
Enabling Business Environment for SME

Discussion Paper and potential pathways



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Summary

SME play a crucial role in all economies of developing countries, forming the **backbone** of the country's economic development and providing millions of jobs. Making it easier for these firms, to do business will support economic recovery in these countries, create jobs at low capital cost and help to fight poverty, the **overarching goal** of the MDG and Swisscontact.

For the governments of many developing economies, a new relationship with the private sector is being forged. Both, governments and the business sector have realized that shaping an **enabling business environment / EBE** is paramount for development. Improving the immediate environment of SME - shaped by government policies and markets - is fundamental to **driving growth and reducing poverty**, expanding jobs and other opportunities to create a more inclusive, balanced, and peaceful world. There are two driving forces to shape an EBE: **functioning markets** and **government policies**.

In the mid-1990s, discussion began on development reforms beyond sectorial views, applying a wider institutional approach. The quest for **best-fit interlinkages** between the private sector and the state was raised, that would improve the business environment with two ends in mind: ensuring market transparency and closing the regulatory loopholes and deficiencies of the state administration.

Large parts of economic activity are best organized in **markets**. Markets have proven effective in creating opportunity for citizens to obtain jobs, increasing incomes based on productivity growth, and producing the goods that people want to buy. Functioning markets are thus a critical mechanism to help **reduce poverty**. Key to effective markets is an EBE that provides (i) sound rules for the market, (ii) the expectation that the rules will be adhered to both by all market participants on an equal basis and the state, and (iii) physical access to the market.

The quality of **public policies** determines costs, risks and opportunities of doing business. In this respect rule of law and government administration play a key role in shaping the growth of SME. While governments have limited influence on such factors as geography, they have more decisive influence on the security of property rights, approaches to regulation and taxation (both at and within the border), the provision of infrastructure, the functioning of finance and labor markets, and broader governance issues such as justice and corruption.

The **experience of Swisscontact** demonstrates that the promotion of an EBE is not a quick fix and thus needs a **long-term commitment**. Secondly, EBE promotion is, in most cases, a **combined approach** that concentrates in sectors with high potentials with strong employment effects linked up to other SME promotion instruments such as BDS networks, access to credit, voucher programs, one-stop-services. Swisscontact as a promoter of EBE applies **two entry strategies** that depend on the specific country context and the potential to combine both approaches:

A **Market Development Approach** to increase the competitiveness of SME: Swisscontact conceives operations to support SME as an essential part of LED and RED¹ in order to improve forward and backward linkages (clusters), boost incentives for partnerships, alliances and other horizontal arrangements with the aim to improve their competitiveness.

B **Policy Networks Approach** to improve government regulations for SME: Swisscontact conceives operations as policy network approach in order to prepare, facilitate, empower and organize SME stakeholders taking an active part in negotiation processes with government on local and regional level with the purpose to improve the governance related business environment for SME development.

The strategic choice builds on the **assets of Swisscontact** with its long-term presence in the partner countries. Thus, fostering the EBE can be linked up to the established partnership network of the private sector promotion in the country. Secondly, in both approaches, Swisscontact orients its programs to palpable results on local and regional (subnational) level. Action and demonstrated results speak louder than words.

¹ Local and Regional Economic Development

1. Potential benefits of SME development

In developing countries SME are at the heart of the development process. Driven by the quest for cost recovery and striving for survival in a difficult environment, firms of all types - from farmers and micro entrepreneurs to local manufacturing companies and service providers - invest in new ideas and new facilities that strengthen the foundation of economic growth and prosperity. SME provide between **60 to 80 percent of jobs** - creating opportunities for people to apply their talents and improve their situations. They provide the goods and services needed to sustain life and improve living standards. They are also a major source of tax revenues, contributing to public funding for health, education, and other services.

Thus, SME play a crucial role in all economies of developing countries, forming the **backbone** of the country's economic development and providing millions of jobs. Making it easier for these firms, and the micro enterprises that hope to graduate to SME status, to do business will support economic recovery in these countries, create jobs at low capital cost and help to fight poverty, the **overarching goal of the MDG** and Swisscontact.

Example: Of Indonesia's 2.8 million industrial establishments, 2.5 million are micro enterprises and 245,000 are SME. Together the entrepreneurs who run these small operations account for 60% of manufacturing employment in the country. Although these companies are key to the national economy, their potential is hindered by a variety of factors. There is limited access to quality business services such as basic accounting, preparation of feasibility studies and business plans, and international marketing. Cumbersome licensing and regulation requirements raise the cost of doing business. And the lack of an efficient credit information bureau makes it hard for small business people to access the financing they need to expand.

The potential **economic and social benefits of SME** are attributed to their capacity to:

- create jobs at low capital cost;
- contribute significantly to the economy in terms of output of goods and services;
- improve forward and backward linkages between economically, socially, and geographically diverse sectors;
- create opportunities for developing and adapting appropriate technology;
- provide an excellent breeding ground for entrepreneurial and managerial talent;
- develop a pool of skilled and semi-skilled workers;
- act as ancillaries to large-scale enterprises;
- adapt to market fluctuations;
- fill market niches which are not profitable for larger enterprises;
- lend themselves to development policies favouring decentralization and rural development.

While the advantages of SME and their contribution to national economic and social development are recognised by many, the methods for small enterprise promotion are the subject of continuous debate and revision.² In some cases, small enterprises are a symptom of underdevelopment and poverty, but elsewhere they are indicators of a vibrant, entrepreneurial economy. Both developed

² The term 'small enterprises' is used to describe a wide range of enterprises that are often disaggregated into micro enterprises as well as small- and medium-sized enterprises (SME), with the specific definition depending on the purpose or country context.

and developing countries have come to recognise the **importance** of the small enterprise sector and its relationship to large enterprises and the strategic position that many countries are looking for in the world economy.

Throughout the last decades, SME, development agencies and governments have taken direct measures to support the development of SME. They have established BDS and incubators, launched training programs, encouraged mentors, facilitated the access to technical and financial services, created special councils or taskforces, adopted promotional policies, and even offered tendering preferences to the SME sector. In some cases, these initiatives have been ill informed; they have created or perpetuated **market distortions** and usually only benefited a handful of enterprises in a sporadic and unsustainable manner. However, there are also cases where BDS and governments have promoted SME in a more strategic, market-oriented manner, where they have recognised the role other actors can perform and sought to facilitate the development of markets for business development services.³ Nevertheless, one major **overall conclusion** drawn from these experiences is that the contribution to the SME sector remains fragile when it is not seen in a **wider perspective** of an enabling business environment.

For the governments of many developing economies, a new relationship with the private sector is being forged. Governments have realized that shaping an **enabling business environment** is paramount for development and governments are required to recognise the value of **markets** and ensure they only interfere with them when they have a clear and good reason. Furthermore, **globalisation** and the removal of barriers to trade have opened enterprises of all sizes to competition from the world economy challenging many national governments to find new ways of managing their economies. Typical examples of SME-specific **concerns** found in their business environment are:

- Expensive and time-consuming regulatory requirements such as licensing and registration
- Official and unofficial levies that discourage small enterprises from growing and becoming formal
- The legal framework for commercial transactions and the resolution of disputes
- Barriers to entry and non-competitive behaviour in markets where small enterprises are potentially competitive
- Zoning regulations that restrict small enterprise operations and entry into high-income markets
- Labour market rigidities that make hiring workers difficult and expensive, and limit the flexibility and mobility of the labour force
- Tax structures that distort incentives and discriminate against small firms
- Government procurement procedures that discourage successful bidding by small enterprises

There is a range of models and frameworks donor agencies use when approaching the enabling business environment and to describe the elements of interest or concern. The term *enabling business environment* used throughout this concept paper, for example, is not used by all agencies. Others use the term *conducive environment*, *business climate* or *investment climate*. The concept paper sets a definition of the enabling business environment in regard to their relevance for SME. There are good reasons for this, not the least of which is the broad experience of Swisscontact dealing with SME promotion. The concept of a business environment may be

³ See: White, Simon et al.: Enabling Small Enterprise Development through a Better Business Environment. The findings were presented during the annual meeting of the Committee of Donor Agencies in Turin in September 2002.

