

Implementing the Market Approach to Enterprise Support

An Evaluation of Ten Matching Grant Schemes

David A. Phillips

This evaluation of ten matching grant funds for enterprise development concludes that matching grant funds address the need to build domestic capacity to support businesses.

Performance has been mixed, however, and best practice models are needed. Grant funding may be justified for technical knowhow, but support should be temporary and should be phased out as soon as the main objective, market take-off, is achieved.

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Summary findings

Developing viable new business is critical to recovery and long-term growth, especially in transition economies. There has been a long history of public support of enterprise development, starting with centralized state agency initiatives but moving more recently to decentralized instruments for development of the business services market.

The window of time during which the benefits of intervention are likely to be greatest: when a market is in its infancy and its development is constrained by uncertainty and lack of information. Interventions for enterprise support should be demand-responsive and flexibly organized. In some circumstances, centralized assistance may still be effective, but it is generally better to use competitive private service providers responding to enterprises' changing needs. The main task is to stimulate the private services sector, improving its capacity to respond to the demands of new and expanding private enterprises.

Support for enterprises has tended to be either free or heavily subsidized. But such subsidies can be justified only if interventions efficiently supply public goods. Providing technical and management knowhow can be a public good if it generates externalities—if, for example,

knowhow benefits can be disseminated at proportionately low additional cost. Any subsidy for an intervention should be temporary and should be phased out when the main objective of intervention is achieved—that is, when the market takes off.

Grants should generally be for knowhow, not for equipment. There may be a case for unbundling the knowhow component of loans (including feasibility studies and follow-up expert services) for grant funding. A package combining loans and grants—through a single financial institution or through separate institutions—may work, provided safeguards can be put in place to prevent perverse use of grants.

The matching grant model, which is used increasingly in the World Bank and elsewhere, is one solution—but it must be justified and carefully designed. After evaluating ten matching grant funds, Phillips concludes that performance is mixed. Best practice models are needed. Ensuring economic benefits requires proactive management with clear objectives of market facilitation (“making a market”). And it requires a balance between rapid grant approval procedures and careful selection of services for grants.

This paper—a product of the Private and Financial Sectors Development Unit, Europe and Central Asia—is part of a larger effort in the region to develop new instruments to support enterprise restructuring and development, especially in former Soviet Union economies. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Sylvia Torres, room H6-298, telephone 202-473-9012, fax 202-522-0005, email address storres@worldbank.org. Policy Research Working Papers are also posted on the Web at <http://econ.worldbank.org>. The author may be contacted at dphillips2@worldbank.org or davidphillips1@msn.com. April 2001. (27 pages)

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IMPLEMENTING THE MARKET APPROACH TO ENTERPRISE SUPPORT

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for

Europe and Central Asia Region
Private and Financial Sectors Development Sector Unit

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IMPLEMENTING THE MARKET APPROACH TO ENTERPRISE SUPPORT: AN EVALUATION OF TEN MATCHING GRANT SCHEMES

EXECUTIVE SUMMARY

- i. The development of viable new business, especially in transitional economies, is critical to recovery and long term growth. Yet in many economies the enterprise sector (especially SMEs) is faced with macroeconomic constraints, numerous regulatory and institutional hurdles, and operational bottlenecks. Enterprise support interventions try to address these problems. The menu of interventions ranges from macro-economic management through institutional and regulatory change, to firm-level finance, technical and management assistance. The Bank has used many types of interventions over many years, including enterprise-level support in rural and urban areas and at micro-, SME- and larger scale. The effectiveness of such micro-level interventions cannot be separated from the broader policy, and the broader policy cannot be successful without enterprise-level interventions. This study however focuses on the micro level, i.e how to effectively provide enterprise development assistance.
- ii. Public support to promote enterprise since the 1970s in developing countries has moved from centralized state development agency initiatives to decentralized market development instruments. It is now increasingly agreed that, if it is to be economically efficient and practically effective, technical assistance for the enterprise sector needs to be flexibly organized and demand-responsive. While traditional centralized assistance may continue to be effective in some circumstances, assistance needs to be to a large extent moved out of the State or quasi-public agencies to competitive private service providers responding to the evolving needs of client enterprises, subject to service quality control. Stimulation of private service supply and upgrading its capacity to respond to the demands of new and expanding private enterprises is therefore a central task of public policy. Such concerns have been the focus of a series of international workshops on business development services (BDS) held during 1999 and 2000 under the auspices of the Committee of Donor Agencies for Small Enterprise Development.¹
- iii. Public sector enterprise support has in the past been either free or heavily subsidized. But such subsidies can only be justified if it can be shown that the interventions efficiently supply public goods. Technical and management know-how provision is potentially likely to be a public good if it generates externalities - for example if its value can be increased through knowledge dissemination without incurring proportional additional financial cost. In such a case there may be a justification for subsidized intervention to support faster and more effective development of the market for business knowledge. In practice implicit subsidies have been provided through traditional State agency support, and to a lesser extent through the fee-for-service autonomous public agency model. While these models may continue to be valid in some cases, such interventions on the supply side have been problematic because, inter alia, they may run the risk of missing the main market needs while actually undercutting sustainable domestic capacity and having only a weak effect on service demand. Such an outcome would be counter-developmental and would mean that, instead of providing a public good, the subsidy actually made matters worse.

¹ The conferences were held in Hanoi, Rio De Janeiro and Harare. Their outcome is summarized in J. Levitsky (ed) 'Business Development Services; A Review of International Experience ITP 2000; implementation policy is summarized in : 'Business Development Services for Small Enterprises: Guidelines for Donor Intervention' – Committee of Donor Agencies for Small Enterprise Development. November 2000.

iv. If subsidies are justified, then instead of implicit subsidies to a single supplier, or centrally selected suppliers, grants targeted to service buyers combined with cost recovery (via service fees or co-payments), are likely to be more efficient because they stimulate a competitive response from existing and new independent providers of business services. Grants targeted not directly to the buying and selling of services, but to 'non-transactional' activities such as provision of public information or development of upgraded services, might be more efficient still because they do not distort buying and selling decisions. But carefully designed intervention in transactions might have inherent dynamic benefits. As well as being better targeted, grants are also likely to be easier to phase out at an appropriate time than subsidies to State agencies.

v. Grants for equipment rather than knowledge are not easily justified on public goods grounds, but to reduce effective cost of investing there may be a case for 'unbundling' equipment loans. The software/know-how components (e.g. feasibility studies, on-the-job training, start-up and follow-up expert services) could, subject to certain conditions, be provided through grants, helping to reduce the effective cost of finance. A combined loan/grant package, either through a single financial institution or through other institutions working in tandem with the banks, might be justified provided that there are appropriate safeguards.

vi. Whether a grant window is made available jointly with a credit or is implemented as a free-standing instrument, best practice models are needed. The matching grant fund (MGF) is an instrument increasingly widely used in the Bank and outside which may be the best available approach. An evaluation of ten MGFs is carried out in this paper. The conclusion on performance of this instrument, based on a variety of indicators, is however mixed. While the output benefits of such schemes (expressed as export- or sales-multiples of the grant amounts) appear to have been good, sustainability and impact seem to have been weaker. Operating costs have in some cases tended to be high and implementation has in some cases been complicated and delayed, calling into question their ability to inject liquidity rapidly, and efficiently, into the service market.

vii. Another grant-type model has been based on vouchers, especially for business training. Voucher instruments are in principle similar to MGFs but they provide a currency of payment for services which may better reduce both supplier and user risk, thus providing a greater market stimulus. However, they have relatively complex management requirements and correspondingly high operation costs, needed to provide successful coordination, guard against fraud, and ensure high quality service provision. The Bank has not implemented enough of these projects to draw firm lessons yet.

viii. The mixed evaluations suggest that MGFs have to be carefully justified in terms of additionality, and more carefully designed, if they are to be cost-effective and to achieve their potential market-making impact. Above all, because the more decentralized is the approach the greater the overall project management burden for the facilitating agency, a key requirement is competent fund management with clear objectives and procedures and a proactive market-making stance aimed at both providers and users in transactional and in non-transactional assistance. MGFs also have to balance streamlined procedures which allow rapid response to clients, with the need to ensure that grants are targeted to economically viable subprojects. Experience also suggests that MGFs are most likely to produce net economic benefits if they target the SME rather than the larger enterprise sector.

ix. Given the fact that many donor-driven public sector service providers are in existence, the question arises of whether and how to best leverage their capacity. There may be an acceptable combined facilitator-provider model. Such a combination could create a conflict of interest, because provision could undermine facilitation. However, in practice intelligent managing of a combined approach could work if

the service-provider function focused on specific specialized services not available domestically, was oriented to training and dissemination, and was to be phased out *pari passu* with the increase in domestic capacity, according to a clear timetable and an agreed market development model.

IMPLEMENTING THE MARKET APPROACH TO ENTERPRISE SUPPORT: AN EVALUATION OF TEN MATCHING GRANT SCHEMES

I. THE NEED FOR ENTERPRISE SUPPORT

Alternative Policy Approaches

1.1 The Bank's approach to assistance to the enterprise sector has increasingly focussed on the competitive and incentive environment and the institutional and regulatory framework. Interventions at the firm level have moved away from fixed investment (e.g. through financial intermediary loans) to knowledge transfer and business support services.² Firm-level interventions are justified if broader policy interventions by themselves do not create conditions adequate for enterprise development, while, at the same time, (i) private markets do not adequately provide the firm-level inputs needed and, (ii) enterprises are able to use efficiently the public sector inputs that are provided.³

1.2 This paper is concerned with micro-interventions; it therefore makes the assumption that the above two conditions hold, at least in a significant number of economies and in a significant number of situations. The paper is concerned with how such interventions can be made more cost effective in terms of sustainability and development impact by targeting the existing capacity within an economy to provide business services to enterprises.

