur, although frequently espoused, is difficult to achieve in practice.

An often neglected aspect of microenterprise support is capacity building/upgrading of the institutions that support these businesses. The quest by donors for short-term visible results mitigates against this longer-term development support. Dessing argues, however, that institution building should be incorporated into the microenterprise support project as an explicit objective, and must be included in the budget. Donors can also assist NGOs by providing management information, sharing their often more extensive expertise and research documentation, and helping hire external expertise. However, there is an inherent conflict that must be resolved: most NGOs have a social orientation while donors have economic efficiency in mind. This fact leads some NGOs and PVOs to categorically reject government and donor support.

DEBATE ABOUT THE ROLE OF SMALL-SCALE ENTERPRISES

The literature reviewed in the previous section reflects a concern for two types of issues. First, the donor agencies are increasingly concerned about the sustainability of their programs. At one time, much of their concern was to document the efficiency of small-scale firms that they were committed to assist because of equity objectives. But as evidence mounted that many of the programs they supported were not sustainable, they shifted their attention to factors that influence sustainability. The current popularity of minimalist credit programs reaching large numbers with efficient operations, high loan recovery rates, and interest rates high enough to cover costs reflects this shift. Instead of detailed targeting of types of enterprises to be assisted, donors now tend to zero in on only the end users, not the end *uses*.

The second issue which is most evident in the literature surrounding AID and World Bank programs, but largely ignored by other institutions, has to do with the economics of the small-scale sector. Some of the evaluations recognize the important role of microeconomic policies in affecting the performance of the small-scale sector, but do not delve into the question of how the structure of the economy changes with development and growth, and whether it is really useful to assist the small-scale sector. This section seeks

to highlight some of the issues reflected in the debate about the future of the small-scale sector in developing countries.

A recent workshop sponsored by AID provided a forum for a review of what has been learned through AID's support of small, micro and informal enterprises.⁵ Emphasis was placed on discussing the research conducted in the Employment and Enterprise Policy Analysis (E.E.P.A.) Project. Snodgrass presented a paper which summarized the debate about the role of small and medium manufacturing enterprises in industrialization and economic development. He defined SMEs as firms employing fewer than 100 workers. He argued that India was one of the first developing countries to advocate small-scale industrialization as early as its 1956 Industrial Policy Resolution. Subsequent research has documented the positive role of SMEs in the development of China, Taiwan, Japan, and Columbia. As noted in the previous section, the research summarized by Liedholm and Mead suggests a positive role for SMEs in several developing countries. The research by Little, Mazumdar, and Page (1987) on India and other developing countries, however, arrives at a different conclusion. They did not find small, especially very small, manufacturing enterprises relatively efficient users of resources, asserting that medium size-firms are often more efficient.

Snodgrass argued that the industrial structure of many developing countries is dualistic. There are a large number of small firms, a substantial number of large firms with 100 or more employees, and in between the "missing middle" in which there are few firms and relatively less employment. There is also a wide diversity in productivity among firms. Labor intensity is greater among industries than among firm sizes; thus, pushing labor-intensive industries rather than small firms may be a more efficient way of promoting employment.

As countries develop, Snodgrass believes that average-firm size rises in manufacturing and productivity and wage differences narrow. The rise in firm size occurs for two reasons: the industrial structure shifts in favor of industries in which firms tend to be large, and firm size grows within industries. These trends are due to changes in technology, demand, transportation and information costs, firm strategies, and government policies. Inter-firm productivity and wage differentials narrow because of improved economic integration as

5. The proceedings of this Workshop are reported in the DEVRES summary.

economies develop and the marginal contribution of resources tends to equalize across firms and industries.⁶ Biggs and Oppenheim (1986) argue that the aggregate size distribution of firms will be influenced by policy bias with respect to size, sector or both. The best way to reduce the share of large firms in manufacturing is likely to be the elimination of bias in favor of industries in which output is concentrated. Furthermore, it will often be counter-productive to implement policies which attempt to improve the competitiveness of small and medium firms.

Following this same line of thought, Snodgrass contends that small firms in low-income countries are reservoirs of surplus labor. Only a few have the potential for developing into medium and large firms, and it is difficult to identify them in advance. Policies that explicitly favor small firms, by providing subsidies through differential application of minimum wages, taxes, zoning, etc., can actually inhibit their growth into medium-size firms and accentuate the missing middle. On the other hand, the favorable policy treatment that large firms have obtained for themselves should be eliminated to gain a more even playing field for competition.

The E.E.P.A. series of studies attempted to delineate recommended policies for different types of country situations. Snodgrass advocated a role for active government support of industrialization, including the participation of SMEs, if it is performance-based, as was the case in Taiwan and South Korea. The trick, of course, is to limit government assistance to truly deserving firms. The E.E.P.A. research in the Philippines,⁷ Ecuador and Honduras concluded that import substitution policies were biased against SMEs, causing them to remain small and/or informal. It is argued, therefore, that these countries need to reduce their anti-labor and anti-SME policies, and open themselves up to more foreign competition.