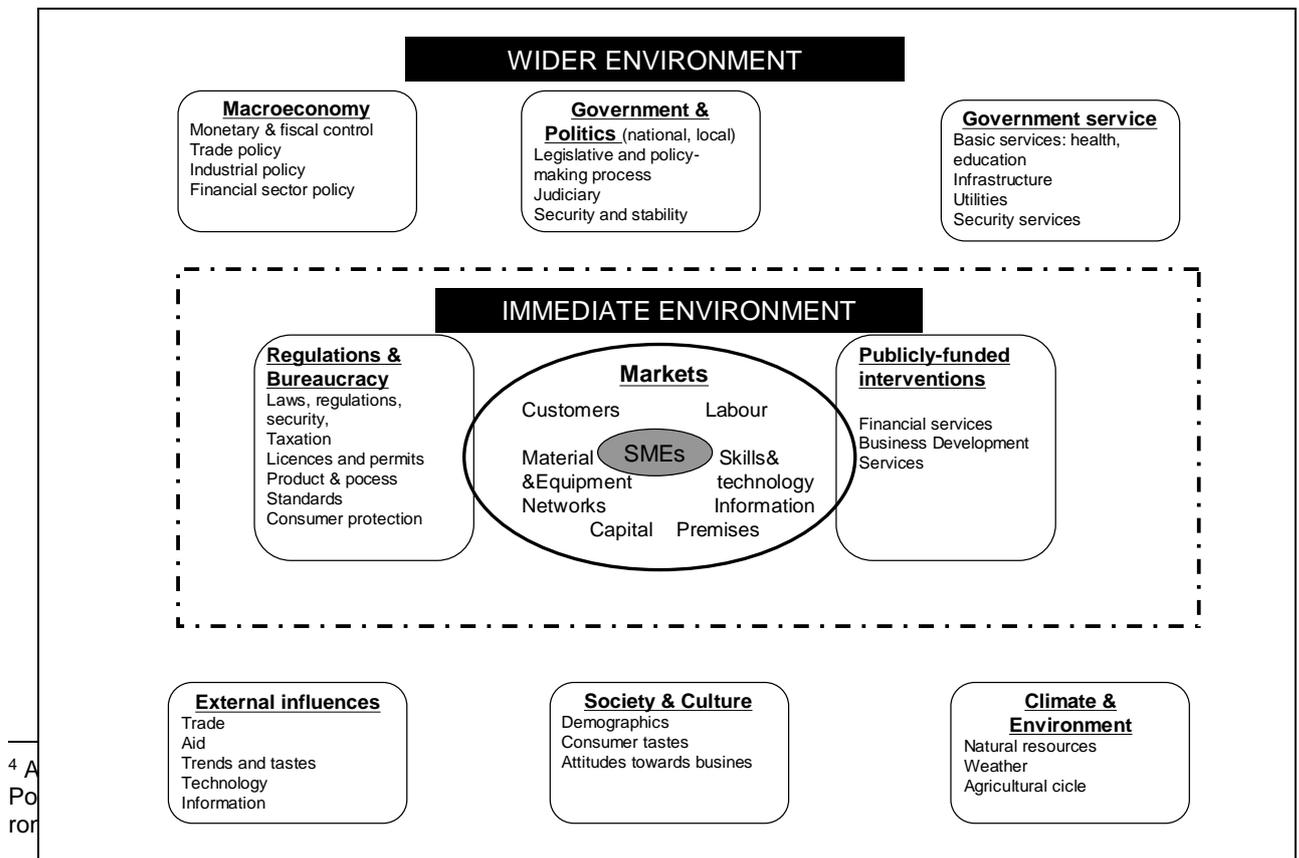
broadly defined, but for Swisscontact dealing with the practice of development projects, there is a need to clearly demarcate the most relevant factors.

2. SME development interlinked with government and market

What conditions create a climate in which SME of all types have opportunities and incentives to invest productively, create jobs and expand, and thereby contribute to **growth and poverty reduction**? What determines the contributions SME can make to a more inclusive and balanced development?

It is mainly the enabling business environment for SME in terms of the location-specific factors that shape the opportunities and incentives to grow and access to markets. In this respect **government policies** and behaviours play a key role in shaping the growth of SME. While governments have limited influence on such factors as geography, they have more decisive influence on the security of **property rights**, approaches to **regulation** and **taxation** (both at and within the border), the provision of **infrastructure**, the functioning of **finance and labour markets**, and broader **governance** features such as justice and corruption.

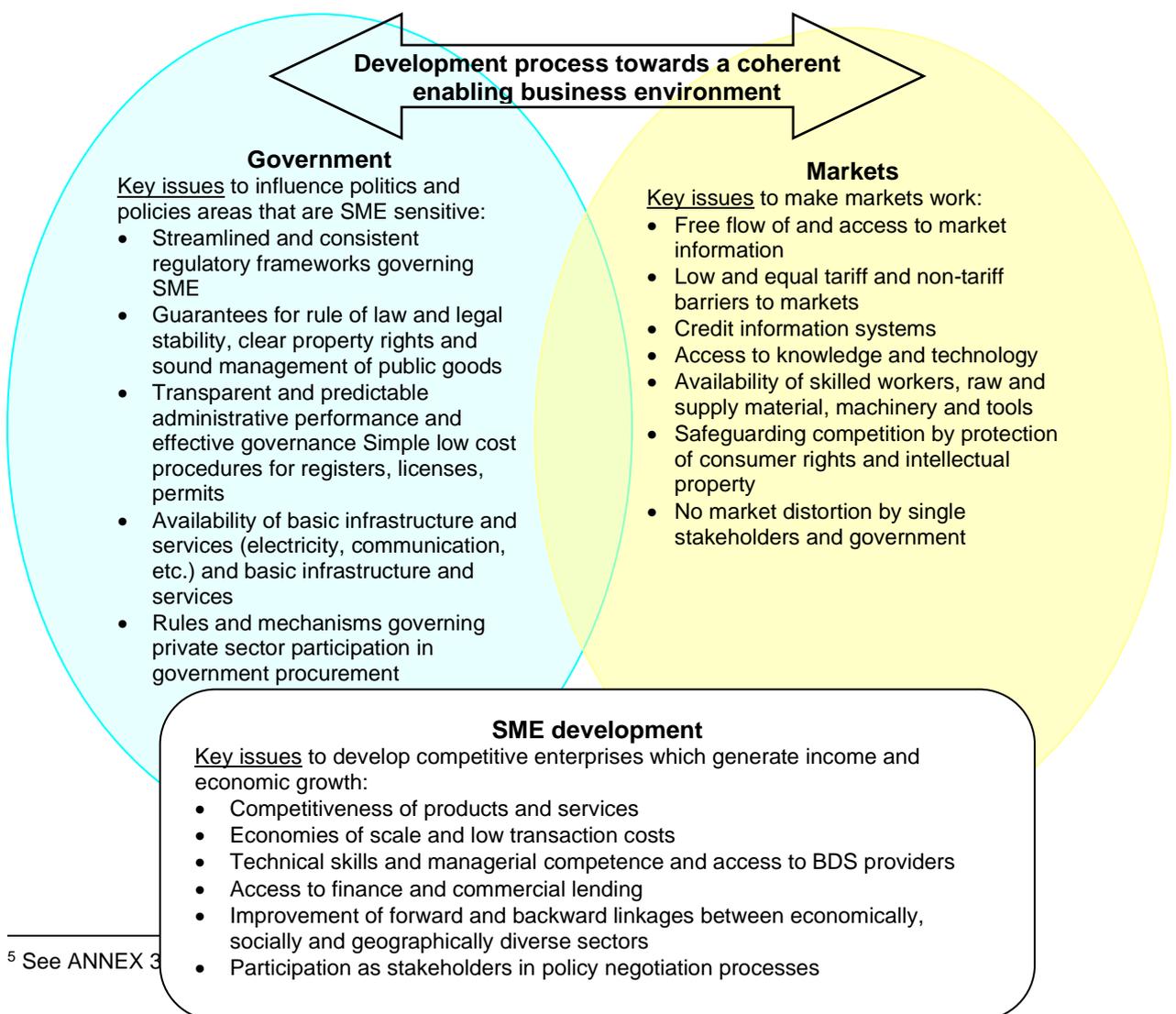
Over the last decades of SME promotion, one of the major lessons learned by Swisscontact and other development agencies, is the importance of the **policy and regulatory environment** for SME development. Based on the key lessons from international experience, the ADB Policy Paper on *Best Practices in creating a conducive Environment for SME⁴* provides a practical framework of the recognition that a wider perspective of SME development is required, which places SME in the wider context of government reforms.



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Improving the immediate environment of SME shaped by government policies is fundamental to driving growth and reducing poverty. That makes progress especially critical for governments in the developing world, where **young people** have more than double the average unemployment rate and where demographic changes will add nearly 2 billion more people over the next 30 years. Expanding jobs and other opportunities for young people is essential to create a more inclusive, balanced, and peaceful world.⁵

For **capacity development and technical assistance** directed to the growth of SME, the immediate environment is most relevant while some of the influencing factors of the wider environment might be less important. Looking at the model in a systemic perspective, the basic interlinkages of SME development are twofold: to the **government** and to the **market** as the major coordination mechanism that is strongly interlinked with the state. Therefore, a basic systemic model can be shaped as follows:



An **enabling business environment for SME** has a number of important characteristics: macroeconomic stability, an effective and accessible legal system, recognition and protection of property rights, flexible, competitive markets for inputs and outputs and a 'light' regulatory and taxation system which avoids curtailing firm formation, operations and ability to enter and exit markets.

Many aspects of **weak government policies** and **inconsistent market regulations** lead to a poor enabling business environment that hits SME and those in the informal economy the hardest.

Business environment vary not only across countries, but also within them. Variations can stem from differences in the policies and behaviours of subnational governments, or from the way national and local policies are administered. In general terms, investment climates tend to be less hospitable in rural areas, reducing opportunities for farmers and non-agricultural firms alike. Even within a single location, the same conditions can affect SME differently. This can be true across activities - farmers, local manufacturers and small service providers can each have different perspectives and priorities, but on the long run their decision making and prospects are increasingly tied to the implementation of government policies in practice and the driving forces of local and globalized markets.

The **role of government policies** is to enable the development of SME and to promote competitiveness in the markets among all business sectors rather than insulating SME by protecting them from competitive pressures. International experience indicates two salient trends that are redefining the role that the states play in private sector development. These are

- (i) a priority focus on improving governance that is directly related to SME development;
- (ii) shaping a competition-enhancing environment, safeguarding an equilibrium between national interests and the globalisation of production, trade, market places and communication.