SME constraints and development policy

1.3 Entrepreneurs in developing and transitional economies face a triple burden of macroeconomic, institutional/regulatory, and micro- (firm level) constraints. Many new enterprises fail as a result of the excessive costs of entry relative to their fragile financial positions at startup, or inability to secure permits, access finance or obtain business/ technical support, while others fail because of high costs of operation, such as the cost of servicing debt, inaccessible business information (e.g. how to export), and either burdensome state regulation (e.g. onerous tax compliance) or inadequate state regulation (e.g. weak contract enforcement). These hurdles are particularly problematic for SMEs.⁴

1.4 Up to the 1960s the share of SMEs in output in OECD countries had been falling, a trend that was seen generally as the inevitable and probably desirable consequence of the development of economies of scale. However, the start of the 1970s saw a reappraisal of their role, boosted as a result of the oil-price led recession of the 1970s when SME entrants were considered to be playing an important role in the recovery of employment⁵. The re-appraisal showed that, despite the decline in share, they maintained an important niche presence even in advanced technology sectors, and made major contributions to

² See Kristin Hallberg "A market oriented strategy for small and medium scale enterprises" IFC Discussion Paper no 40. (Table 1).

³ This is discussed in "Post-privatization assistance; when is it justified and how can the World Bank help?" Syed Mahmood; ECSPP Occasional Paper No. 2, 1998.

⁴ The disadvantages faced by SMEs may be characterized as *direct costs* and *compliance costs*. Of the latter, Government planning regulations and tax administration are the most frequently cited burden. See e.g. Graham Bannock and Alan Peacock "Governments and Small Business" chapter 10. Chapman 1989.

⁵ The extent of the overall employment effect counting both births and deaths of small enterprises has however been debated e.g. see D. Snodgrass and T. Biggs "Industrialization and the small firm; patterns and policies" International Center for Economic Growth 1996.

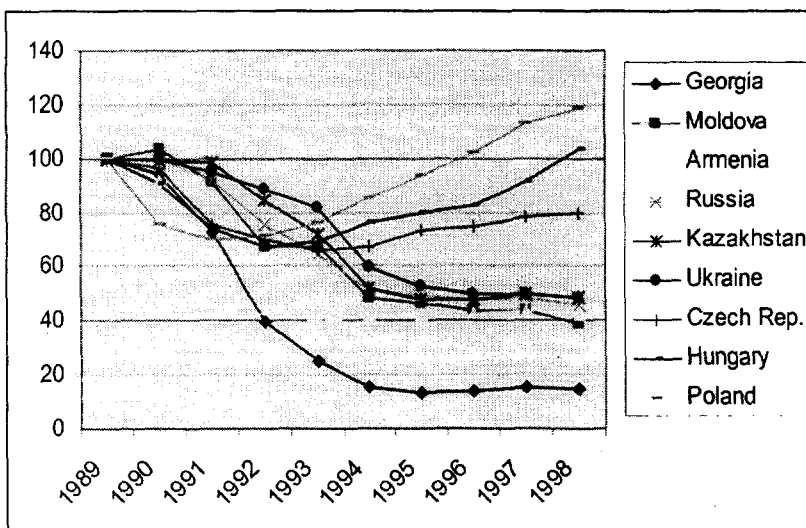
innovation⁶. In some OECD economies, SMEs (under 100 employees) still accounted for 95% of establishments and their share of employment, though considerably smaller, was in fact quite stable at around 30%. They were increasingly viewed as critical to the health of the enterprise sector as well as justifying relatively intensive support measures.

1.5 A parallel reappraisal of enterprise policy occurred in the developing world where, given the prevailing relative factor prices and labor-intensive product mix, the role of SMEs was likely to be even more significant and where the contribution of SMEs to GDP was in any case significantly larger (outside the ex- centrally planned economies). Typically firms with less than 100 employees accounted for 99% of total enterprises and well over 50% of total employment in the sector. The reappraisal in policy was reflected in intensified policy research such as through the ILO World Employment Program⁷. It was shown that in some industries economies of scale were achievable only when other complementary inputs were present at adequate scale and quality— notably capital-intensive transport, energy and technical support services, i.e. that scale economies were factor-price specific and might not apply. In economies that lacked infrastructure, and where relative wages and land rents were low, small to medium scale operation could be relatively efficient. As a result of such findings small and medium enterprise support schemes in developing economies proliferated since the 1970s.

Enterprise Decline - the transitional economies

1.6 The problems facing enterprise in the transitional economies are particularly acute. The serious output declines and decapitalization of the past few years, resulting from the collapse of the large scale state enterprises and the lack of a basis of small (e.g. service) enterprises, have made it particularly urgent

Figure 1 Real Industrial Output Trends in Transition



Source: UN ECE and D. Grigorian

to find ways to foster the growth of new enterprises, whether state sector spin-offs, privatizations, or *de novo* businesses⁸. Figure 1 shows the initial collapse and continuing serious situation in the industrial sector in a group of transitional economies, with 1998 real output significantly below 1989 levels in all but Hungary and Poland. Taking account of the unrecorded contribution of the informal sector, the general pattern still seems indisputable. In those economies in Eastern Europe where recovery does seem to be under way, it has been characterized by a shift from

⁶ Eg in the UK this was a finding of the 1971 Bolton Committee Of Inquiry on Small Firms.

⁷ E.g. as represented by "Technology and Employment in Industry" Ajit S. Bhalla ed, ILO 1975.

⁸ Scale definitions; micro-enterprises are very small businesses either in rural or urban areas including artisans, craftsmen, processing units and service suppliers employing less than 10 workers. Small and medium scale enterprises are in general manufacturing, processing and service enterprises in urban or semi urban areas employing from 10 up to about 100 workers, and in some case up to 500. These definitions are indicative only, and vary according to the level of development, the size of an economy, and other factors.

large to smaller scale enterprises, with small enterprise shares rising steadily to over 50% of employment since 1992 in countries such as the Czech Republic, Hungary and Lithuania, whereas in the late-recovery CIS economies (Russia, Ukraine, Kazakhstan) recorded small enterprise shares of sector employment remain below 25%.

1.7 While the relative efficiency of small scale versus large scale production is not clear in all conditions⁹, it is however likely that in appropriate factor price/ endowment conditions small scale production can be economic in many product areas, and in some sub-sectors small firms have been the most innovative, and dynamic. But leaving aside the efficiency arguments the existence of large proportions of the labor force in this sector in market economies means that the sector's development has to be a central focus of economic policy for the transition economies and the current relative stagnation is a major problem.

II. ALTERNATIVE ENTERPRISE SUPPORT MECHANISMS AND THEIR DEVELOPMENTAL RATIONALE

Evolution of Support Instruments

2.1 SME assistance has been at three main levels – the macroeconomic, the ‘meso-economic’ (market institutional, regulatory), and the micro (firm) level. As stated at the start of this paper, our concern is with trying to identify cost-effective interventions at the level of inputs to firms.

2.2 Development policy in general until the 1970s tended to assume that Governments generally acted in the public interest, to enhance welfare through eliminating market failures and through redistribution of resources. Accordingly, the design of technical support for enterprise in general and SMEs in particular, in the Bank and outside, tended to be located centrally within the Government bureaucracy. Increasingly however, it was found that Government failure may be as or more important than market failure. For example, whether in the area of exports assistance through official trade promotion agencies, or in the area of small business support through centralized Government enterprise departments, the experience of support to business was unsatisfactory¹⁰. In the case of enterprise export support, the use of public sector service suppliers is considered to have failed¹¹ in all but a few cases (e.g. in East Asia¹²). Even given an appropriate policy environment, experience suggests that State institutions are only likely to be effective as long as they enjoy the support and participation of the business community, are well funded, have staff experienced in relevant technical areas, and have a significant degree of autonomy from bureaucracy and political interference. These conditions have generally not been met.¹³ The conclusions of one Bank study of the issues were that interventions should (a) support,

⁹ See Kristin Hallberg IFC Discussion Paper No 40, 1999; op cit.

¹⁰ e.g. see “World Bank Lending for Small Enterprises 1989-93” L. Webster, R. Riopelle, and A. Chidzero World Bank Technical Paper no. 311 (1996).

¹¹ Keesing and Singer for example reviewed 27 Bank enterprise development and export support projects approved between 1980 and 1990. With few exceptions (eg the Philippines Design Center) they found that staff themselves considered the results unsatisfactory both in terms of export achievement and institution building. See “Expanding manufactured exports through support services” Don B. Keesing and Andrew Singer, World Bank 1990.

¹² E.g. in Hong Kong, Taiwan and Singapore. However in these cases State agencies were also helped by exceptionally strong export environments and a dynamic private sector, and attributability of State support is difficult to assess.

¹³ Keesing and Singer strongly advocated a change in approach. See e.g. “Development assistance gone wrong: failures in services to promote and support manufactured Exports” World Bank, 1990.

Box 1 Traditional Export Promotion in Kenya

The need for a supportive economic policy regime and the ineffectiveness of state promotion was highlighted in the SAR for the Kenya Export Development Project (1991): "despite extensive help by external donors the Ministry's activities are a textbook study in the ineffectiveness of official trade promotion agencies. Without general policies that support exports, exporter assistance programs ... have proved premature and ineffective..... the Ministry's staffing, small budget, and lack of accountability to the private sector render it unsuitable to provide the broad range of services required by Kenyan exporters."

not replace, the marketplace, and (b) have a 'light touch', through decentralization of services.¹⁴ The box refers to similar conclusions from Kenya.

2.3 To try to find ways of assisting more effectively the Bank has tried new approaches to supporting enterprises, and exporters, avoiding State promotional organizations. One way has been to establish autonomous semi-public business support institutions, which provide assistance in a more market-sensitive way. These interventions

nevertheless remain essentially supply-side. Another approach has been to try to directly expand the market for business development services, by providing incentives to purchasers of services. The resulting increase in demand in turn stimulates service provision from existing and new independent private service suppliers. Another version of the demand-driven, decentralized approach to enterprise support, but more experimental, has been based on vouchers, mainly in micro-enterprise support and training.

Public Goods, subsidies and Enterprise Support

2.4 To justify public intervention in general it has to be shown that the public sector is (i) resolving a clear market failure (greater than any distortion the intervention itself might create) and (ii) intervening in a cost-effective way. *It is not enough simply to show that a public intervention successfully produces an output.* (Equally it is not enough to evaluate projects on the basis of whether they simply meet output objectives). The intervention has to produce an efficient net benefit additional to what private initiative left on its own would have been willing to produce - i.e. a positive externality. It has to produce a public good, to 'make the market'.¹⁵

¹⁴ Brian Levy et al. "Technical and Marketing Support Systems for Successful Small and Medium Size Enterprises in Four Countries" World Bank Policy Research Working Paper #1400. Dec 1994.