The African countries pose the largest challenge and disagreement within the E.E.P.A. research project. The Michigan State collaborators in the project argue that micro-level intervention is needed to create the conditions for economic growth. The Harvard Institute for International Development (HIID) group represented by Snodgrass, however, is skeptical because they feel that such

6. A paper by Biggs and Oppenheim (1986) presents empirical tests of these arguments.

7. The Philippine research is reported in Biggs et al., 1987.

interventions are expensive and often ineffective. Yet, they offer no suggestions as to what should be done to create productive SMEs in economically stagnant African countries.

CONCLUSIONS

The most striking difference noted among the several donor evaluations summarized in the preceding pages is the wide range in size of loans made in the various projects. At the small end are the \$500-700 loans provided in the AID-funded projects, while at the large end are the \$200-300,000 loans in the EIB projects. The World Bank average loan size of \$35,000 falls between these two extremes. The small-size loans appear to be focused on simply helping family-based firms to make small improvements, while the larger loans seem to be part of projects that aim to make a larger impact on employment creation.

Despite the differences, a surprising degree of consensus emerges in these evaluations.

First, the donors are increasingly concerned about project sustainability. Such a preoccupation seems to arise from the criticism that many donor-supported activities either fail during the lifespan of the project, or are unable to reach an adequate performance level that will keep them going once donor support is terminated. Therefore, several evaluations seek to identify factors that contribute to sustainability.

Second, there appears to be a diminishing donor concern about the borrowers' reasons for obtaining loans and the loans' impact on them. Some years ago, donors were heavily involved in targeting the end use of loans so that funds would be channeled into so-called productive purposes. There was also immense interest in measuring the impact of the projects on the poor. Today, a greater appreciation for the difficulty in measuring impact because of the interchangeability of loan funds is manifest. A greater acceptance is so apparent now that a positive impact can be assumed if entrepreneurs value a program enough to borrow and repay so they can become repeat borrowers.

Third, the macroeconomic environment in which small-scale enterprises operate was mentioned in several evaluations as a factor that should be considered when designing a support project. However, relatively minimal evidence is presented of the extent to which the environment was a significant cause of a project's success

or failure, or the small-scale firms it was attempting to assist. Few guidelines are provided about what specifically should be looked at in project preparation besides the general issue of policy bias toward large-scale industries. The extreme view is that projects should not even be undertaken unless the macroeconomic environment is first improved.

Fourth, there appears to be consensus emerging about the features of a successful micro- and small-scale enterprise support project. It should be minimalist (providing few services besides loans), reach thousands of beneficiaries, operate on a commercial basis with interest rates and fees high enough to cover costs, and possess an ability to recover loans. Solidarity group lending is often advocated as the means to efficiently lend and recover loans. Emphasis is placed on targeting the poor as end users, but not targeting the end uses of loans. Loans should be directed toward enterprise expansion, rather than enterprise formation or transformation. Institutions selected to implement projects should be carefully screened and many require considerable assistance before they can efficiently operate loan programs.

Fifth, NGOs and PVOs are advocated as preferred implementing institutions. However, there is a concern about how many are actually capable of handling the task. Like government agencies, many require considerable strengthening because their formidable commitment to the poor is not a sufficient attribute for operating a sustainable program.

A *sixth* common feature of these evaluations is their concern for client graduation. Most projects operate on the assumption that after an initial period of special assistance, small-scale entrepreneurs will be able to graduate to a commercial banking institution for loans. But in practice, this rarely happens that is why suggestions that entire programs eventually evolve or graduate into commercial lending institutions are rife.

Seventh, it is rather surprising that the evaluations do not say much about savings mobilization. First, savings mobilization will provide support institutions another source of funds to help offset the uncertainties of donor or government funds. Second, small-scale entrepreneurs benefit as much from a secure place to hold their savings as they will from getting loans. Third, encouraging entrepreneurs to save will help them develop the concept of a continuous banking relationship usually necessary for graduation to a commercial institution.

Eighth, except for AID, donors support surprisingly minimal analysis about the role of small and medium enterprises in the development process. The sustainability and growth of support services to these enterprises is inextricably linked to how well the sector performs over time. For example, enterprises that subsist by producing inferior goods will find it difficult to survive as rural incomes rise and consumers seek higher-quality products. Providing support to these enterprises will accomplish little.

A *ninth* point that emerges is the generally poor and irregular quality of documentation available to evaluators. It appears to be a problem for both project design documents as well as monitoring and evaluation reports. This casual approach to documentation may help explain the so-called unbusinesslike institutions that donors often support.

Finally, the tenth observation is that none of the evaluations recommended that the donor discontinue or reduce support for the small-scale sector in spite of all the difficulties identified by the evaluators in the past projects. An optimistic stance — previous shortcomings can be rectified — shines through. It probably also reflects a certain pragmatism by the evaluators; support for microenterprises is currently an important donor “fad” and funds will be pumped into these projects until a new fad replaces it. Furthermore, a strong NGO and PVO constituency has been built up that will continue to pressure for financial support for its involvement in microenterprise projects.

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