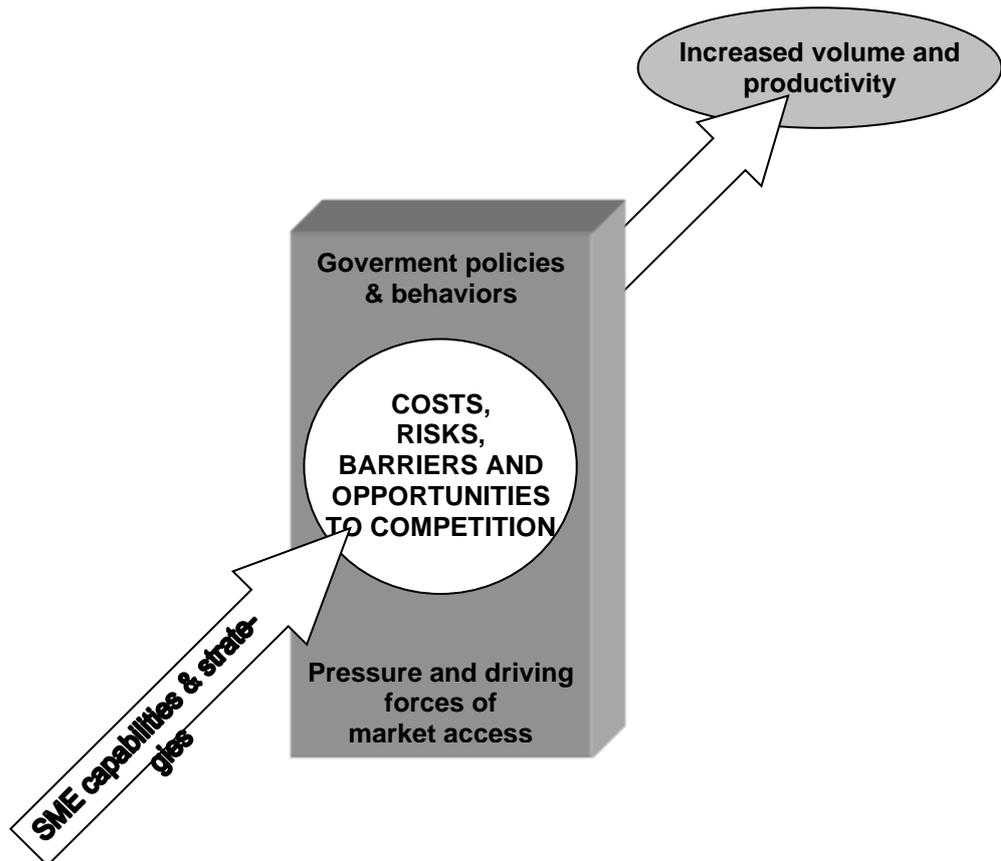
In a first approximation, this model differentiates a couple of variable elements, attributed to each of the two major issues: government and market. In a given situation a **systems analysis** would be more appropriate than a simple cause-effect analysis for understanding how variable context elements influence SME in an open, dynamic system. To describe them systemically, however, we need (i) to define at least some of the interlinked variables (or elements), (ii) to analyze if they are mutually strengthening over a period of time (positive cycles) or destabilizing one another (negative cycles).

The recent World Bank Report⁶ on "A Better Investment Climate for Everyone" emphasises both government policies as well as market configuration as paramount for enterprise development. In

⁶ World Bank: World Development Report 2005: A Better Investment Climate for Everyone. Washington, D.C. 2005
The Report draws on surveys of over 30,000 firms in 53 developing countries, the Bank's Doing Business database, country case studies, and other new research. Policy-related risks dominate the concerns of firms in developing countries. Uncertainty about the content and implementation of government policies is the top-rated concern, with other significant risks including macroeconomic instability, arbitrary regulation, and weak protection of property rights. Unreliable electricity supply and other infrastructure, crime, and corruption can impose costs that are more than

addition the report concentrates on three key factors for decision making on enterprise level that are shaped by government policies and markets: (i) **costs**, (ii) **risks** and (iii) **opportunities to competition**.

The following enhanced model, adapted from the recent World Bank report⁷, highlightens the perspective of the SME that are acting under pressures and driving forces of local, national and globalized markets.



(i) Costs: Wages, raw materials, and the like are normal costs associated with any commercial activity. But many costs flow more directly from government policies and behaviours. Taxes are the most obvious example. But governments also have an important role in addressing market failures, providing public goods, and supporting the provision of infrastructure. Weaknesses in government performance in these roles can greatly increase the costs for SME and make many investment opportunities unprofitable. Surveys show that the costs of unreliable infrastructure, contract enforcement difficulties, crime, corruption, and regulation can amount to over 25 % of sales, or more than three times what SME typically pay in taxes. Both the level and the

double those of regulation. High risks and costs restrict competition, but governments also limit competition through policy barriers to market entry and exit, and through inadequate efforts to curb anticompetitive behavior by firms. The report highlights opportunities for governments to improve their investment climates by expanding the opportunities and incentives for firms of all types to invest productively, create jobs, and expand. Further it shows how the international community can strengthen those efforts.

⁷ World Bank: World Development Report 2005: A Better Investment Climate for Everyone. Washington, D.C. 2005

composition of these costs vary widely across countries. Costs also have a time dimension. Surveys highlight big variations in the time taken to get goods through customs and to obtain a telephone line as well as in the amount of time SME need to spend dealing with officials.

(ii) Risks: Because investment decisions are forward looking, SME' judgments about the future are critical. Many risks, including uncertain responses by customers and competitors, are a normal part of investment, and SME should bear them. But governments have an important role to play in creating a stable and secure environment, including by protecting property rights. Policy uncertainty, macroeconomic instability, and arbitrary regulation can also cloud opportunities and chill incentives to invest. Surveys show that policy related risks dominate investment climate concerns across developing countries.

(iii) Opportunities to competition and driving forces of market development: In first place, there are lots of barriers to competition that benefit big enterprise and deny opportunities, raising costs for SME and for consumers. Barriers can also dull the incentives for protected firms to innovate and increase their productivity. Some barriers and opportunities stem from natural features, such as distance and economies of scale associated with particular technologies. High costs and risks can act as barriers to entry. Governments also influence opportunities and barriers more directly through their regulation of market entry and exit and their response to anticompetitive behaviour by big firms. While difficult to measure at the aggregate level, surveys show how the competitive pressure felt by firms can vary greatly across countries. Opportunities to competition that stem from the globalisation process need a closer look:

(a) Increased **interdependence** and interlinkages between countries and markets, commonly known as globalization, has been the defining phenomenon of the last decade. A number of different factors have contributed to this process, most notably, increased flows of foreign direct investment (FDI). According to the World Investment Report 2000, the level of FDI in 1998 was estimated at \$2.5 trillion dollars. Such investment takes many forms: that of joint ventures, often in minority positions; subcontracting and production sharing; and non-equity arrangements, for example turnkey operations and long-term contracting.

(b) Lower production and labour costs, differences in regulatory frameworks, and the desire to **access outside markets** has led the firms across a wide range of industries to transfer some of their operations to developing countries. From an organizational perspective, there has been a fundamental shift in the nature of the relationships in and the governance of corporate production chains. The formerly dominant model of rigidly hierarchical firms manufacturing goods within wholly-owned facilities in national operations for local markets has given way to transnational operations of alliances and supplier-based manufacturing that serve a range of global markets, leading to sharper competition on a global work and marketplace. In these conditions, fragile states and non-competitive enterprises shift easily under pressure from economic forces from outside that make more effective use of economies of scale, location strategies, technology and production sharing schemes that result easily to dumping and market distortion.

(c) Clients and the resulting markets, especially in industrialized countries, are increasingly more sensitive on **environmental** as well as **social aspects** of products and on enterprises delivering these products. Trade, product or production requirements are expressed e.g. in state regulations, voluntary codes of conduct or labels and certification. Examples are the HACCP (Hazardous Analysis and Critical Control Point) regulations in the food industry, a wide variety of eco- and fair trade-labels or standards such as

SA 8000⁸. Consumers are increasingly taking the living and working conditions of the producers into consideration when they decide what to buy. Were those flowers or coffee beans cultivated under sound conditions for the health of the workforce? Were the carpets or items of clothing manufactured under decent and just conditions in their countries of origin? Companies which cater towards these markets need to adapt their products, their production process and their management system to maintain and eventually broaden their position in these competitive markets. Export companies as well as companies in supply-chains are thus under **pressure** to go for environmentally friendly production as well as to integrate principles of corporate social responsibility.

(d) Following transparent **CSR rules** and providing decent work for employees entail a process that requires firms to tackle what is often seen as a trade-off between internal profit objectives and standards set by national legislation and universal principles such as those set out in the UN Global Compact and the ILO Declaration on Fundamental Principles and Rights at Work. At the same time, the variety of initiatives and principles that have emerged in the social arena have proven confusing for many companies, while the blurring of corporate boundaries, which has seen shifting expectations concerning the responsibility for supply chains that stretch into developing countries and the process of globalisation, has added to the **confusion**. A need has thus emerged for an approach to helping employers to meet profit objectives, these standards and society's expectations in order to reduce the potentially negative impact of these market and client imposed non-tariff market barriers.

(e) International environmental and CSR conventions as well as markets are thus **driving forces** towards more sustainable production modes. Products and production processes which harm less the environment and corporate social responsibility are core ingredients to improve the **market access** as well as the bottom-line of enterprises. Companies – smaller and larger in size and access to external markets - which clearly position themselves in this way thus gain a sustainable competitive advantage leading finally to better jobs, reduced poverty and increased welfare in a healthier environment. Looking into comprehensive **supply chains** and **clusters** that include the involvement of SME can thus play a crucial role of SME development.

3. Government and market forces

3.1 Quality of public policies determines costs and risks of doing business

The poor performance of the private sector in developing countries can be attributed in large part to the absence of a favorable, enabling business environment. Surveys from various sources show that **costs and risks of doing business** remains persistently high in many countries, and the public institutions needed to support a dynamic private sector continue to be inadequate. High transactions costs result from unsecure property rights, weak credit frameworks, unwieldy bureaucratic procedures that promote corruption, and cumbersome labor laws. Weak public institutions fail to deliver the legal, educational, health, and infrastructure services that are required to do business. The combined effect of these factors on small business is increased uncertainty and risk, shortened investment horizons, the limited availability and high cost of financing (both external and domestic), reduced worker productivity, and, in general, more difficulties and lower profits for small businesses attempting to pursue commercial opportunities.