¹⁵ A market failure occurs when an externality exists. A private activity that would be economically and socially beneficial is discouraged because the perceived costs to the private activity are higher than its cost to society, and/or because the expected value of the benefits accruing to the private activity are lower than the benefits to society.

Box 2 The Market Failure/ Public Goods Rationale for Assistance with Business Development Services

The economic justification for public intervention to increase the supply and demand for business services depends on the existence of failures in the private market. For example:

Demand side failures may result from lack of knowledge by firms of what is available in terms of business services, and how they can be of use. Such lack of knowledge is often caused by market segmentation with information only flowing to certain firms (usually larger export/import firms). Information on export potential is particularly lacking for SMEs. There is also a problem of 'short term-ism' (excessively high discounts on the value over time of outside advice due to perceived risk/uncertainty); low valuations of outside advice mean that access costs of services are likely to be seen as too high. In some poorer economy situations private valuation of training is reduced because of lack of certainty about its benefits, so that its costs appear excessively high in relation to its benefits. Putting a value on training is particularly difficult because it is an 'experience good'. The benefit received is difficult to value prior to completion of the training, at which point the incentive to pay is reduced.

Supply side failures are linked to the demand side—an underdeveloped market results in low expected returns to business service provision. First mover transaction costs may also be relatively high. Market segmentation can be another problem—if services are tied traditionally to certain sectors and there is a lack of knowledge about other sectors. Preemptive foreign competition (external trade, accounting and auditing services) may put up barriers to local entrants, or, on the other hand, protective policies may reduce the demonstration effects of foreign competition. There may also be a lack of/ inappropriate professional training infrastructure to produce advisors— or a relatively high threshold investment in such training.

Linked market failures may occur in, for example, the financial sector—SMEs are seen as risky borrowers due partly to lack of a track record and bank knowledge and lack of access to finance could reduce activity and demand for business services. In the case of exporting firms, lack of pre-shipment and post shipment finance effectively constrains production and indirectly reduces demand for business services.

2.5 Development assistance generally involves by definition some form of subsidy. In the case of technical assistance, whether local or foreign, the existence of a market failure may justify a subsidy if, for example, it can accelerate early stage market development. But the level of the subsidy has to be in some sense proportional to the market failure being addressed. Larger subsidies may be justified by larger failures. The greater the financial cost-revenue deficit, the larger must be the public goods (externality) element in order to justify covering the deficit from public funds. In general, in terms of economic efficiency and growth, subsidies should be (a) small enough to just offset the distortion or market failure (which implies being well targeted); (b) they should achieve their objective within a limited time (otherwise the targeting may break down); (c) they should be transparent (to minimize abuse, and to allow their impact to be easily monitored); (d) they should not have significant macro/fiscal effects (which may complicate the incidence of the subsidy and the incentives arising from it); and (e) they should be feasible without excessive administrative cost.^{16 17}

2.6 Earlier schemes for centralized provision of business development services were relatively insensitive to demand and also tended to create a monopolistic service supplier that could undercut the development of competitive private suppliers, and might over-invest in services not necessarily in demand nor of high quality. Such approaches did not adhere to the rule of minimizing the distortion created by

¹⁶ The Bank's OP 8.30 (para 8) states that subsidies should be (a) transparent, targeted and capped (b) funded through Government budget or other sources subject to regular control and review, (c) fiscally sustainable, (d) they should not give an unfair advantage to some FIs over other qualified and directly competing institutions, and (e) they should be economically justified, or the least cost way of achieving poverty reduction.

¹⁷ See "The Banks Approach to Subsidies" CPD Discussion Paper no 1986-44. Robert Myers et al. Subsidies can improve efficiency in two ways: first best, where they adjust prices directly to capture externalities or smooth price shocks; second best where they offset price distortions created by Government policies which cannot be removed in the short term. Firm level interventions are mainly of the second type.

intervention itself, and they were neither temporary nor transparent. Even if they managed to effect an increase in services leading to an increase in output, this was not by itself an adequate justification for public technical assistance intervention, and could actually be harmful if it did not lead to sustainable development of the market. An illustration of this is from Tanzania (see box).

2.7 To address the problem, a more recent approach to enterprise support has been to establish semi-public autonomous agencies¹⁸. Such approaches may be more market-sensitive; services may be provided with some degree of cost recovery, and the agency may assist to some extent capacity building in service provision (e.g. outsourcing to local consultant firms) as well as itself providing services to specific enterprises. However, these schemes are normally designed still to inject into the market a donor-driven central provider; the central provider may have a mandate to upgrade local capacity, but as a general rule such schemes do not address demand and market creation directly.

Box 3 Tanzania - State Support Bypassed Existing Local Capacity.

Despite the hostile environment for private enterprise in the 1970s, the commercial district of Dar Es Salaam still hosted many small private business service providers – bookkeepers and accountants, forwarding and courier agencies, marketing agents, and business training establishments. These small businesses seemed to be invisible both to the donor agencies and to the Government, both of whom preferred instead to set up high profile central promotion facilities. Yet these micro-firms were operating as profitable commercial businesses; they understood the market and the business environment. To the outside observer it seemed that the small accountants offices, for example, stimulated by increased demand and with some technical help, could be the seed-corn of future accountancy, business advice and consultant service firms. But instead they had to compete with donor-financed facilities working out of expensively staffed and equipped offices, and providing free services. Fortunately for them, the local knowledge and the marketing efforts of these state-sponsored bureaux was weak, so that the local service suppliers were not seriously damaged and they largely retained their traditional 'invisible' customers. However, it was an opportunity wasted because it was these existing fledgling service firms themselves that would have benefited from advice, training, and incentives to upgrade to contribute to enterprise growth and improved governance.

Moving from Supply side Subsidies to demand side grants

2.8 The market for business development services may be divided into strategic and operational services¹⁹. Operational services are routine activities such as freight and mail forwarding, printing and publishing, and bookkeeping. The market does not generally fail for routine services. The failure is more likely with strategic services which are outside the regular experience of small firms - such as diagnostic analysis, financing, reorganization, specialized market planning (e.g. exports), identification of investment partners etc. It is in these areas that a subsidy may be justified.

2.9 If a subsidy is needed and justified then a more effective way to provide it than implicitly through a service-supply institution may be to target the subsidy in the form of an explicit grant for the purchase of specific services - i.e. addressing the particular demand side failure²⁰. A subsidy to the demand side could still be distorting if it failed to stimulate appropriate sustainable development of the market, but it is

¹⁸ Some alternative types of essentially supply-side instruments are summarized in Syed Mahmood; op cit. Recent examples in transitional economies are the Lithuania Enterprise and Financial Sector Assistance Project, and the Moldova Private Sector Development Project.

¹⁹ It may also be divided up into several categories of service, each of which might face different market conditions, but we are simply outlining the overall principle here.

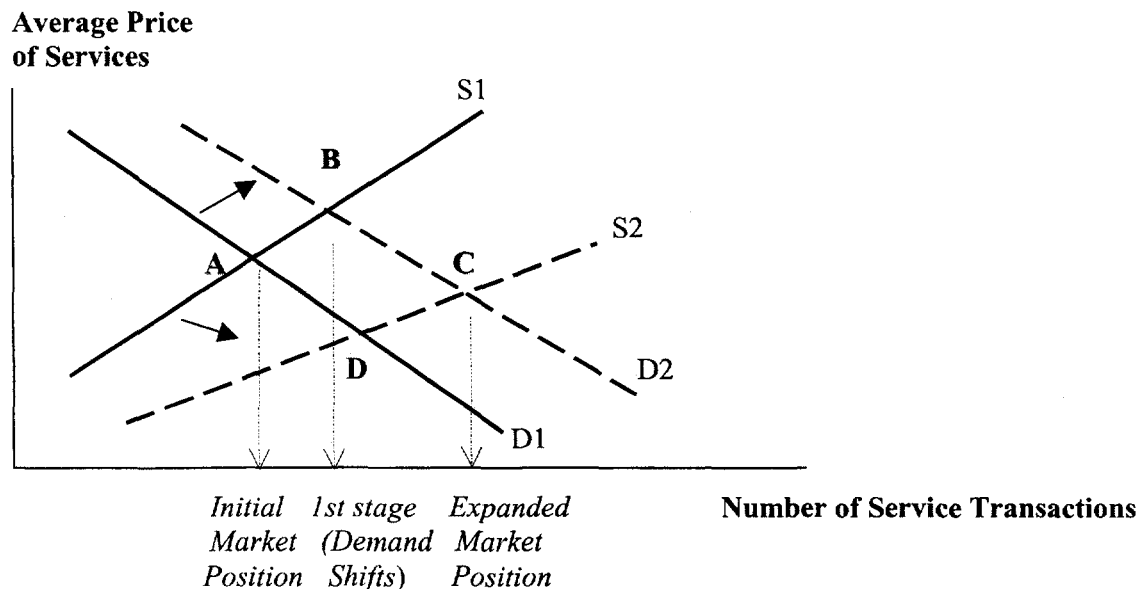
²⁰ It should be pointed out that who gets the subsidy depends on market conditions. Subsidies to purchasers are to some degree 'passed on' to suppliers, and vice versa, depending on elasticities of demand and supply. But who is the initial recipient may be important for incentive reasons.

more likely to stimulate a sustainable expansion than the imposition of a subsidized supplier on to an infant services industry.

2.10 A subsidy to transactions (demand or supply) is less efficient in static terms than a non-transactional subsidy (e.g. a subsidy for public information or general technical upgrading) because it directly affects (distorts) selling and buying decisions. However, market creation is not a static but a dynamic process in which incentives and sequencing may be as important as resource allocation, and a market transaction carries an inherent learning-by-doing benefit different from that of pure information provision 'offline'. This is because the learning process may be delivered more effectively. If this is so, then giving incentives to directly boost demand and accelerate transactions may produce as great or greater benefits than non-transactional subsidies.

2.11 Figure 2 depicts the market creation process. Initially the market at A is small and insensitive to the cost of services. A subsidy to demand for services (say through a grant) results in an upward shift in demand from D1 to D2. Service supply responds by initially expanding to point B (at a higher supply price). But if the grant both increases demand and reduces supplier's risk, thereby changing the supply conditions and encouraging new entrants, then the supply also shifts upwards, to S2, and the market to point C, at an average price equal to or below the starting level. The supply may also become more competitive, shown by increased elasticity, reflecting a more active and liquid market.

