

BY ALAN J. PATRICOFF AND JULIE E. SUNDERLAND

In a slew of developing countries, an unusual array of small and medium-sized enterprises, ranging from food processors in Africa, to component suppliers for multinationals in Eastern Europe, to information-technology contractors in Southeast Asia, have, against the odds, established themselves as global competitors.

While some of these businesses are delivering impressive returns to their investors, the bigger story here is their impact on development potential at home. In stark contrast to state-owned enterprises, these companies are figuring ways to operate efficiently in inhospitable circumstances – and in the process spawning entrepreneurial business cultures and offering immensely valuable training to workers.

Like their counterparts in wealthy nations, small and medium-sized enterprises – SMEs, for short – in poor countries are responsible for a disproportionate amount of innovation, growth and employment compared to the resources they consume. Yet, in addition to bearing the usual risks faced by all businesses on the frontier, these companies bear another burden: they have little access to the long-term capital they need to grow. While large infrastructure projects that generate steady revenues – power plants, water systems

and the like – can usually tap private foreign capital, and many tiny enterprises are eligible for donor-supported micro-credit, businesses that need, say, a few million dollars to reach efficient size have almost no place to turn. And that stifles opportunities for economic growth.

**WHERE THE ACTION IS
AS A PERCENTAGE OF GDP**

	COUNTRY INCOME		
	LOW	MEDIUM	HIGH
Informal Activity	47%	31%	13%
Small & Medium Enterprise Activity	16	39	51
Remaining Activity	37	30	36

SOURCE: Meghana, Demirguc-Kunt and Beck, “Small and Medium Enterprises Across the Globe: A New Database,” World Bank Policy Research Working Paper No. 3127 (August 2003).

**SME: AN ACRONYM
FOR ECONOMIC SUCCESS**

We see the need for a three-pronged approach to encourage the flowering of SMEs in poor countries. First, governments must reform their business environments, with the focus on easing regulation and stemming the corruption that feeds on it. Second, access to

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capital for these enterprises must be expanded, with government- or donor-supported capital augmenting private sources. Third, entrepreneurs and managers of SMEs need access to skills gleaned from practical experience and international best practices.

All three concepts are familiar to development specialists. The insight that has been lacking is that all three must be pursued simultaneously; with any component missing, competitive businesses will not take root. Furthermore, initiatives are unlikely to succeed as long as government and business see themselves as adversaries. Indeed, success turns on long-term commitment from governments and international organizations as well as investors. Wealthy nations should follow up on the findings of the UN Commission on Private Sector & Development and the Commission on Capital Flows to Africa (an initiative of the Corporate Council for Africa in the United States, along with the Washington-based Institute for International Economics), by making support of small business an explicit objective of development policy.

Business-Sector Reform

As disturbing as the current wave of major business scandals in the United States and Europe may be, the response has been reassuring. The resulting reforms in securities regulation and corporate governance show that institutions in place can effectively respond to

evidence of rot. By contrast, minority-shareholder rights, business-credit regulations and the rules of bankruptcy and collateral repossession that set the parameters of business behavior elsewhere often don't exist in poor countries – or if they do exist, they are not enforced. Investors rarely risk their money in businesses in poor countries unless they have known the principals for decades because they cannot otherwise count on getting honest information and cannot rely on redress through the courts. By the same token, banks will not provide long-term loans because they cannot trust firms' financial statements and do not know whether the courts will allow them to foreclose on their collateral in the event of default.

Large domestic corporations and foreign companies can use old-boy networks to settle business disputes and bypass corruption – or, more typically, to exploit it. Small companies, on the other hand, are easy pickings. Owners of SMEs therefore see government as the enemy, preferring to remain in the informal sector to avoid paying taxes and to minimize contact with regulators. And the resulting lack of transparent records disqualifies them from arm's-length investment.

Hence, a prerequisite for any foreign-donor support of small business must be a government commitment to the rule of law as well as a regulatory environment that enables well-managed businesses to thrive. Increasing funds for the courts, property registries and



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law enforcement agencies, and providing adequate pay for judges, are obvious first steps.

Where the political elite has the will, regulation involving the areas of business start-ups, labor law and bankruptcy procedures can be streamlined relatively quickly. For example, from 2003 to 2004, Kenya reduced the number of procedures required to start a business to 12 from 25, and the num-



ber of days to 47 from 255. Similarly, Bangladesh reduced procedures to 8 from 15, and days to 35 from 270. During the same period, the days required to enforce a contract in Botswana went to 56 from 154, and in Malawi to 108 from 277.

Governments can build on this kind of progress by creating regional one-stop shops that provide easy access to enforcers of regulatory and tax requirements, market and export information, and assistance programs to resolve the regulatory problems of small businesses. Tax amnesties and graduated tax burdens could also encourage small businesses in the “informal” economy to operate in the open.

As an incentive to make such changes, wealthy nations should tie assistance to achievements on the home front. Washington’s recently implemented Millennium Challenge Account takes this approach, requiring poor countries to make progress against

benchmarks (measuring, for example, government effectiveness, rule of law, control of corruption, regulatory quality and the number of days needed to start a business) to qualify for more aid. But national governments must take the lead in designing and implementing support for small business.

Access to Capital

The challenges faced by small and medium-sized enterprises in poor countries, and the lack of exit opportunities for investors, make it unrealistic to expect that potentially viable businesses will attract private capital, since they will not achieve rates of return that justify the risk. Thus, foreign donors must accept the reality that, in the short term, they need to provide a portion of capital at below-market returns. But markets should still rule; programs to deploy below-market capital should leverage private investment in the SME sector (through measures like guarantees, co-financing and tax breaks), rather than crowding it out.