⁸ SA 8000 is an international standard for social accountability initiated by CEPAA (Council on Economic Priority Accreditation Agency).

Sustainable and equitable development requires a democratic and efficient **state** that establishes a regulatory framework conducive to the efficient functioning of **markets**, that guarantees a stable and predictable macroeconomic environment, that is capable of adopting social and economic policies appropriate for poverty reduction and environmental preservation, and that implements such policies in an efficient, transparent and accountable manner. In the development debate a consensus has formed that the **quality of public policies** and its application is an essential, and perhaps the most important, ingredient, for sustainable and balanced growth in a market economy. Macro-economic stability, well-defined property rights, a sound judicial and contracting system, a reasonable level of certainty about government policy, functioning financial institutions and a good physical infrastructure, such as a transport system, are all ingredients of a sound investment climate and thus of an enabling business environment.⁹

An enabling business environment for SME and good and transparent regulatory governance are strongly **interlinked**. The idea of using regulation to improve economic performance of the private sector, and in particular SME in developing countries, has a long history. Roman civil law and regulations in the European Middle Ages as well as in China or in other regions of the world were shaped to improve, regulate and expand markets. In the 18th and 19th century, the industrial policy of England and in Europe strengthened the legal framework for longer-term land management and wider market access, trying to lower or undergo protection barriers and providing tax incentives to established factories to process agricultural products, such as food or cotton, and to widen and access new markets, developing infrastructure and encouraging investment.

An inadequate relationship between the state and the private sector, in particular the SME's, has translated in an erosion of the possibilities for **sustainable and equitable development**. Political-institutional weaknesses have been frequently expressed in the phenomena of authoritarianism, clientalism, corruption, and capture of institutions and public policies by particular interests. These political system features have resulted in state actions that discourage an efficient functioning of the potentials of SME development, the market and instead promote rent seeking and speculation. Fragile and failed states produce market ineffectiveness, poverty, social unrest and violence.

Against this background, the institutional requirements of the **rule of law** play a crucial for the smooth functioning of the relation between the state and the private sector. An assessment of the state of justice in most developing countries reveals multiple problems, including: the lack of judicial independence, the obsolescence of laws and procedures, congestion in the court system; a scarcity of resources; the absence of modern systems of organization, information, and administration; barriers of access and the limits of the coverage of the system; the deficiency and poor state of the physical infrastructure; and the precariousness in the protection of fundamental rights. The result is justice with **low credibility and inequality** that denies or limits the access of broad segments of the population, without the capacity to reliably uphold and enforce rights and obligations or effectively prosecute and impose sanctions to curb the growth in different forms of crime and other threats to citizen security and SME development.

⁹ World Bank: Private Sector Development Strategy; Directions for the World Bank Group, p. 3, Washington, D.C. 1999

At the same time, these same weaknesses have contributed to a **policy-making process** in which the resulting policies do not reflect the processing and aggregation of the demands of the majority of SME's but rather lead to the exclusion of broad sectors from the benefits of growth and to the delegitimation of the state. This **democratic deficit** is also responsible for the absence of significant economic growth and a reasonable degree of social cohesion. A consequence of this inadequate relation between the state and markets is **chronic political instability** and changing rules of the game that have discouraged SME development, saving and investment. The above analysis implies the necessity of promoting significant reforms of the **business environment** oriented to overcome these dysfunctions in the relation between the state and the private sector and at the end between the state and the citizens.

The legal system is a **critical factor** underlying the growth of businesses of all sizes from microenterprises to SME. For smaller firms, the absence of legal enforcement and unregistered property rights raise the cost of financing and limit their ability to invest and grow. Evidence indicates that where creditor rights cannot be enforced effectively the amount of credit available to the private sector suffers. An appropriate legal framework defines agreements between businesses and facilitates contract enforcement and dispute resolution, thereby improving access to finance. This allows businesses to grow as objective, "arm's length" transactions permit them to move beyond the circle of family, friends, or neighborhood acquaintances in which they initially operate.

Informality is closely linked with poverty and has corrosive effects on the market incentives needed to sustain economic growth. Many economies, especially the lower income countries, offer no strong incentives to become formal, especially for micro- and small and medium-sized enterprises. Failure to **attract firms to formal market** activities results in foregone tax revenues and serves to undermine the quality and coverage of public services (such as roads and education) and inhibit the transparency and confidence in markets (as firms pursue tax- and regulatory-avoidance strategies to survive). The close link between informality, low growth and poverty suggests that efforts should be focused on low-income countries or low-income regions within countries where these conditions are most prevalent.

Barriers and transaction costs, examples from Bolivia and Peru¹⁰: In Bolivia, the survey identifies about 86 different registers and records, for which fully formalised small enterprise must provide data. On average, each register requires four forms of documents. Completing the work takes 362 hours of direct contact with public agencies, plus the time required to gather the needed data. The documents refer to five inspections, filling out 28 single forms and 31 more accompanied by a bank deposit confirmation, the payment of 46 different "value documents", three payments for regular services, 14 additional procedures and the presentation of 159 certificates, declarations, testimonies, receipts, etc. All paperwork and procedures combined, including waiting periods, required 284 days of work. When a group of students and associates of the "Instituto Libertad y Democracia" in Lima were assigned to set up a clothing factory to look at the process of formalization, the formalization took 10 months and they were asked for 10 bribes and from these they needed to pay 2 in order to keep the operation going.

¹⁰ Brugger, Ernst A., et.al.: *The cutting edge: Small business and progress*. 1996; FUNDES; p.130 ff.

3.2 Market development

All businesses function within markets. Whether they are buying wood to make into furniture, hiring new workers, borrowing funds for expansion or selling their products and services, all companies must **interact with markets**. This interaction exposes entrepreneurs of all scales to the rules, regulations, trends and technology that shape the way they and their competitors do business. The market system is generally regarded as the proper basis for modern economies. But markets themselves are **imperfect, incomplete or missing**. In these circumstances there is the need for governments and other institutions to play a role in helping markets to function efficiently.

Market development has been very uneven among and within the countries: major segments of the population and property remain outside the market economy, and rent-seeking situations persist, which limit the development of productive capacity. It is necessary to develop government institutions and public policies that will create the **conditions and incentive systems** conducive to the efficient, competitive operation of a market economy, which is a core requirement for **dynamic growth and job creation**, in the context of globalisation.

Large parts of economic activity are best organized in **markets**. Markets have proven effective in creating opportunity for citizens to obtain jobs, increasing incomes based on productivity growth, and producing the goods that people want to buy. Functioning markets are thus a critical mechanism to help **reduce poverty**. Key to effective markets is an enabling environment that provides (i) sound rules for the market, (ii) the expectation that the rules will be adhered to both by all market participants on an equal basis and the state, and (iii) physical access to the market. The development of wider markets, that favor the inclusion of sectors of the population that are at present excluded, but that are also more efficient and capable of competing in the global economy, should be the double objective of each government.

The relation between the state and the market has experienced very important changes derived from the **economic reform process** carried out over the last two decades. These reforms have resulted in gains in terms of macroeconomic stability, creating an environment more favorable for SME development and investment. In addition, entire sectors of productive activity, once dominated by inefficient state monopolies, have been opened to the market. In a similar manner, trade barriers¹¹ and sector-specific regulations restricting internal and external competition have been dismantled. To match with economic growth targets, markets in goods and services are developing increasingly.

However, the causal relationship between **economic growth** and **poverty reduction** is not clear cut and has given rise to some controversy. The question is, if the increase of sea level takes all

¹¹ When speculating about trade barriers, it is helpful to keep certain basic figures in mind, such as: Public aid of DAC-countries in total amounts to approx. 60 billion USD/year. If there are roughly 1.2 billion poor in the south this makes 40 to 60 USD per head/year. Less than 10 percent of this amount is spent in SMD. Donor investment in comparison to total investment in the industrial sector is, according to UNIDO, at best 10 to 15 percent. Most investment comes from the domestic or the international private sector. In comparison to other sectors (e.g. agriculture, water, infrastructure, health) donors have little influence on investment decisions and at policy level. But they can help to pave the way for improving the policy framework. According to UNCTAD, industrialized countries maintain trade barriers which deprive developing countries of their comparative advantage in industrial production (leather, textiles, chemicals) in the order of 700 billion USD/year. Trade barriers and export subsidy schemes of the industrialized countries in the agricultural sector are even far more important and lead to much higher income losses on the part of developing countries in terms of export restrictions and unfair competition on the home market.

boats. Some observers claim that growth, at least in its early stages, actually leads to a worsening of income distribution and, in the extremes case, an increase in poverty. Yet, there is also increasing evidence that growth improves the situation of people at all levels of income in about the same proportion. Clearly, economic growth results in higher employment, income and government revenues, providing the resources to finance programs to address social needs and improve living conditions for the poor. From this we can conclude that sustained economic growth is a necessary condition for reducing poverty. Since, as already shown, the SME account for a **significant share** of national output, and hence economic growth, and since increased growth plays an important role in reducing poverty, a strategic focus on SME development is key to creating employment opportunities for the poor.

Nevertheless, the passage towards an economy in which market forces play a more central role has not been sufficiently accompanied by the development of **regulatory frameworks that promote competition**, reduce rent-seeking and protect the general interest. In addition, the move to a market economy has been unequal, and in not a few cases, has been based on the capacity of organized interests to take advantage of or resist the opening. It is also important to note the absence of broadly **inclusive social partnership mechanisms** that include those interests that are positively or adversely affected by the reforms, in such a manner that the countries can have long-term strategies based on a wide social consensus.

Economic growth alone may not suffice to raise the living standards of the poor in the absence of complementary and effective poverty reduction programs. Opportunities for achieving social inclusion and equity are also necessary to create the **social and political stability** needed for sustained growth. Economic and social development policies should promote sustainable growth, and include activities targeted to the poorest segments of the population. Such targeted interventions favoring the poor include social infrastructure, investments in human capital, market improvement of BDS, access to financing and the enabling environment for SME.