Figure 2: Stimulating the market for business services



2.12 A fairly rapid change in conditions of supply (e.g. through better information and reduced supplier's risk) is key to the development of the market. If a supply shift is not achieved and the supply curve remains at about S1 (and the market at point B) then most of the subsidy would be captured by service suppliers in higher profits, with little expansion of the market. The more the service supply shifts outwards, the greater the benefit will be for the users of services and greater the increase in market activity. A favorable shift in user-firm perception must also take place (e.g. through greater certainty about the value of services), such that demand remains elevated above D1 even after the subsidy (and its incentives) has been removed. (If demand remains at D2 this would suggest that the subsidy exactly eliminated a market failure). Otherwise, the market would contract back towards D, and then to A as

suppliers exit, and the whole exercise would have been a costly waste of resources. To help lock in the essential changes in market perception the subsidy should be phased out over time.

2.13 In contrast to the market-expansion scenario, the ‘traditional’ public sector enterprise service provider approach could conceivably result in a reduction in domestic service supply (because the subsidized supply of services reduces the average price obtainable for services), or a contractionary shift in supply (e.g. if existing service firms perceive that they can no longer compete and they have to exit the market). Its effect on demand is difficult to predict (it could reduce demand for existing services or it might over time have a learning/demonstration effect from increased knowledge of available services).²¹

2.14 Among the partial approaches to market development is one which fosters competitive supply. This occurred for example with business training services (used e.g. in Chile). The approach was to allow private service provision but to select providers centrally through a (donor or State-sponsored) competition process (an approach which retains a degree of central control of the supply side). This is partial because it supports competitive supply and price but it does not directly solve the problem of relevance and quality vis-à-vis client demand. The same procedure is used by one of the leading consulting agencies in this field.²²

2.15 One method of targeting demand, through a partial subsidy, has been through a Matching Grant Fund (MGF) instrument, which has been used by the Bank increasingly (though still infrequently) for delivering consulting and training assistance to business enterprises, as well as inputs into other sectors such as education and social services. The MGF has up to now been used mainly to boost demand but it could be also used to expand and upgrade service providers to meet more sophisticated demand by user firms. It could fund both non-transactional and transactional services ranging from simply free information provision to financing the purchase of a business service.

2.16 Another demand-side approach is to use vouchers. Vouchers are a partial transactional subsidy like a matching grant, but they provide a currency of payment for services.²³ This feature can further reduce the risk of the transaction to both service supplier and user. Some voucher projects have had good results. For example the evaluation of a Paraguay training voucher project claimed that “instead of the empty classrooms and lack of enthusiasm for the supply side approach even with private providers, demand for training services picked up strongly.”

2.17 Figure 3 depicts a continuum of assistance approaches, from the traditional centralized supply side method to the most decentralized demand-driven method. In practice there are many variations on these models and there is no case for saying that one approach is *necessarily* superior to another; specific conditions are critical. For example some facilities are not intended to be part of a local service market, but are temporary donor agency outreach or coordination offices, supplying specific services to support donor projects. But theory and experience suggest that a demand-driven approach if it can be adequately managed, will give superior capacity building results and a stronger development impact.

²¹ These issues are also explored in ‘East Africa – Non-Policy Instruments for Private Sector development’ World Bank 1994

²² SwissContact have designed many projects around the idea of local firms bidding to become preferred providers.

²³ It should be noted that the value of the voucher ‘grant’ still depends on the ability of service supply capacity to shift. If supply is inelastic then the increased demand would simply cause prices to rise.

Figure 3. A continuum of Enterprise Assistance Models

Supply Driven					Demand Driven
State Development	Autonomous	Assistance Fund	Assistance Fund	Voucher program	
Promotion Agency	Public agency	Public agency	Pvt/Contract mngmt	Pvt/Contract mngmt	
Government Mngmt	Private/Contract Mgt	Govt control	Decentralized	Decentralized	
Centralized	Part decentralized	Part decentralized	Private SPs	Co-payment	
Government SP a/	Private/public SPs	Private SPs	Co-payment	Private (?local) SPs	
Full subsidy	Some service fees	Co-payment		(Small/micro ents)	

a/ SP = service provider

Who gets the grants?

2.18 In trying to maximize social benefits all grant programs face a rationing problem. That is, if services are supplied at below free market price then there is by definition 'excess' demand, which leads to queuing, and thus the potential for arbitrary/corrupt behavior on the part of those in control of the funds. This problem has to be guarded against by designing a market-like rationing method. In practice Matching Grant projects have used simple objective eligibility criteria, and firm self-selection through FIFO and partial co-payments. Those eligible firms that are first in the queue are not necessarily the most efficient firms, but selecting the fastest respondents may have momentum benefits, which might be called X-efficiency effects. If the primary objective is institution building (e.g. making a market for business services) and if this is most likely with rapid momentum, then rapid disbursement of funding (FIFO) with low selection discretionality might be X-efficient. Nevertheless, the use of grants should best involve criteria which approximate to efficient selection.

Should there be subsidies for equipment purchase?

2.19 To assist small firms to invest there may be a case for subsidizing the cost of equipment. (This has been done in some micro-enterprise projects). However the case is not strong. A market failure in financing of fixed assets is less likely than for financing of know-how. Know-how benefits are more diffusable than is the case with equipment, yielding a benefit potentially considerably higher than the market cost²⁴. For example know-how embodied in workers can move between jobs, or to people outside the workforce, while equipment tends to remain proprietary and inaccessible to other firms. Thus for equipment the benefits are generally fully captured by the purchasing enterprise whereas for knowledge acquisition they may not be. There may also be a market failure in access to finance which penalizes know-how purchasers. For equipment loans banks have norms for asset valuation and loan security (e.g. collateral), which reduce the uncertainty of lending. For investment in knowledge such norms may not exist.

2.20 The case for equipment subsidies is stronger in some special cases. For example, with collective investments there may be external knowhow benefits. This might for example apply to a design center or a common repair facility. Collective investment arrangements have been promoted for this reason by business associations in countries such as Italy and Germany, or public-private assistance centers (Japan, Denmark, Korea). In South Africa business partnerships were encouraged to prepare joint programs for outside assistance²⁵. Nevertheless, a collective investment that captures these external benefits is more

²⁴ A prime example of positive knowledge diffusion externalities is the mass acquisition of internet capability throughout the population which may be considered to produce social benefits far greater than the financial costs (e.g. salaries of IT workers) or the price of software and IT products.

²⁵ See "South Africa; Industrial Competitiveness and Job Creation Project" World Bank Appraisal Report 1997.

likely to access adequate private loan finance. A more important exception to the rule is perhaps where a fixed investment generates clear externalities such as environmental improvement (e.g. pollution control).

Reducing Investment Cost by Unbundling Equipment Loans

2.21 Pressure to help firms by subsidizing investment has resulted from the very high real interest rates (between 20% and 50%) that have prevailed in some transitional economies countries (e.g. Armenia, Georgia, Kyrgyz, Russia, and Ukraine and Moldova) due to macroeconomic adjustment difficulties. A way of addressing this need may be to unbundle loans into know-how finance and fixed investment finance, using grant finance for know-how in parallel with credits for fixed investment. Most ICRs and PARs for the Bank's matching grant projects have cited as a main lesson the need to coordinate enterprise grants and credits in the form of an assistance package that could address both the hardware and the software needs of firms.

2.22 Unbundling of finance according to the public goods characteristics of the assets financed would not compromise the financial system since the bank loans would continue to be made for bankable investments at market rates while the grants would be from parallel windows financed outside the banking system. Nevertheless, the grant windows should conform to norms (limited fiscal effects, transparency, temporary and should not pervert incentives to borrow). Grants should not be for knowledge assets which are integral and proprietary to the equipment, should not distort lending/borrowing behavior by being made contingent on loans e.g. 'teaser grants' purely to attract business, and, finally should not be used to reduce general lending risk by leveraging the free funds.

Initial Country Conditions and Environment

2.23 The generation of externalities (e.g. through accelerating market development) may require particular economic conditions. In the case of enterprise technical assistance these conditions must be ones that promote the dissemination of know-how beyond the confines of the immediate recipient enterprise. A principal condition is adequate capacity and motivation of the productive sector to absorb innovative know-how. An economy which is in restructuring and recovery mode, but which possesses existing (if obsolescent) underutilized technical skills in the enterprise sector, may be more likely to reap long term benefits from a short term resource injection into the market for technical services than an economy that is trying to overcome long term structural constraints on the development of the technical services industry. An environment (e.g. a transitional economy) in which existing skills are being wasted may also generate stronger incentives to make the market work than an environment in which skills are being developed ab initio. The public goods case for intervention in the technical services market may therefore be clearer in transitional economies.

III. EXPERIENCE WITH VOUCHER PROGRAMS

Characteristics Of Voucher Schemes

3.1 To develop the market for business services by addressing demand, training and technical assistance voucher schemes have been tried in several countries²⁶, usually as part of wider projects.

²⁶ See "voucher programs; potential, problems and prospects" Gabriel Schor and Lara Goldmark, IDB March 1999 (paper for Rio conference). The IADB is financing eight voucher programs in Latin America.

Vouchers are subsidies to transactions that are expected to promote demand by lowering service cost in relation to its expected value, and by providing liquidity direct to the user. They promote service supply since the currency (redeemable vouchers) used for payment in advance eliminates a part of the supplier's payment risk (compared with ex post reimbursement) while the fact that the vouchers have to be endorsed by the user on completion of training reduces the purchaser's risk. Voucher schemes require close management because of their relative administrative complexity and because vouchers are convertible to cash, resulting in greater exposure to possible collusion and fraud which could be counter-productive for the sustainable development of the services market

3.2 One of the first pilots was an IDB project initiated in 1995 in Paraguay²⁷. Service providers were screened and registered, with the register remaining continuously open during the project life to promote new entries and competition. Vouchers had a fixed monetary amount that was set to partially cover the cost of the training courses. The voucher received from the trainee was exchangeable by the service provider for cash only on the trainee's completion of the course. Prevention of fraud was handled through screening of training providers and clients, personalization of vouchers, attendance records and site visits, and potential disqualification of providers. Initial assessments in 1999 show that after a learning period there was strong growth in voucher use and in the number of service providers. In some cases enterprise directors themselves started training programs for other enterprises. The diversity and convenience of training provision also improved. However, problems lay in the administration of the schemes.