Though governments and international organizations have often tried to invest capital directly in small businesses, bureaucrats have neither the information nor the incentives to invest wisely. Programs to finance SMEs have only succeeded where this responsibility has

stayed in the hands of private investors, even as governments or donors provided incentives to balance the risk-reward equation. Local investors are more likely to have the specialized knowledge and connections critical for effective investment decisions. Equally important, if local private capital is at risk in small businesses, the elites are more likely to support government policies that sustain the sector's development.

Remittances from expatriates represent another source of capital for the SME sector. Indeed, remittances provide an estimated \$150 billion annually to developing countries – triple the flow of development aid. To encourage expatriates to use transfers for investments, wealthy countries could provide tax incentives to those who invest in key sectors back home.

Note, however, that the fact that markets are better at allocating capital than government bureaucrats are doesn't mean that private investors are likely to be particularly good at the task. As a practical matter, bankers and investors in poor countries rarely have the skills to evaluate business risk. Even with the incentive of guarantees from donors, banks in developing countries are usually unwilling to adopt sophisticated credit-analysis techniques, or to take the time to process small yet still relatively complex cash-flow loans. Therefore, programs need to be implemented in cooperation with foreign experts, and intensive training and mentoring programs for local investment professionals should be part of the package.

Programs should also be open to the use of innovative financial instruments. Pure equity may only be attractive to investors where liquid markets allow for exit. On the other hand, the need for substantial cash flow to service high-yield debt may stifle growth. Hybrid instruments providing long-term financing

while compensating investors with modest current returns coupled with upside bonus incentives – an approach used successfully by Business Partners, an SME investment firm operating in South Africa – may be part of the answer.

At the end of the day, however, young businesses need access to permanent equity-like capital, regardless of the instrument, to accelerate their growth. And until the returns on equity investing in these markets balance the high risks of these types of businesses, donors will need to provide capital at below-market returns to induce private investment into this sector.

Assistance to Small Business

Access to capital is necessary – but far from sufficient – to exploit opportunities for small businesses. Managers must also acquire the skills to run modern organizations that can compete in export markets. Thus, part of the capital provided by donors on a pure grant basis should be dedicated to training and mentoring. Formal training and consulting can lay the groundwork for acquiring technical skills. Business-linkage programs that promote firm-to-firm knowledge transfer, and cluster programs that encourage innovation and dissemination of best practices among networks of firms, have proven most effective in spreading the less-tangible knowledge needed for success.

Most poor countries now encourage foreign direct investment, in part to stimulate the transfer of knowledge to local firms and entrepreneurs. Donors and governments need to be much more proactive in promoting links between large multinational firms



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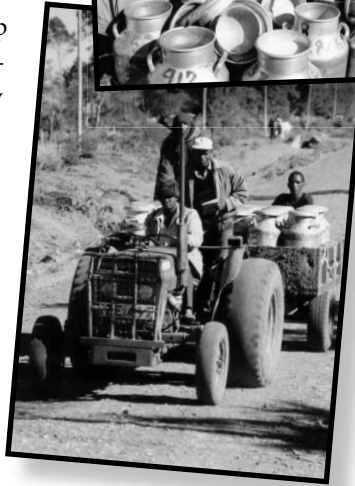
and indigenous small businesses.

And multinationals must recognize that their citizenship in a global business community carries a responsibility to support small and medium-sized enterprises. To this end, donor-sponsored assistance programs could help them identify potential partners among small and medium-sized enterprises. For example, BHP Billiton, a diversified mining and resource-processing company headquartered in Australia, is already doing this in Mozambique and South Africa. It is training small and medium-sized suppliers for mining operations with support from the Africa Project Development Facility of the World Bank's International Finance Corporation.

To be competitive in world markets, small and medium-sized enterprises in poor countries must become more conversant with the language, practices and networks of the industries in which they operate. A full-scale "business peace corps," building on successful programs like the International Executive Service Corps, could support exchanges and apprenticeship programs in relevant areas.

Cluster programs are especially effective when they are aimed at specific industries in which a country has a competitive advantage. Several countries, among them India, Ireland and Taiwan, have created industrial parks, often near universities or large companies, to promote innovative small businesses.

Moreover, governments need not be the only sponsors, and clusters can be virtual as well as geographic. TechnoServe, a Connecticut-based non-profit economic-development



organization, is creating networks of small and medium-sized enterprises in specific markets like coffee, dairy and tropical fruit in Latin America and Africa, and in the process transforming the efficiency of small-scale production.

To cope with resource constraints, smaller-scale businesses should get the basic skills they need, while established businesses with the ability to team up with multinationals or to develop export markets should receive more-advanced assistance and mentoring. For example, Endeavor, a New York-based nonprofit adviser operating throughout Latin America and now starting to operate in South Africa, has successfully used panels of foreign and local businessmen to identify high-performing small and medium-sized enterprises for comprehensive support.

TIME FOR ACTION

For a host of reasons, which boil down to enlightened self-interest, we think it is time for the United States to take bold action on the model of the Marshall Plan and Peace Corps. Current levels of foreign aid will hardly make a dent in the lives of 1.2 billion people who live on less than \$1 a day. And micro-finance programs to buy sewing machines and the like can only go so far in helping the very poor. But helping to build indigenous companies that are both capable of competing globally and committed to establishing the institutions of capitalism will create the conditions for growth, stability and equality. From this perspective, it's a no-brainer. **M**