Against this background, the **market development approach** to a comprehensive SME promotion should incorporate the SME into the wider perspective of LED and RED in order to improve forward and backward linkages, pooling SME to gain economies of scale, boost incentives for partnerships and support information systems with the aim to improve their competitiveness. Furthermore, instead of working through selected providers of BDS, on an intermediate level, the service market itself can be promoted through demand orientation, market transparency measures, market research and by qualifying the BDS providers.

3.3 Public policy and stakeholder participation

The relation of the state, both with citizens running SME's and with markets, is conditioned by the capacity of the public administration to make and implement public policies in a **participatory way**, on all levels, from municipal to regional and national level. During the last two decades, however, public administration reforms have not, for the most part, increased this capacity since in general they have been carried out under the pressure of severe fiscal crises and recurrent external shocks.

At the same time, the reforms necessary to improve and widen markets with the two-pronged objective of increasing their efficiency and inclusiveness, can only be achieved by implementing

wide **partnership mechanisms** (policy networks) between the different economic and social agents. Public policies should emerge from the negotiation among the concerned stakeholders.

As a consequence of the fiscal crises, policies and institutions established to promote and support productive sectors have been absent or ineffective. In many cases the state's capacity to provide **public goods** and **basic infrastructure** necessary to promote social cohesion, participation and the expansion of production activities has weakened. In this context, the necessary emphasis on the operation of markets should be accompanied by the recognition of the complementary and important role played by **public policy processes** that rely on the **informed participation** of stakeholders that negotiate and shape new enabling regulations. As shown by diverse cross-country studies, there is growing evidence that countries which have benefited the most from economic reforms are those that have advanced more in implementing institutional reforms consistent with the requirements of democratic participatory governance.¹²

The process of democratization and redefinition of the relations between the state, civil society and the private sector has been accompanied, in almost all of the countries, by a strong impulse toward **decentralization**. This issue is particularly important **on all levels of government**, given the fact of decentralization as a growing process in most developing countries that imposes changes in all administrative systems, on local, regional and national level including their necessary interlinkages.

Even though it is difficult to identify a paradigmatic process of decentralization, one can find some common **deficiencies**. Among these deficiencies could be included: the imprecision in the distribution of responsibilities; an imbalance between responsibilities and resources, larger fiscal deficits, the capture of subnational governments by local elites, scarce technical preparation of those who have been leading these processes, the lack of efficiency and effectiveness in the provision of decentralized services which play a major role for SME development. This decentralization process has given considerable power to local governments, including powers to regulate and administrate SME, local infrastructure, markets and trade. This has led to new regulations or to the improper enforcement of old regulations, sometimes with negative impacts on businesses when local governments have issued hundreds of regulations imposing taxes, levies, and other fees without proper assessment of their impact.

Policy networks need to involve the concerned private and public stakeholders, because new regulations emerge from the **negotiation process** among them. In particular, this holds also true for **local and municipal governments**. They need to learn how to negotiate and evaluate regulations in the light of their full economic, social and environmental impact. Thus, the SME need **voice, informed participation** and **advocacy** to express their needs and to participate in improvements of the business environment. Most of local governments remain unprepared to shape this kind of policy process and do undertake a negotiation process leading to a more

¹² See e.g.: Sylvain H. Boko: Economic Freedom, Democracy, and Economic Growth in Africa. Wake Forest University, 2003 – However, there are also diverging voices, such as the *Wall Street Journal* (04.05.2004) by David Hale: As India's election will testify, democracy is not always supportive of coherent economic policy and prosperity. India should recover in the long term because its democracy is mature and enduring, but the economy will suffer in the near term. The real challenge lies with countries at an earlier stage of political transition. In such places, the West should attempt to promote the preconditions for democracy, such as a free press and the rule of law. It should be more hesitant about promoting political competition which could destroy the leadership pursuing the economic changes essential for the ultimate emergence of democratic institutions. In the search for democracy, every country will have to find its own way.

enabling business environment. An integral part of these negotiations is the constructive interaction among public officials, the private sector, universities and NGOs. The institution of **ombudsmen** and **public consultation** enhance the transparency of the decision-making process, government accountability and improve the information provided to policy makers in local and national government.

4. Summary of trends and challenges of SME development

Government and markets shape the **institutional setting** of SME. In the mid-1990s, discussion began on development reforms beyond sectorial views and that would complement the earlier ones but adopt a different and wider institutional approach. The result was a set of so-called *second generation* reforms, characterized by their emphasis on **institutional and governance issues** and the quest for **best-fit interlinkages** between the private sector and the state. This new institutional reform pattern would boost competition and improve the business environment with two ends in mind: ensuring **market transparency** by penalizing enterprises engaging in monopolistic practices and closing the **regulatory loopholes** left following deregulation and **deficiencies** of the state. According to a number of authors, policies favoring competition contribute to social welfare since they facilitate the entry into the market of new competitors, protect competition from restrictive trade practices, and, above all, foster the private sector development and consumer welfare.¹³

Major trends and challenges of SME development	
From	To
One-level and sectorial view on SME development.	
Improvement of supply providers to SME and institutional development of BDS.	
Promotion of rural or semi-rural small industry with little regional outreach, low population density, low monetarization of the economy and underdeveloped infrastructure.	
One-issue driven and sequencing of single problems to tackle.	
Micro level support to individual SME through non-profit BDS and associations with standardised programs that comprise a large range of services, modes of delivery, cost recovery features and	
	<p>Territorial and spatial understanding: LED and RED, looking into interlinkages, value chains and clusters, improving complimentary relationships between private sector development, expansion of markets and local and regional public governance.</p> <p>Market promotion of BDS (diversified offer and demand, information) in order to prevent from market failures.</p> <p>Promotion of spillover between rural and urban areas with high degree of under-/unemployment and growing informal sectors that lead to strong SME development in (semi) urban areas.</p> <p>Knowledge based approaches dealing with result oriented issues such as performance, competition, market promotion and EBE.</p> <p>Tailored business development focused on income and job generation, arrangements of different private and public actors (the landscape of stakeholders, networks), on macro level addressing the governance related framework as</p>

¹³ Jatar, Ana and Luis Tineo. Competition Policy in the Andean Countries: The Ups and Downs of a Policy in Search of its Place. Paper presented at the conference on "US – Andean Trade and Investment Relations: Policy Issues and Choices," organized by the CAF, the OAS and the Inter-American Dialogue. 3-4 September 1997, Washington, D.C.

tools, looking at little markets and at micro and informal sector.		determining factor for business development and looking at mainstream markets and effects of globalisation.
Politics and policy are taken as a given context factor.		Improvement of the EBE by setting up and facilitation of policy networks based on the informed participation of major stakeholders, including the SME.

5. Strategic choices: EBE as a business case

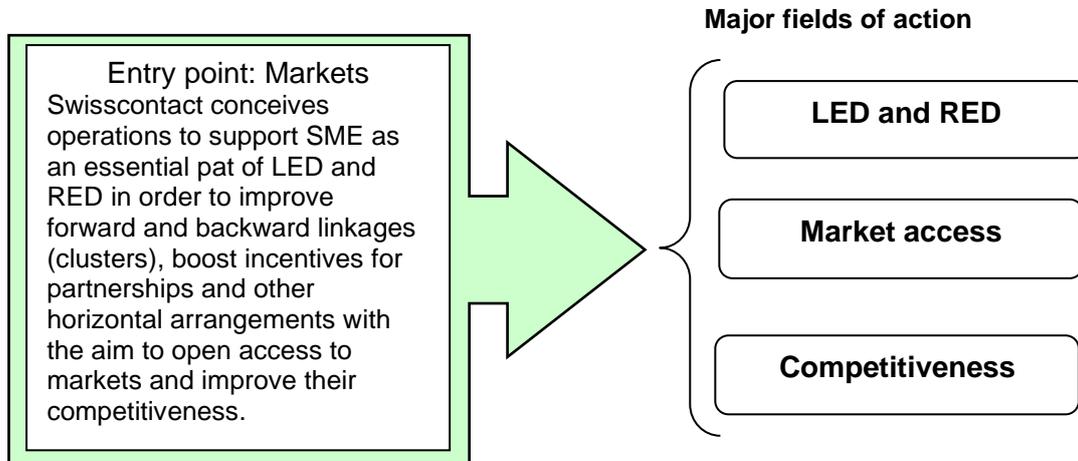
The experience of Swisscontact demonstrates that the promotion of an Enabling Business Environment (EBE) is not a quick fix and thus needs a long-term commitment. Secondly, EBE promotion is, in most cases, a combined approach that concentrates in sectors with high potentials with strong employment effects linked up to other SME promotion instruments such as BDS networks, access to credit, voucher programs, one-stop-services, etc. - The following two strategic choices for Swisscontact depend on the specific country context and the potential to combine both approaches.

A Market Development Approach: Increased competitiveness of SME

See ANNEX 1: The DESIDE Program: BDS Market Development.

Competitive markets, by definition, are self-regulating, and government regulation and intervention should be directed toward establishing clearly defined market procedures, ensuring equal access to and open disclosure of information, and facilitating market transactions. Markets, however, do not operate in a vacuum and at times market failures, asymmetric information, and other problems require interventions to improve efficiency and resource allocation. When implementing a private sector strategy and dealing with market development it is important that we keep in mind a number of principles, namely:

- The time horizon for implementing policies to promote market mechanisms in private sector development, in particular for SME and their coming to fruition is long. Programs need to take into consideration that successful market development requires a long time to be effective and they must factor this perspective to ensure the success.
- A powerful private sector development strategy recognizes that market and government failures are interlinked. Therefore, implementing a market development strategy requires identifying the needs of the private and public sectors.
- In the case of local market development such as LED and RED, poor management quality, or missing public goods will often be the prime focus.
- Getting markets right – supporting this through technical assistance and advisory services – is the top priority. This action requires coordination between the private sector and governments on the respective level.
- Stakeholders of the private sector that belong to a cluster or sector belong to a broad variety in terms of capacity and innovation potential, free riders and pioneers. Deciding how to start on the complex undertaking of market development requires a careful stakeholder analysis.
- Like all change, market reforms are a continuous process that is never complete. Once the first round of reforms is underway there will be a need to go deeper.