3.3 A scheme in Peru was less successful. This was because vouchers were distributed to a limited number of donor clients, and their face value was set as a percentage of total cost so that larger enterprises tended to receive larger grants, building in a bias against smaller firms. Fraud was not adequately controlled (especially collusion between trainers and clients) and a secondary market grew up which distorted the planned pattern of voucher usage. The percentage valuation of voucher may also have led, via collusion, to increases in training course fees. Technical assistance services proved difficult to standardize and control for quality and fraud. The project demonstrated the major importance of publicity and control, and a credible, autonomous managing institution. In other projects low uptake of vouchers has been a problem suggesting the need to carefully identify the target market, set the value of vouchers to provide an adequate incentive to user firms in relation to average service expenditures, simplify voucher acquisition and redemption, and ensure wide publicity²⁸.

Voucher Initiatives in the Bank

3.4 The Bank initiated a voucher project in Kenya in 1994,²⁹ under a scheme known as the Jua Kali (hot sun) program. Tracer studies prior to completion showed that assets, sales, product range and employment were all significantly greater in the grant recipient firms than a control group.³⁰ Early indications show mobilization of the apprenticeship market and training by entrepreneurs of other entrepreneurs. The mobilization of this previously 'invisible' source of enterprise technical support is key to successful local market development as it provides domestic learning and empowerment. Complications of voucher allocation and collusion are being addressed. The use of Jua Kali associations themselves to allocate vouchers has mobilized additional 'invisible' capacity as the JKAs become participants and not simply beneficiaries in the project. This may be regarded as a critical element of

²⁷ See "Paraguayan vouchers revisited: strategies for the Development of Training Markets" Caren. Botelho and Lara Goldmark DAI/ USAID. Hanoi conference paper, April 2000.

²⁸ "Developing Performance Indicators for Voucher Programs: The Cordoban Experience, Caren Addis and Linda Fitzgerald." Draft, August 2000.

²⁹ Kenya—Micro and Small Enterprise Project 1994.

³⁰ "Kenya—micro and small enterprise development project—tracer study for phase one" Netcom Jan 1999.

successful decentralization and demand-orientation. The overall cost-benefit performance of the project has yet to be assessed.

3.5 As in other interventions an important issue is the need to identify what if any market failures actually apply, the implicit assumption being an information failure in the market for business services. If this is correct then provision of information should result in an upsurge in sustainable services which will continue after the project ends, rather than finishing when the temporary injection of voucher-based liquidity ends.

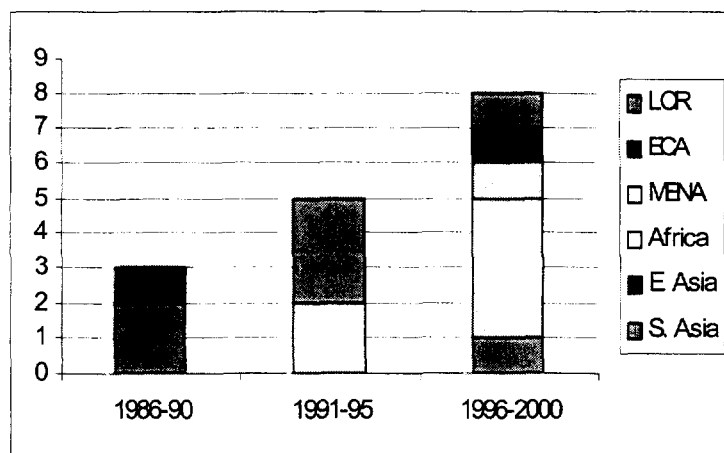
3.6 Voucher schemes have to overcome relatively complex design issues and management requirements and they incur high operation costs to provide successful coordination, guard against fraud, and ensure high quality service provision. The Bank has not implemented enough of these projects to draw firm lessons, and none have yet been completed. Careful evaluations should be made of the initial projects while new projects are under preparation, including an urban micro-business project in Mexico and a proposed Rural Investment Fund in Zambia, which is expected to include agricultural input and technology dissemination vouchers.

IV. IMPLEMENTING MATCHING GRANT FUNDS

Experience with MGFs

4.1 Matching grant funds (MGFs) have been increasingly used to finance know-how services and training in the enterprise sector (see figure 4). MGFs promote demand by lowering the cost of business services compared to the user's (risk-adjusted) valuation of the service, and increased demand in turn induces expanded supply. They may be less effective than vouchers in reducing the service provider's risk but the MGFs are administratively simpler than voucher schemes while probably promoting more quality control over the supply of services as part of a sustainable market for business services.

Figure 4 MGF Project Approvals by Region and Time Period



4.2 One of the first MGFs was set up in 1961 by the Irish Export Board as a marketing development fund. Grant funds have also been set up for business advisory services in Europe, including the UK, France, Italy, and Norway. A scheme set up by the British DTI in 1988 was designed to encourage firms of less than 400 employees to use management consultants. A review of that project in 1991 showed that 21,000 programs had been started for firms, 90% of beneficiaries stated that they had received value for money, and 74% of beneficiaries planned to use consultants again paying full market price.³¹

³¹ Cited in the SAR for "Mauritius—Technical Assistance to Enhance Competitiveness" Page 15.

4.3 Since 1986, about 16 Bank MGF projects for business development and/or export support have been completed or are ongoing (one cancelled) (as shown in the annex). The total value of these funds is US\$216.5 million or on average US\$ 13.5 million per fund, and approximately 6,000 subprojects have been implemented so far. The rate of implementation has accelerated along with geographical diversification.

4.4 The earliest significant Bank scheme was the 1986 India Engineering Export Development Project, which contained a consultant fund and a productivity fund, each of \$10 million. Both were managed by State banks (ICICI and Eximbank). They required 50% matching funds and single firms or groups of firms could receive up to \$200,000 in subsidy. The managing banks kept staff to a minimum and used decentralized, streamlined approval procedures. The project was rated a success, though there were implementation delays and not all (80%) of the funds were disbursed. Estimated export growth rates of beneficiaries following the grants far exceeded the national average. This was the model for a follow-up project in India in 1989, with four funds totaling \$20 million and maximum grants of \$500,000 per firm. This project was also rated a success with significant incremental export achievement. A significant feature of the Indian project was the use of banks as administrators of the funds; this facilitated parallel loan activity to finance fixed assets and working capital alongside the grant financing of advisory services.

4.5 A similar project, for export development and small medium enterprise assistance, was started in Indonesia in 1986, although in this case the managing agency was a State-sponsored entity—the Export Support Board. Total funds were \$8 million supporting exports through marketing, production management, training, technical assistance and including small equipment purchases. The co-payment percentages were 50% or above. Grants for advisory services were linked to a credit line and maximum grant amounts were relatively small at \$10,000 per assignment. Processing delays caused slow disbursement (68% at closure) but the advisory services were considered successful and exports increased by a large multiple of the grant amount. Nevertheless firms were not prepared to pay full price for the services after project completion, which suggests that the market creation impact may have been limited.

4.6 Among the principal lessons of implementation from these early schemes was the need for a supportive enterprise policy regime (e.g. export policy), autonomous management unencumbered by Government or political pressures and good internal controls. Despite implementation problems the evaluation of these schemes was positive and similar projects went ahead in Latin America from 1990, and in Africa from 1991 starting in Kenya.

4.7 A recent study on MGFs in Chile and Mauritius³² states: “the programs offer evidence that private sector operations of BDS support programs with maximum autonomy and accountability of the implementing agents offer significant benefits in cost effectiveness versus previous State executed regimes. In addition to reduced cost, the private operators offer increased flexibility, improved responsiveness and a more entrepreneurial attitude in meeting client needs than public sector providers.” The keys to success were arms-length management, low discretionality, and private sector service supply.

MGF Impact Assessment: the issue of additionality

4.8 The study of Mauritius and Chile also pointed out that it has been very difficult to assess the impact of MGFs, partly as a result of lack of systematic data on the market development impact. The question of impact is critical to the case for MGFs, as it is for all public interventions. Despite the

³² Dan Crisafulli “Matching Grant Schemes for Enterprise Upgrading: A Comparative Analysis” Paper presented at Rio De Janeiro Conference on Small Enterprises, March 1999.

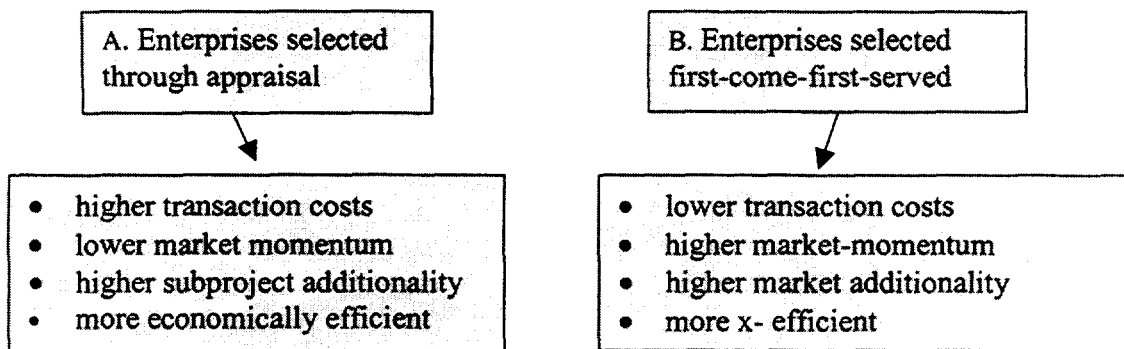
apparent improvement in design relative to traditional approaches, there remains the central concern about whether MGFs are helping to create additionality, i.e. benefits beyond what the private sector would otherwise be able to produce, in the form of economically efficient enterprises in a sustainable market for services. If for example the constraint on enterprise demand for business services is simply lack of finance, rather than high risk aversion due to lack of information, then market activity stimulated by a temporary injection of liquidity will most likely fizzle out when the source of funding ends.

4.9 Another study of the Mauritius project³³ focused on enterprise efficiency. Additionality required that enterprises were economically efficient, capable of creating spillover benefits, and able to absorb assistance effectively. If the wrong enterprises were targeted then the rationale of the assistance intervention was in doubt, so an appropriate enterprise appraisal procedure was needed. The *ideal targets* were firms that did not show financial profits (so could not get market finance) but were economically efficient and could achieve maximum benefits per assistance input. (The worst-case recipients were ones that were both financially and economically unprofitable and needed subsidies just to stay afloat).

4.10 The contrary view³⁴ is that the momentum of activity itself is critical for the development of the market (reducing transaction costs for all players), and that a first-in-first-out approach to subprojects with minimum transaction costs is essential to build the services market. Detailed appraisal procedures introduce bureaucracy and discretionality. The strength of the Mauritius project was its flexibility, simplicity in operation, management autonomy, and simple subproject selection.

4.11 Figure 5 is a stylized representation of the two views.

Figure 5 Two views of the design of matching grant funds



4.12 On the one hand the appraisal approach may reap externalities but it may be more discretionary, bureaucratic and slow disbursing, thereby running the risk of failure to develop the momentum to create a market. On the other hand the non-targeting approach avoids discretionary approvals, has higher rates of disbursement - but is potentially less able to target the externalities. In reality these are not mutually exclusive. Without creating a sustainable market the targeting approach cannot achieve additionality in the longer run. Without creating additionality the non-targeting approach cannot maintain a sustainable market in the long run.

4.13 In practice both approaches could also fail to meet their objectives if they are not designed and managed properly. In the case of targeting there is risk that the wrong projects are selected, or that initial

³³ See Tyler Biggs "a microeconomic evaluation of the Mauritius Technology Diffusion Scheme" World Bank, RPED discussion paper November 1999.

³⁴ See Dan Crisafulli: op cit, and Andrew Singer's comments on the Biggs study (Jan 2000).

targeting is too inflexible. In the non-targeting case there have been many instances where fast disbursement has not been achieved. Delays and interference, which are characteristic of schemes that receive subsidies, could damage rather than develop a nascent market for business services. Optimal design should aim to find a way of combining the best of both approaches, retaining the good access and ease of disbursement but paying more attention to economics, possibly by including broad target groups of firms and products and by pre-identifying clusters of promising enterprises.

V. A COMPARATIVE EVALUATION OF TEN MATCHING GRANT FUNDS

The Projects Selected

5.1 Ten projects were examined which had significant matching grant fund components for general or export assistance. Six of the projects were selected because they have been completed and have ICRs and/or PARs, and four are more recent projects in varying stages of work-in-progress. The inclusion of more recent incomplete projects helps us to assess what changes in design have resulted from past experience, although it is too soon to assess the impact of the evolved design.

5.2 The completed projects are from India (2), Indonesia, Argentina, Mauritius and Kenya. The two projects in India were the pioneer funds, focussing on export services. Indonesia, Kenya and Argentina also focussed on exports, while Mauritius was concerned with the broader provision of business services to boost productivity. The other four projects selected are from Mexico, South Africa, Bangladesh and Uganda, all of which have the broader business services focus. The Uganda project is nearing completion and has been the subject of tracer studies.

Main MGF Project Design Features

5.3 The major features of the ten different MGF projects implemented by the Bank were as follows.

5.4 **General principles.** All ten projects subscribed to the principle of client-driven, decentralized service provision, with a subsidy, via a matching grant, paying for services from private local, and foreign, providers, with the central purpose of stimulating the market for expert services.

5.5 **Uses of grants.** All the projects offered grants for knowledge-based services, combined in two cases with training. In the case of *export development* these included: marketing research and plans, quality testing and certification, product adaptation, export fairs and national/international marketing tours. In the case of *business support* they included business strategy and planning, production management, product design, quality standards and control, productivity studies, information systems, and training. Grants were not available for equipment and in some cases (e.g. South Africa) were explicitly excluded.

5.6 **Grant size and payment arrangements.** The size of grant funds (the Bank's contribution) varied widely, from US\$2.0 million (Kenya) to US\$30.0 million (Mexico), approximately related to the size of the respective enterprise sectors. Individual grants were subject to a maximum ranging from US\$50,000 to US\$200,000 and, exceptionally, above. The actual average grants paid varied from about US\$8,000 (Kenya) to US\$64,000 (Indonesia). Payment arrangements were 50% grant and 50% co-payment by the recipient enterprises (except in Indonesia where it was 25% co-payment). Grants were all on a reimbursement basis, subject to proof of eligible expenditure. (This latter arrangement is necessary for

internal control purposes although it does create some uncertainty in the client firm, which may tend to depress demand for grants).

5.7 *Fund Governance.* All projects had multi-tier governance with a Government agency or autonomous Government entity (e.g. a Foundation) in overall control, usually complemented by a steering committee or consultative council that approved larger grants. Where a non-Government institution was in overall charge (e.g. Mexico and Uganda) there was an additional layer of administration which was intended to act in place of the Government entity. The type of fund managing agency varied; in India the fund was managed by State and private banks; in Mexico by the National Science Foundation through multiple individual managing agents, and in Indonesia by a specially created Government office (the Export Support Board). In other projects, management was provided by a single external specialist consultant firm selected under international bidding rules. The autonomy of the managing agent, both from political pressure and from ties to the service providers it was accrediting and paying, was thought to be critical in achieving a streamlined and market-credible mechanism

5.8 *Management Capacity building.* The indigenisation of fund management varied. In the case of India for example participating banks staffed special 'cells' to develop in-house expertise in export advisory services. In other cases (e.g. Uganda) a foreign specialist management firm appointed a manager and assistant manager plus local staff. The foreign consultant might act either as manager or as management advisor. The local capacity building impact of the two approaches was different. In the first case sustainable local capacity was put in place while, in the second case, the foreign management approach did not aim to build fund management capacity, on the grounds that MGFs were supposed to be temporary channels of support.

5.9 *Service providers and quality control.* The managing entities took responsibility for the quality checking of service providers. The extent of supervision varied from on the one hand proactive assistance for firms to develop proposals and select providers, to on the other hand more hands-off support such as simply development of lists of registered providers or checks on providers selected independently by the beneficiary firms.

5.10 *Firm eligibility.* All projects focused on individual or collective private sector SMEs, some export oriented, some with broader business orientation. In a few cases (especially for exports) the funds were also open to larger firms, and in one case (South Africa) micro-firms were included. Apart from the first project in India (focused on engineering goods) there has been no product targeting, although the actual sub-sectors supported were mainly in manufacturing, or (e.g. in South Africa) tradable services and manufacturing.

5.11 *Subproject eligibility.* The eligibility of subprojects was in all cases based on the first-come-first-served principle (FIFO) subject to set eligibility criteria, usually including provision of an agreed marketing/business plan and, in the more recent projects, monitorable deliverables. In most cases restrictions were put on the number of grants per firm over the life of the project. Beyond establishing eligibility, past practice has been not to conduct more detailed appraisals, but the thinking on this is shifting (see section 4).

5.12 *Monitoring and evaluation.* Earlier projects did not contain rigorous procedure but the later projects incorporated explicit performance targets, deliverables targets, a double-funding safeguard, and a monitoring agreement between the fund manager and the recipient firm to provide evaluation data.

5.13 *Indicators of Output and Impact.* This was addressed unevenly, because some projects were implemented prior to the introduction of mandatory indicators, and also because impact, as opposed to output, indicators, were not included except in very general terms (e.g. under development objectives).

The most commonly used indicator was the number of subprojects completed and the sales or export multiple (the ratio of sales/ export growth to grant value), and many projects were highly successful on these criteria. These are unreliable measures for project impact as they do not measure efficiency or additionality, nor market development performance.

Evaluation of The Six Completed MGF projects

5.14 **Measurement issues** The benefits of the projects are difficult to measure in the absence of sensitive output, sustainability and impact indicators. This section makes an attempt to draw some conclusions from indicators of cost-effectiveness that were created ex post.³⁵

5.15 **MGF operating costs.** Measurement of fund operating is available for the completed projects, with the exception of India where local banks took the management role and costs were not reported. The MGF operating cost divided by value of grants disbursed gives an indicator of the efficiency with which the MGF was implemented. This ranged from 18% (Argentina) to 57% (Kenya). The burden of this cost is high compared with a typical fund management charges in other types of funds (e.g. in managed venture capital funds the norm is about 3% of gross assets per annum). There are also overall governance costs (e.g. project advisory committees and Government implementation units) that in principle should be included.

5.16 Operating cost per grant approved ranged from US\$1,326 per subproject (Kenya) to US\$6,047 per subproject (Argentina³⁶). This was because Kenya gave a lot of small grants (average size US\$2,320) while Argentina gave few larger ones (average size US\$16,792). Nevertheless, the Kenyan cost was a much higher (and seemingly excessive) proportion of the value of each subproject. If governance costs and Bank preparation and supervision costs are added to these figures there is certainly a presumption of excessive overhead costs.

5.17 **Momentum effect - speed of Implementation.** The speed of implementation is a rough indicator of the momentum effect thought to be important to developing the services market. The disbursement lag, where it can be isolated for the MGF alone, is a possible indicator of the momentum effect. The most delayed disbursement over the project life was in the case of the Indian Engineering Export project, while the most on-track performance was Kenya. In the case of the first India project, disbursements were greatly delayed (and closing was put back by 2.5 years) as the participating banks took time to understand the procedures of the MGF. The follow-up project in India was more successful in disbursing as the initial participating banks had learned the procedures (although two new participating banks were somewhat slower). In the case of Kenya, despite the good recorded disbursement performance, measured by the small average disbursement lag, the ICR reported six-month average delays in the processing of individual grants which soured relations with clients. Start-up delays were also reported for Indonesia; in Argentina there were problems because of subproject cancellations, Government interference and weak management follow-up. In Mauritius initial disbursement was reported as slow but then picked up. In

³⁵ A relevant part of the cost of a project, not accounted for by the Bank, is the cost of Bank and Government preparation and supervision effort, especially in relation to loan size. Staff inputs ranged from 120 SW (Argentina) to 354 SW (Indonesia). However it is not possible to disaggregate the MGF component from the remainder of the project, except in Argentina where the MGF (US\$32 million) was the principal component. Thus in Argentina 120 SW plus the real cost of Government staff would amount to over US\$ 600,000 or over 2% of project cost.

³⁶ However, many approved subprojects were not completed and some were cancelled because of adverse macro economic changes.

Uganda a mid-term report suggested that implementation was slowing because of bureaucratization of the process (lack of site visits).