A-1 LED - Local Economic Development, Productive Municipality and RED - Regional Economic Development

The purpose of LED and RED is to build up the economic capacity of a territorial area (local, regional) and to improve its economic future and the quality of life for all. It is a process by which public, business and non-governmental sector partners work collectively to create better conditions for economic growth and employment generation. This includes the development of a demand oriented diversified BDS market (see below: A-3: Competitiveness of SME through BDS market development).

The view on clusters and production chains promotes SME within their specific economic and social environment and promotes interlinkages in order to low transaction costs and improve economies of scale. Clusters are a multi-sectoral and spatial and geographical concentration of enterprises which produces and sells a range of related or complementary products and are, thus, faced with common challenges and opportunities. These agglomerations give rise to external economies (such as the emergence of specialized suppliers of raw materials and components or the growth of a pool of sector-specific skills) and favour the emergence of specialized services in technical, administrative and financial matters.

Clusters are also a fertile ground for the development of a network of public and private local institutions which support local economic development promoting collective learning and innovation through implicit and explicit coordination. To a considerable extent the success of both LED and RED depend on the capacity of private SME and public organizations to work together and become equal partners (see below: B-3: Policy negotiation process).

A-2 Access to markets

LED and RED are means to overcome barriers to competition and to prospect and open new markets, particularly external markets driven by consumer pressure (environmental conditionalities, certification, fair trade, CSR). Swisscontact supports information systems and the necessary capacity development to enforce access to markets. By using the potential of the information and communication technology, these systems facilitate sound information and relevant knowledge on market access conditions for SME and promotes interlinkages between

SME and market agents. Such programs identify and bridge over market entry gaps for SME in specific sectors, goods and services. Swisscontact strengthens technical and organizational capacities of the SME until they are able to comply with market regulations and conditions in a competitive manner.

A-3 Competitiveness of SME through BDS market development

Swisscontact identifies the instruments and conditions needed to improve SME competitiveness in local, regional and international markets. To achieve this Swisscontact screens the potential of SME to enter new markets, investigates an area (sectoral, clusters, market sizes), defines the framework for support and selects BDS providers to be promoted.¹⁴ On the supply side such providers can be: private companies (medium, small), mainly in urban centers, serving rather medium to large size companies; associations, cooperatives, government institutions (training centers, common service facilities, export promotion services, etc.), NGOs and Universities. Qualified BDS are then strengthened to establish and provide the demanded services and monitored closely. The support to BDS is based on a business-like support mechanism; it reflects as closely as possible commercial practice on a contractual basis, mutually beneficial, simple to administer and transparent and concrete from the outset. In addition, Swisscontact impulses inter-linkages between BDS through alliances, facilitating cooperation between participating BDS and other institutions. As a means to impulse processes and increase the knowledge in the respective fields, the program facilitates the elaboration and ample dissemination of relevant information.

B Policy Networks Approach: Improved government regulations for SME

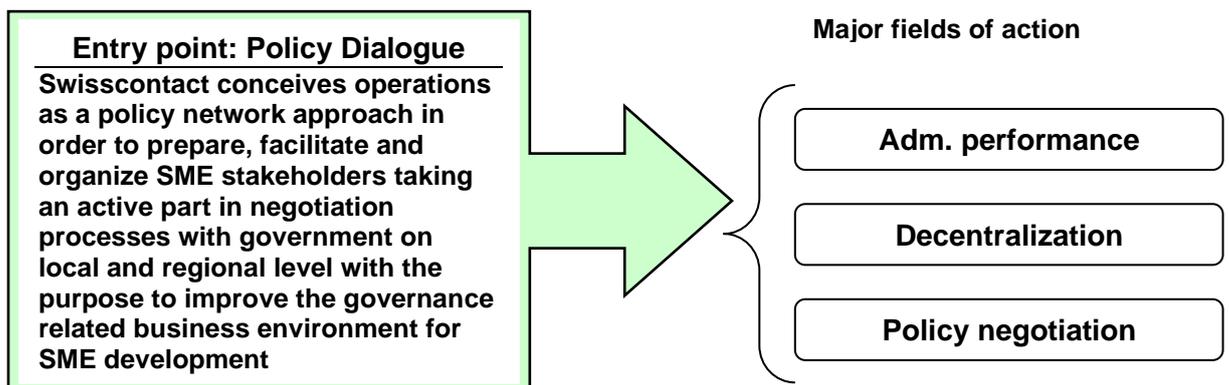
See ANNEX 2: The SHARE experience in Indonesia: Advocacy and Policy Dialogue.

Governments on all levels play a critical role in preparing the ground for business. They determine and enforce *the rules of the game* for private enterprise, particularly for SME. They establish and oversee a raft of tools essential to the **efficient conduct of business**. Vibrant SME development and markets depend on sound supporting infrastructure such as laws, regulations and quality public services, and the maintenance of this infrastructure is the responsibility of government on all levels. Reform programs can help governments sharply define their role as facilitators of business; and to make available to small entrepreneurs the basic business skills and assistance they require to develop. What is it that government must do in order to make markets work and foster an enabling business environment? They must:

- Create a stable and predictable legislative environment.
- Focus on quality, speed and transparency in government and administration; ensure effective and responsive public management.
- Facilitate overall market access in the country and open doors to export markets

¹⁴ Swisscontact has gained broad experience in this approach in the DESIDE Program in Peru, as well as in Indonesia. Establishing new BDS providers is an appropriate option for underserved regions and/or for demonstration purpose, especially in cooperation with local investors – but look at the market first! Key success factors from the Program in Indonesia are: (i) Selection through tender and two – step selection procedure, (ii) Intensive work on business plan and training of manager prior to final selection. (iii) Repeat tender if no viable partners can be selected rather than starting with doubtful partners, (iv) Clear contract, financing scheme and rigid financial monitoring scheme. (v) Limited company as legal form recommended, (vi) Non-financial support is important, but organize non-financial support in way that markets are not distorted, (vii) Be careful in selection of local investors – they might have different interests.

- Develop aggressiveness on the international markets (exports) as well as attractiveness for foreign direct investment.
- Invest in traditional *and* technological infrastructure.
- Promote private savings and domestic investment.
- Maintain a relationship between wage levels, productivity and taxation.
- Preserve the social fabric by reducing wage disparity and strengthening the middle class.
- Invest heavily in education, especially at the job related secondary level, and in the life-long training of the labour force.
- Balance the economies of proximity and globality to ensure substantial wealth creation, while preserving the value systems that citizens desire.



B-1 Administrative performance - from Red Tape to Smart Tape

Swisscontact strengthens sustainable economic growth of SME through tangible organizational administrative reforms in particular on local and regional level. These reforms have to be seen in the wider perspective of all concerned stakeholders. The unfriendly business environment cannot be turned around and changed only by SME. The redesign of institutions and processes, e.g. of a municipal administration, in terms of their effectiveness and of the relation between the public administration and the SME forms part of a broader process based on informed participation of major private and public stakeholders: SME and their associations, credit institutions, BDS providers, chambers, unions, professional organizations, municipalities and regional governments, etc.

Too much red tape is one of the most common complaints from SME and citizens in developing countries. Filling out forms, asking for permits and licences etc. is often extremely complex and cumbersome, generating unnecessary regulatory burdens. When excessive in number and complexity, administrative formalities can impede innovation, create unnecessary barriers to business, investment and economic efficiency, and even threaten the legitimacy of regulation and the rule of law. Swisscontact applies a set of tools and practices commonly used by local and regional governments to make administrative regulations simpler and less burdensome to comply with: One-stop shops (physical as well as electronic); simplification of permits and licence procedures; time limits for decision-making; assistance to small and medium-sized enterprises in implementing regulation; methods to measure administrative burdens; organisational and structural approaches to administrative simplification, and, more broadly, the use of IT-driven mechanisms.

B-2 Decentralization

In the context of RED and LED approaches, Swisscontact supports public service reforms based on proximity to users, fiscal responsibility, inter-governmental coordination and complementarity with the private sector. This includes: (i) to develop instruments for horizontal and vertical inter-governmental coordination to promote economies of scale in the provision of services; (ii) to correct regional imbalances through the coordination of multi-sectoral actions at determined regional and local levels; (iii) to promote the creation of a disciplined budgetary framework and shared fiscal responsibility on the part of subnational entities; (iv) to develop institutional capacity in subnational governments to effectively and efficiently provide public services that include a professional civil service and flexible structures for the provision of public services that include market incentives; (v) to strengthen the fiscal capacity of subnational governments, encouraging them to develop their own income as their primary source of revenue, including taxes and rates charged to citizens for services provided.

B-3 Policy negotiation process

Swisscontact supports joint private-public policy dialogues to strengthen private sector participation in the negotiation processes on SME related issues and establishes and implements institutional frameworks that recognize the participation of SME in the policy negotiation process of public policies. Swisscontact as a longterm partner of SME is an accountable partner to promote and encourage such participation in public policy formulation and execution on local, regional and national level. The support can be strongly linked to Programmes that aim at LED and RED or the support of the competitiveness of SME.