5.18 **Project Benefits.** Project output was measured in terms of sales and/or export multiples. As discussed, this is not necessarily a good measure mainly because it is not an efficiency or profitability measure and because of attributability questions, but it can provide some indicative measure. The achieved export and sales multiple was calculated for five projects and gave fairly uniform measures, ranging between 37:1 and 50:1, except in the case of Mauritius where a remarkably high ratio of 163:1 for revenue and 124:1 for export sales was apparently achieved. If these sales were (a) economically profitable, and (b) largely attributable to the grant funding, then these indicators would suggest that the MGFs performed very well. With regard to impact (both institutional impact and sustainability) no usable quantified indicators were provided for the projects complete. A proxy indicator was speed of disbursement, representing market stimulation. However, the Bank's ICRs and PARs made some non-quantified assessments. The ICR/ PARs for the six completed projects rated outcomes as satisfactory in five cases, and highly satisfactory in Mauritius; institutional development impact was rated partial or modest in three cases, satisfactory in two cases, and highly satisfactory in Mauritius. Sustainability was rated weak in Kenya, likely in four cases, and highly likely in Mauritius.

5.19 Table 3A shows the evaluation for five of the ten projects, all of them completed and closed.

Table 3A Comparative Cost Effectiveness of MGF Projects

1. Project Name	INDIA Industrial Export (Engg) Project 1986	INDIA Export Development Project 1989	INDONESIA -1 st Export development project 1986	KENYA Export Development Project 1991	MAURITIUS TA to Enhance Competitiveness Project 1994
Appraised cost (\$million)	MGF 20.0 Total Bank 250.0 Tot proj 1000.0	MGF 20.0 Total Bank 295.0 Tot project 730.0	MGF 5.7 Total Bank 68.7 Project total 115.9	MGF 2.0 Tot Bank 90.3 Tot Project 109.2	MGF 3.2 Total Bank 7.7 Total proj 13.3
Cost of prep/ sup (\$ million)	Total project 250.2 SW	Total project 225.7 SW	Total project 353.6 SW	Total project 165.5 SW	Total project 214 SW
Number of subprojects	359	449	685	603	266
disbursed (\$ million)	15.6 (77% of appraisal)	16.48 (82% of appraisal)	5.17 (91% of appraisal)	2.0 (100% of appraisal)	2.52 (95% of appraisal)
oper. cost (\$ million)	Operated by PFIs- No data	Operated by PFIs- No data	Apprsd cost = 2.5 Actual = 2.42	Apprsd cost = 0.8 Actual = 0.8	Apprsd cost = 0.49 Actual = 0.49 ?
Avg annual actual/ apprsd disbursement	45%	68%	70%	90% (est.)	N/A Cum. total at closure = 91%
% oper cost/ grant value apsd	Unknown	Unknown	44%	57%	18.1
% op. cost /grant value- actl	Unknown - bank internal cost	Unknown - bank internal cost	47% (with training)	57%	19.4%
Actual op cost/ No of projects Actl grant value/ no of projects	Unknown	Unknown	\$3,518 per subproject \$7,547 per subproject	\$1326 per subproject \$2,320 per subproject	\$1,842 per subproject \$9,479 per subproject
Sales or export multiple	37:1	50:1	36:1	42:1	163:1 (revenue) 124:1 (exports)
ICR/PAR Performance Rating	Outcome S Instit developmt S Sustainability L	Outcome S Instit developmt S Sustainability L	Outcome S. Instit dev el partial sustainability L,	Outcome S. Instit devt modest Sustainability weak	Outcome HS Instit dev HS Sustainability HL

Ongoing MGF Projects

5.20 Table 3B shows a sixth completed project (Argentina) and the four ongoing projects. The ongoing projects have moved away from export advisory services to general business support services, which is characteristic of other more recent projects. Not much can be said prior to project completion data. But one issue is that the designs are widely divergent; e.g. the expected management-intensity of each project differs greatly. Planned operating costs as a percentage of the expected value of grants ranged from only 6.2% in the case of South Africa, to nearly 50% in the case of Uganda. Since management quality is so critical to the success of these projects, while at the same time the operating cost of grant funds has to be kept in check, this suggests that good practice models for management and governance of the MGFs have not been followed.

Table 3B Comparative Cost-effectiveness of MGF Projects

Project name	ARGENTINE Export Development project 1995	UGANDA Private Sector Competitiveness Project 1996	SOUTH AFRICA Industrial competitiveness project 1997	MEXICO Knowledge/Innovation Project 1998	BANGLADESH Export diversification project 1999
Project cost (\$ million)	MGF 32.0 Total Bank 38.5 Total proj 74.2	MGF 3.0 Total Bank 14.5 Tot. Project 20.9	MGF 24.4 Tot Bank 46.0 Total Proj 88.6	MGF 30.0 Tot Bank 300.0 Tot Proj 663.0	MGF 15.8 Tot Bank 32.0 Tot project 48.0
Cost of project prep/ supn (\$mn)	Total project 0.5 (119.8 SW)	Project not complete	Project not complete	Project not complete	Project not complete
Grants disbursed (\$mn)	17.8 (26.6 approved).	1.5 (at 3/31/00)	N/a	N/a	N/a
Number of subprojects	1060	570 (at 12/99 - after three years)			
MGF operating cost over project life (\$ million)	Appraised cost = 5.80 Actual = 6.41	Appraised cost = 1.3 (approx)	Appraised tot proj admin cost = 1.5	n/a. (fund managed by Nat Sci Foundation)	Appraised cost = 4.46
Avg annual actual/ appraised disbursement %	N/a Cum. Disbursed at closure = 66%	N/a	N/a	N/a	N/a
MGF appraised operating cost/ grant value %	18.1%	40% to 50% expected (midterm est)	Tot project op cost/ grant value = 6.2%	N/a	18.5%
MGF actual operating cost/ grant value %	36% (higher if partial programs accounted)	N/a.	Not complete	Not complete	Not complete
Actual oper. Cost/ No of subprojects	\$6,047	N/a.	N/a.	N/a.	N/a
Actual Grant value /no of subprojects	\$16,792	\$2,631 (interim - approvals only).			
Sales/export multiple	N/a (Beneficiary firms increased exports relative to control group)	N/a. Significant increase in sales (mid-term)	N/a	N/a	N/a
Bank Performance Rating	Outcome S Institutional M Sustainability L	PSR ratings satisfactory	Project not yet completed	Project not yet completed	Project not yet completed

5.21 As stated in section 4, the benefits of the Mauritius project (table 3a) have been reevaluated³⁷; the efficiency of the enterprises selected was in doubt since only 10% of initial proposals were rejected and because, to speed up disbursement, 80% of subprojects were approved after they were already under way.

³⁷ Tyler Biggs; op cit

One quarter of the grants were found to have gone to enterprises that did not produce additionality. While the project may have deepened the market and reduced its riskiness, three quarters of the firms assisted had previously used consultants and were not new to the market. While there were some new suppliers, repeat business was low. Grants went almost entirely to users rather than service suppliers, and only a few grants went to subprojects that generated increased demand for local consulting services. The evaluation also found that nearly half of the firms assisted would have carried out their projects without the grant funding. The net impact on smaller firms was better but still one quarter could have gone ahead without the grants. If the reevaluation is correct then the market development impact was less than satisfactory.

MGF Project Evaluation summary

5.22 There was no clear indication that the different kinds of governance methods systematically affected project performance. Rather performance was more a function of the quality of individual fund management and its relationship with outside Government and non-Government bodies.

5.23 The measured output of the MGF projects was overall very satisfactory. But there are several caveats which have been discussed – questions about additionality, and about attributability. With regard to the latter, the relatively and absolutely high sales and export multiples may be inflated by various factors - e.g. that the grant was only a small part of a wider enterprise investment program, that the enterprises selected were already higher-than-average performers (selection bias), or that there was a secular/cyclical upswing in output and exports affecting all enterprises.³⁸

5.24 The operating costs of the MGFs as a proportion of the total fund were high, and variable. This raises a question about how far project design focused on cost-effectiveness, and how far good practice norms are followed in designing the management structures.

5.25 The momentum effect of the projects, insofar as it can be determined by speed of disbursement, was not good. In some cases major disbursement lags occurred, amounting to years. In no case was disbursement as rapid as planned, even with the use of the first-in-first-out selection of projects. If the market building case for MGFs rests on their momentum effects, then it is difficult to conclude from this measure that the projects evaluated have met this goal.

5.26 The institution building and market development impact was not measured directly for these projects. According to the Bank's own evaluations, based on qualitative judgements, the impact was modest for five of the projects, and only one project, Mauritius, had high scores on these criteria. But the reevaluation of the Mauritius project has shed some doubt on its market development impact as well.

5.27 From the mixed results found in this project evaluation and in other studies and reports for these projects, it is clear that, if MGFs are to fulfil the market creation and institution building potential that we have argued should be achievable, their design needs to be much more carefully worked out than it has been up to now, and their implementation and management carried out under clearer and more appropriate guidelines.

³⁸ In the first India project export gains were impressive but concentrated in a few firms with existing strong international connections (e.g. Cummins, Ingersoll-Rand) which raises doubts about additionality. A further point is that exports were maintained in a time of export decline - was this therefore assistance to 'new exporters'? In Indonesia the success was at a time of major export expansion - how far did the MGF truly contribute to export increase?.

VI. CONCLUSIONS AND RECOMMENDATIONS

6.1 Support to the enterprise sector needs to be flexibly organized and demand-responsive. While traditional centralized assistance may continue to be effective in some circumstances, it is generally better to use competitive private service providers responding to the evolving needs of client enterprises, subject to good overall project coordination. The main task is to stimulate this private services sector, upgrading its capacity to respond to the demands of new and expanding private enterprises.

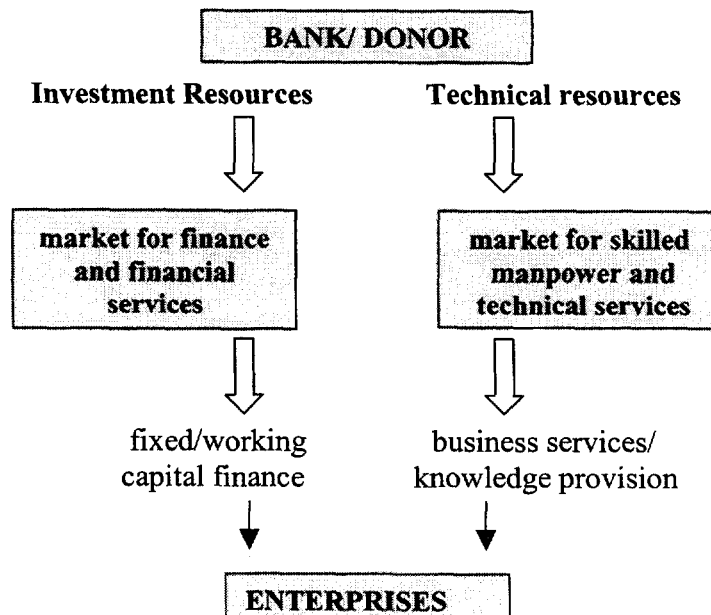
6.2 There is likely to be a window of time in which the public external benefits of intervention are greatest - i.e. when the market is in its infancy and its development is constrained by uncertainty and lack of information. The subsidy should be temporary and be phased out as the market takes off.

6.3 Grants should generally be for know-how and not for equipment. However there may be a case for unbundling the know-how component of loans (e.g. feasibility studies, installation services and follow-up expert services) for grant funding. A combined loan/grant package, either through a single financial institution or through separate institutions, may be feasible provided safeguards can be put in place to prevent perverse use of grants.

6.4 Whether the grant window is combined with lending, or free standing, best practice grant models are needed. The MGF model, which is increasingly used in the Bank and outside, may be a solution but needs to be carefully justified and carefully designed. Above all, because the more decentralized is the approach the greater the overall project coordination burden, it has to have competent management with clear operating procedures.

6.5 The sustainable skills-market-based approach to enterprise technical support may be conceived as the parallel of the sustainable financial market-based approach to enterprise investment finance that has been increasingly accepted by donor agencies over the past few years.³⁹

Figure 6 Parallel financing channels: Investment and Technical Services



³⁹ This was spelled out in the Bank's OP 8.30 .

Optimizing the Design of MGFs

6.6 MGFs have faced problems in terms of the selection procedure for subprojects, management complexity, and slow disbursement. To take advantage of the benefits that the MGF should be able to provide, especially compared with central, supply-side interventions, they must address the problems of the enterprise sector and be cost-effective. The following are some essential steps to be taken and questions to be asked in setting up a MGF.

Step 1. Establish the economic need for the project.

6.7 What is the public goods case for assistance? Is there a knowledge gap constraining provider and user enterprises by increasing market uncertainty? a lack of internal management/technical know-how, a lack of information about the use/value of particular outside business advisory services, a failure in provision of advisory services? Is there an information gap constraining access to and granting of market finance for technical services?

6.8 Are there other more important problems constraining enterprises - e.g. (a) projects may not be bankable for reasons of uncompetitive technology or products; (b) Government regulations may prevent or deter private sector entrants or harass existing companies; (c) tax, trade and exchange rate policy might be putting more of a burden on local than foreign companies. These types of problems require a different approach (e.g. macroeconomic and trade policy reform, regulatory and administrative reform). MGF assistance in an adverse policy environment may be able to produce an output, but is likely to have a weak or negligible market impact.

Step 2. Establish local ownership

6.9 A special effort is needed to bring the Government counterparts into the picture because this is an unfamiliar and possibly controversial instrument⁴⁰. In particular an understanding should be reached on (a) the rationale of the services market-building approach to enterprise assistance when managed properly, (b) the need for autonomous, streamlined management and decision-making, (c) the implications of grants for the Government budget, and (d) the internal controls and safeguards against grant abuse, including last-resort Government oversight procedure.

Step 3. Develop a cost-effective design

- **The Fund managers role.** The management team's terms of reference are key to the success of the project. The team's principal business is to promote market knowledge. It must be proactive in market-making, identifying and forecasting the needs and resources of firms, to upgrade them according to a market development model, and to bring together the providers and the users using various information media. The management team should split its resources and its grant awards between supplier and users. The team should have general business consultant and training skills and experience, but should use this experience to market the skills of the firms in the market, *not* to provide its own formal advisory services. It should not be enmeshed in monitoring and reporting requirements, but should be left to work towards generally agreed targets.

⁴⁰ The Armenia Enterprise Development Project MGF component ran into difficulties because, despite initial agreement, a new Government backed away from explicit grants (even though they were not in cash) because, inter alia, there was a concern about the perception of potential for corruption. The fund has been very slow to disburse (12 projects in three years) and has thus essentially failed to meet the objectives of opening up the market.

- **Fund life.** The life of the fund must have a built-in sunset provision, with its limit tied to indicators of domestic market expansion and capacity development.
- **The fund size, costs and grant level;** the size should be based on the estimated value of demand expressed by firms *over and above* normal willingness to pay for services in the absence of a fund, and the likely upgrading needs of new/existing service providers to meet demand. A larger fund (with a broader eligible product range) may be advisable to minimize unit management costs; fund management internal and outreach work program should maximize cost-effectiveness. A simple norm is advisable for grants, reimbursing 50% of costs subject to indicative maximum per firm (allowing multiple grants per firm).
- **Provider or user grants?** Grants should be available for both sides of the market, to enable service providers to provide the upgraded services demanded by new and upgraded users and to enable a complete-market matchmaking approach by the facilitating entity and fund managers.
- **The types of services;** the services should normally be strategic rather than operational, and they should be defined on the basis of an up-front needs study, including both transactional services (mainly addressing demand) and non-transactional services (mainly addressing supply). Concern with economies of scale may justify opening up the fund to combine both training and knowledge services for general business and specialized services for export/import and international contracting, depending on the availability of an appropriate combination of fund expertise.
- **Governance and management;** last-resort Government oversight should be included through a policy committee with limited power (e.g. general fund policy, and approval of above-threshold grants); autonomous fund management should be established either through a market entity (e.g. a financial institution) or through a specialized fund management company, allowing autonomy of decisions. Oversight by a quasi-public entity such as a Foundation may increase layers of supervision if it has to report to a Government department, so its autonomy must be ensured.
- **The approval process;** generally a reasonably streamlined FIFO process should be used, but it should be subject to a set of carefully designed and clear enterprise and subproject eligibility criteria including broad (flexible) product group targets.
- **Firm and subproject eligibility;** the focus should generally be on SMEs and microenterprises⁴¹; both user-firms and service providers should be eligible; criteria should target (a) firms that require but are not willing to pay for services; (b) product areas and technologies most likely to generate spillover benefits; and (c) types of assistance most likely to stimulate demand for local service provision. Grants should comprise a significant part of the business plan provided by applicant firm. The development of eligibility criteria will require up-front research into the sources of growth of the enterprise sector and functioning of the market for services.
- **Managing Service provision;** the fund manager should be responsible for developing a register of local and foreign providers, conducting quality checks and giving upgrading grants to service

⁴¹ Some MGFs have included larger firms. However evidence (from Mauritius) suggests that the additional benefit from assisting large firms is especially weak. This is not surprising considering that large firms have got large because they are already well aware of how to access needed resources on their own, are accustomed to paying for it, and because the available grant finance is likely to be marginal to their investment expenditure plans.

providers according to its market development model; subject to limiting overhead cost of the project, the manager should work actively with user firms to identify providers.

- **Performance indicators and criteria:** output and impact indicators may be built into the project design via a 'project score-sheet'⁴²; monitorable deliverables and obligations of the fund manager, service provider and user firms to provide performance data can be spelled out in project agreements; performance measures require output indicators, institutional development indicators and market development indicators⁴³. The indicators must allow for selection bias and non-attributability. Additionality indicators would require information on whether proposal would have been undertaken in the absence of a grant, how it would be improved with grant support, and what external (spillover) benefits can be expected from the subproject. It would also require information on the quality and speed of development of the services market. However, progress reporting should not become a bureaucratic burden on the fund manager that adversely affects the objective of market-making.

Providers vs. Facilitators - Mixed projects

6.10 This paper has argued that facilitation and not service provision is the role of public support. Nevertheless, many public sector service providers, sponsored both by donor organization and by Governments, are in operation, and the question is how to best utilize their services to continue to transfer know-how. One solution is to combine facilitation with provision. One reason this may not work is the possibility of a conflict of interest between the service provider role and the capacity building role that tries to develop outside service providers. The way to avoid such a conflict may be to arrange service provision so that it (i) focuses only on specialized types of expertise not likely to be available locally in the near future (e.g. advanced information technology services, corporate finance, or export facilitation in new markets), (ii) adopts a training and dissemination program for such expertise in the course of its provision, and (iii) phases out its service provision *pari passu* with the development of local capacity, according to a timetable and a market development model agreed by both sides and the donor organization.

6.11 Combination provider/facilitator projects would include a management team that had the skills to both provide these services and manage a market facilitation/ development fund, accessible by both providers and user firms. As the provider role is phased out the team would be adjusted to a pure market development fund management role, which would itself be phased out according to a market development timetable.

⁴² This is being developed for the proposed Mozambique Private Sector Development project.

⁴³ The Donor Committee on Small Enterprise development is supporting work on a Performance Measurement Framework for BDS which would develop ways of measuring market development and sustainability.

ANNEX 1
COMPLETED, ONGOING AND PLANNED MATCHING GRANT SCHEMES FOR
ENTERPRISE SUPPORT

Country	Project Name	Fund Value ⁴⁴	Start Date	Close Date
COMPLETED				
ARGENTINA	Export Development Project	32.0	1995	2000
INDIA	Engg Export Development	20.0	1986	1991
INDIA	Export development project	20.0	1989	1996
INDONESIA	1 st Export Development Project	5.7	1986	1992
KENYA	Export development program	2.0	1991	1995
MAURITIUS	TA Competitiveness	2.7	1994	1999
COLOMBIA	Export Development Project	36.6	1993	cancelled
ONGOING				
ARMENIA	Enterprise Development Project	3.5	1997	2002
BANGLADESH	Export Diversification Project	15.8	1999	2003
JAMAICA	Private Investment and Export	4.4	1994	2001
MEXICO	Knowledge & Innovation Project	30.0	1998	
SOUTH AFRICA	Industrial Competitiveness Project	24.4	1997	2001
TUNISIA	Export Development Project	13.5	1999	
UGANDA	Pvt Sec Competitiveness Project	3.0	1996	2001
ZAMBIA	Enterprise Development Project	2.5	1997	2002
ZIMBABWE	Enterprise Development Project	0.42	1996	2001
PLANNED				
MOZAMBIQUE	Private Sector Development Project			2000

⁴⁴ MGF component of IBRD/IDA loan (excluding local contribution and cofinancing)

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