As an entry strategy, Swisscontact facilitates public policy reviews focused on the business environment that incorporate the perspective of SME development. In such review process, ensuring and structuring participation is paramount for success. New regulations are often inadequately considered and have unforeseen negative impacts on SME. Thus, policy assessments require thorough consideration and consultation among the stakeholders regarding the desired objectives and likely benefits of a new regulation at the formulation stage and scrutiny once the regulation takes effect. Based on the review's results, all stakeholders will be supported in conducting a participatory negotiation process that leads to concrete improvements of the regulations related to business registration, commercial lending, market development and other issues of an EBE. To overcome old patterns, advocacy of SME such as ombudsmen may help to improve mutual understanding between public sector actors and SME. Technical assistance of Swisscontact, based on its broad experience, will work with local and subnational governments and SME (i) to provide the access to new relevant knowledge about an EBE, based on a review of the effects of the present conditions and best practice in other countries, (ii) to enhance and ensure the participation of SME and other stakeholders in policy negotiation processes, aiming at an appropriate regulatory framework and efficient administrative procedures, and (iii) to shape and facilitate the negotiation process with the involved stakeholders (i.e. agenda management, confidence building, process facilitation).

ANNEX 1: BDS Market Development

Source: Systemizing experiences and results of the DESIDE program of SDC/SWISSCONTACT in Peru, by Markus Reichmuth, TULUM S.A.

In 1994, the Swiss Development Cooperation (SDC) decided to start a new kind of program in support of small enterprise development (SED). Instead of working through one or two selected counterpart institutions, it aimed at promoting market development in favour of SEs, in particular the market of Business Development Services (BDS). It entrusted this task to SWISSCONTACT, which called the program "Support to SE – DESIDE".

DESIDE inscribed itself fully in the new paradigm coming up towards the middle of the 1990s: to contribute to economic growth, to the consolidation and competitiveness of SEs by rendering BDS markets for SEs more dynamic. The program defined itself as a second-floor platform to promote the market approach in SED, intervening at the meso level (defined in this case as BDS markets – i.e. essential elements to make them work – and facilitating institutions) and the macro level.

Modes of operation

- *Market approach:* in both the business environment and in SED promotion, the program fosters a market facilitation and development approach; the function of selecting BDS providers to be supported is implemented in a systematic way by a specialized second-floor agency (DESIDE) with market-oriented instruments, selecting those who are interested and qualify; if a program partner does not comply with its obligation, it drops out of the program.
- *Demand-orientation through providers who know the BDS demand:* DESIDE investigates an area (sectoral, clusters, market sizes), defines the framework for support, and invites interested agents who qualify (for BDS supply, market research, monitoring of enterprise development centers/EDCs, etc.); the program establishes and applies the bidding conditions for pre-selected providers, and monitors closely the development of the selected ones.
- *Impulse to processes:* DESIDE implements, itself, few sub-projects on its own; it works through alliances and participates in groups of interested parties (programs, agencies, institutions) set up for specific purposes, facilitating processes and cooperation between participants.
- *Technical assistance:* DESIDE proposes to be a SED competency center, supporting the capacity development of people and institutions in this field.
- *Information sharing:* The program facilitates the elaboration and ample dissemination of relevant information as a means to impulse processes and increase the knowledge in the respective fields.

This approach implies, by design, some characteristics subject to questioning:

- a) Since the program reacted to initiatives and opportunities on several promotion levels, the different interventions by DESIDE can appear as being disperse, generating little articulation among the same target units (SEs) compared, e.g., to a project supporting a specific production sector or a specific local economy. Within all the activities supported by DESIDE, there may result few synergies. However, this approach looks actively for synergies with other initiatives, projects and programs: it defines its area of influence more broadly. A pre-condition for such an approach is an effective coordination and cooperation with other initiatives in the same field.

- b) If a program like DESIDE assumes such a second-floor platform function, the question arises what happens when it ends: Should somebody take over its functions? And if yes, who? Answers have been mixed: SDC aims at sustainability also on the level of promotion and would like to see a Peruvian institution play, or take over, such a role. Interviewed persons indicate, on the other hand, that DESIDE has played an important role in a historically specific moment, and several of its functions continue with a number of institutions, not just a principal one.

Lessons learned

Some of the major lessons which can be learned from the DESIDE program, are the following:

- Is it useful to exert a platform function as an external project? For a large part of the interviewed persons, the pro-active and consistent role of promoter of the market approach played by DESIDE, backed up by action (projects together with others), has been a positive experience. It accelerated the introduction of the market approach in SED up to the point of being mainstreamed. The multiple facilitations of DESIDE at the meso and macro level created learning processes quite intensively shared by interested persons, programs and institutions. The breadth of intervention – at different levels, with different actors – has built up a reputation useful for the promotion of the market approach in SED. As far as counterparts are concerned, the public sector (MITINCI) considered the support to PPME, including its personnel, as a major contribution of DESIDE and other cooperation agencies, allowing it to build up expertise and then obtain funds from the national budget. One (DESIDE as a platform) did not exclude the other (PPME build up, which was, unfortunately, not turned and formalized into a permanent national platform because of political and institutional instability).
- DESIDE applied novel intervention modalities in SED like
 - being able and willing to support opportunities and initiatives of qualified actors during the course of the program
 - not to continue working with partners who do not respond
 - introducing bidding processes for the selection of BDS providersThis last modality is considered useful and replicable, although its application is work intensive and requires the capacity to design bidding processes. Reacting to opportunities and initiatives has led, on the other hand, to program activities which among themselves may show little synergy and are not directed at the same target group; they can appear as disperse. DESIDE defined its role as a facilitating platform emphasizing alliances and effects which transcended a specific target group (e.g. EDCs or their clients). Well played, such modalities can foster several processes as they arise, at the same time. This is an interesting alternative to narrower approaches (e.g. sectoral, or local economy promotion), depending on the SED-relevant institutional set-up in a country.
- Is promoting the BDS offer a correct approach to promote SED? DESIDE's basic hypothesis was a stronger SED through BDS market development. Looking at DESIDE's results and taking into account its specificity (type of BDS provided, micro enterprises as main target group, and this in smaller markets outside Lima), the program's results have not been able to verify this hypothesis. Given the high level of subsidy in the main BDS – training –, it cannot be stated which percentage, and what kind, of BDS providers continue attending micro

enterprises in the absence of (mainly demand) subsidies, which continue to be offered in Peru. DESIDE argues that international cooperation as a payer of BDS is also part of this market and that subsidies contribute to support many markets. But in its pure form – self-generated provision of DESIDE-type BDS for micro enterprises which pay the full price to providers so that they survive on their own –, the hypothesis remains unverified (not necessarily falsified).

- The EDCs supported by DESIDE were heterogeneous in size, origin and orientation. DESIDE looked for those with the best business development perspectives. It learned that
 - NGOs which proposed to operate an EDC within its own structure, almost all failed, basically because the two require different mentalities and management orientation (support versus market).
 - Small individual BDS providers in regional markets remained micro enterprises (with on average three persons employed); they felt strongly exposed to unfair competition by either informal providers or not-for-profit providers exempt from certain taxes, hampering their development perspectives.
- In BDS promotion, should sectoral specialization be encouraged or rather general BDS provision? For a start, no general answer can be given to this question, which depends on circumstances. For EDCs in smaller markets and the type of BDS promoted by DESIDE (training, advisory services, information, marketing), DESIDE was forced in 1999 to abandon its sectoral orientation (e.g. clothing) in favour of general BDS as a consequence of the need of such EDCs to generate more sales. They need to sell larger quantities of low-cost services affordable for micro enterprises, rather than the more expensive technical advice (see the low number of technical assistance services sold by EDCs included in DESIDE's monitoring system). On the other hand, a few small regional EDCs think today they need to hook into specific supply chains to build up their existence (but maybe rather as informal providers, once DESIDE closes its door).

Moving up the firm size, the package SME require for substantial business growth (combination of in-house capacity building, relatively longer-term (expensive) technical advice from outside, investment often requiring external financing) is a different kind of story compared to the BDS markets promoted by DESIDE. The latter generates breadth rather than depth and did, furthermore, little to overcome the traditional isolation of micro enterprises (including EDCs).

- Has the BDS market been dynamized by DESIDE's intervention? Combined with other programs (like demand vouchers), yes, if one looks at the figure of clients attended by EDCs supported by DESIDE (over 30'000), which in the most part started their EDC with DESIDE support. But this market has been strongly subsidized; in fact, around 40% of clients were 100% subsidized. In 2003, 55% of BDS sold were paid by third parties, not the end-users (80% of which micro enterprises). As long as subsidies are coming forth, this offer may well continue, but this is hardly a long-term perspective.
Is, therefore, BDS market development oriented at micro enterprises a proposition with sustainability perspectives? Most interviewed persons reacted with scepticism, including EDCs.
- Has it been useful to provide instruments to BDS providers, like methodologies, performance monitoring, market information? Methodologies are useful if they leave space for further development and if sufficient facilitators are trained. A fixed franchise system with fixed content

did not work in Peru. Such instruments should, furthermore, promote the mentality to develop new services for the same clients, creating client loyalty, i.e. repeat clients.

DESIDE's monitoring system has been considered heavy in information requirements for the amount of incentives obtained, particularly by smaller EDCs, but the benchmarking it provided was highly appreciated – an instrument to be replicated elsewhere.

As to market information systems, the experiences of DESIDE (with the state, with the private sector) are inconclusive and point to further learning from other examples abroad, namely public-private partnerships, possibly privately managed but partly paid by public funds linked to market performance of the private operator.

- What is the impact of BDS provision on micro enterprises? DESIDE did not pretend to measure the quantitative and qualitative impact of promoted BDS on clients, having intervened mainly on the meso and macro levels, but client satisfaction surveys showed high satisfaction with the BDS received. Nevertheless, a majority of those who like to acquire further BDS would not return to the same provider, basically because they do not need the same service again, and most (smaller) BDS providers felt weak in developing follow-up services.
- At the macro level, the coordination roundtable has been an amply recognized positive experience despite its informal character. The high degree of transparency and cooperation among the participants, rather than competition, was felt by many to have exemplary character which should be repeated where possible.
- Efforts at the policy-making level have resulted in ample discussions of SE issues but in the Peruvian environment, the impact of national SED promotion laws are hardly felt by micro enterprises, basically because of a lack of instrumentalization (for SME, however, several interesting instrument have been created by the state, like e.g. export insurance and credit).
- Municipal SED, too, needs the political will, capacities and resources to improve the regulatory framework and take promotional measures. Only in the last two years of the DESIDE project did a change take place in this direction. Much of what DESIDE in a consortium with PPME and a specialized NGO did, was, therefore, preparatory in nature (the idea of local economic development had, politically, not yet come, compared to market development, when DESIDE started).

ANNEX 2: Advocacy and Policy Dialogue

Source: Swisscontact Indonesia

The SHARE Program at a glance

The SHARE program aims to create an enabling business environment that would sustain SME growth. Since 2002, the SHARE Program in Indonesia has set up the Small Business Council (SBC), an intermediary organization between SME and the Government, stimulating an environment conducive to private sector development. Together with the Asia Foundation, SHARE has set up SME groups throughout Indonesia including 64 regional and local forums. The Program aims to facilitate successful advocacy and policy dialogue between SME, BDS Providers and government agencies, big association groups, banks and media. SHARE is also concerned with surveys and research of the SME Market environment as tools to support sustainable bilateral communication. Swisscontact's role is to facilitate and direct specific dialogue between SME, BDS Providers and government. By accommodating their complaints and suggestions, local governments of Indonesia are able to better understand and meet SME needs. Concurrently, by gauging SME complaints and suggestions, local governments of Indonesia are materializing good and clean governance. The SHARE program offers win-win solutions for both SME and local governments. Surely, it is in the best interest to continue with the SHARE program throughout Indonesia.

Background

Indonesia is slowly recovering from the 1997/98 financial crisis. Its current real growth rates of 3 to 4% cannot sufficiently absorb increases in population and new entrants to the labour market, while contribution to poverty reduction also remains minimal. The financial crisis, however, has sharpened Indonesia's awareness of the role of Small and Medium Enterprises (SME) and their significant contribution to the economy and the eradication of poverty. To optimize their contribution to Indonesia's economic growth, Swisscontact Indonesia developed a number of programs focused on increasing SME competitiveness, i.e. a voucher program to boost the BDS market and, ultimately, the SHARE Program to promote an enabling business environment.

SHARE concentrates on developing public participation, especially that of SME, in providing complaints and suggestions to local governments and parliaments. Swisscontact facilitates the dialogue between the SME and government agencies in different provinces of Yogyakarta and Salatiga, Central Java. In Yogyakarta, Swisscontact helped build a Small Business Council (SBC), while in Salatiga, Swisscontact helped create an Ombudsman as vehicles for the public to voice their complaints and suggestions. Today, both SBC and Ombudsman are acknowledged as official extensions of the local governments of Yogyakarta and Salatiga. Inputs provided by these forums are well received and acted upon.

Partners in development and public voice

As a facilitator and partner Swisscontact encouraged and endorsed local stakeholders and governments to participate in building SBC and Ombudsman. This was necessary to create a mutually beneficial partnership and nurture a sense of ownership. Partners in development were selected by Swisscontact on the premise of their ability to best support creation and development of SBC and Ombudsman. As SHARE is a regional based project, many potential partners from a number of provinces, including South Sulawesi, East Java, Yogyakarta, Salatiga, West Java, Jakarta, North Sumatra, and West Kalimantan, were invited to submit proposals.

In selecting the most suitable partner, potential partners were asked to present their ideas on the activities of SBC and Ombudsman, how to approach local governments, how to lobby local parliaments, how to conduct workshops with SME and SME associations, etc. to a panel of decision

makers. The presentation was held in Jakarta and each participant was given the opportunity to present and discuss the proposed action plan. Finally, Swisscontact approved two proposals. From the Special Province of Yogyakarta, Swisscontact selected the Association for Community Economic Development and Studies of Micro enterprises (PKPEK). Founded in August 1992, PKPEK was formally established in August 1994. PKPEK is focused on fighting socio-economic problems faced by marginalized communities through the empowerment of micro and small enterprises and the encouragement of fair and just business practices. PKPEK has been actively involved in supporting community economic development through a number of programs, including conducting needs assessments, feasibility studies, and project appraisals; identifying markets for products; providing managerial, financial, and technical consultation; advocacy to promote policies that create a more conducive business environment for micro and small enterprises. PKPEK has extensive and successful experiences in dealing with the local government of Yogyakarta.

From Salatiga, Central Java, Swisscontact selected the Centre for Micro and Small Enterprise Dynamics (CEMSED). Founded in 1993, CEMSED was formally established in January 1994. CEMSED is focused on being a study center that calls attention to, records, follows, and encourages positive changes in micro and small enterprises, government cooperatives as well as supporting financial institutions. It is also focused on being a study center that provides developmental assistance that deals with constructive criticism and information regarding situations with poverty, injustice, deception, and conflict. In supporting micro and small enterprise development, CEMSED offers assistance in areas of research, training, consultancy, and advocacy; distribution of information and promotions; model development; and development of 5 to 10-year business plans. CEMSED is a seasoned expert in dealing with the local government of Salatiga.

As Local Partners, PKPEK and CEMSED acted as facilitators and organizers in developing forums for advocacy and policy dialogs. In Yogyakarta, since its people have a tendency to create and be engaged in associations, PKPEK created a SBC to facilitate public participation. In Salatiga, on the other hand, since it's a small city and its people are highly interactive, CEMSED created an Ombudsman to gauge public voices. Though different in structure, both SBC and Ombudsman have similar functions in addressing public concerns.

Launching and operation

Since the SHARE program is a new approach that has never been initiated elsewhere in Indonesia, discussions of implementation with local governments, parliaments, and stakeholders took several years. A lot of time was spent on convincing that SBC and Ombudsman would provide benefits for both the local governments and communities of Yogyakarta and Salatiga. Discussions were highly influenced by social and political conditions of the time, which also attributed to the lengthy discussions.

Together with the local governments, parliaments, and stakeholders, it was agreed that there is a need for an infrastructure to receive and process complaints and suggestions from the public. This was especially anticipated to help SME development, since they are the backbones of the local economies. It was recommended that the infrastructure should be easily accessible and offer fast response and solutions. It was decided that the infrastructure should capture complaints and suggestions through phone, fax, mail, email, SMS, and over-the-counter.

To provide such infrastructure, Swisscontact and local partners worked with local IT companies. A tender was also held for selection and assessment criteria included experience in developing information networks and mediums for public participation. In Yogyakarta, the selected IT company was PT Exindo and in Salatiga, Salatiga Camp. Within several months, the IT companies were able to build the required infrastructure.

To promote SBC and Ombudsman to the public, a launching was held in each city. During the launching, the public was given information on the many different approaches available to convey complaints and suggestions to their respective local governments, how their inputs are received, processed, and acted upon.

Currently, Swisscontact and the local governments conduct monthly evaluations. Local Partners now act as consultants, while the IT companies guide SBC and Ombudsman with filing and processing complaints and suggestions.

The Outlook

Since the SBC in Yogyakarta and Ombudsman in Salatiga have shown positive outcomes, the local government of Parepare, South Sulawesi has formally asked Swisscontact to set up a similar vehicle for public complaints and suggestions. The local government of Parepare acknowledges the advantages of good and clean governance, and its need for public participation to materialize better governance. To show their support, the local government of Parepare has specifically asked Swisscontact to help build an SBC and provide software, such as programs and training, while they provide the necessary hardware.

Parepare's enthusiasm proves that there is a need for a vehicle that accommodates public complaints and suggestions in Indonesia. However, continuing with the program requires additional assistance outside of Swisscontact. Those who are already working on the SHARE program with Swisscontact are aware of this problem.

For Indonesia to fully recover from the 1997/98 financial crisis, the economy must be able to absorb increases in population and new entrants to the labour market. In particular, it must support SME, who have proven to be the backbone of the Indonesian economy since the financial crisis. The key to economic recovery lies in sound SME development in an enabling business environment.

ANNEX 3: Reforming the business environment to achieve MDGs

The UN Millennium Development Goals / MDGs form an overarching framework of development objectives. The promotion of an enabling business environment / EBE for SME fully complies with these goals and contributes substantially to the eradication of extreme poverty.

- 1 EBE removes constraints to small enterprise growth, lowers the barriers to participation by the poor in the private sector and contributes to enhance economic growth in particular of low income population groups, hence, it complies with the first goal of the MDGs, the eradication of extreme poverty.
- 2 By removing the constraints and barriers to women's participation in markets and female-owned enterprises, EBE reforms contribute to the third MDG, the promotion of gender equality and empowerment of women, and thus implicitly to the second goal of the MDGs, the access to primary education.
- 3 By improving financial flows into poor households, a better business environment for small enterprises will help poor households gain access to maternal health care, thus improving maternal health and reducing child mortality rates (MDGs Number 4 and 5).
- 4 By improving compliance rates among small enterprises, the EBE can contribute to ensure that sound environmental laws and regulations are enforced to promote environmental sustainability (MDG Number 7).
- 5 By integrating national business environments with global trade and investment opportunities, EBE reforms can contribute to a global partnership for development (MDG Number 8). Specifically, this is achieved through the:
 - Promotion of an open, rule-based, predictable, non-discriminatory trading and financial system, and a commitment to good governance, development, and poverty reduction.
 - Development and implementation of strategies for decent and productive work for youth.
 - Transfer of new technologies, especially information and communications.

ANNEX 4: Selected Bibliography

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