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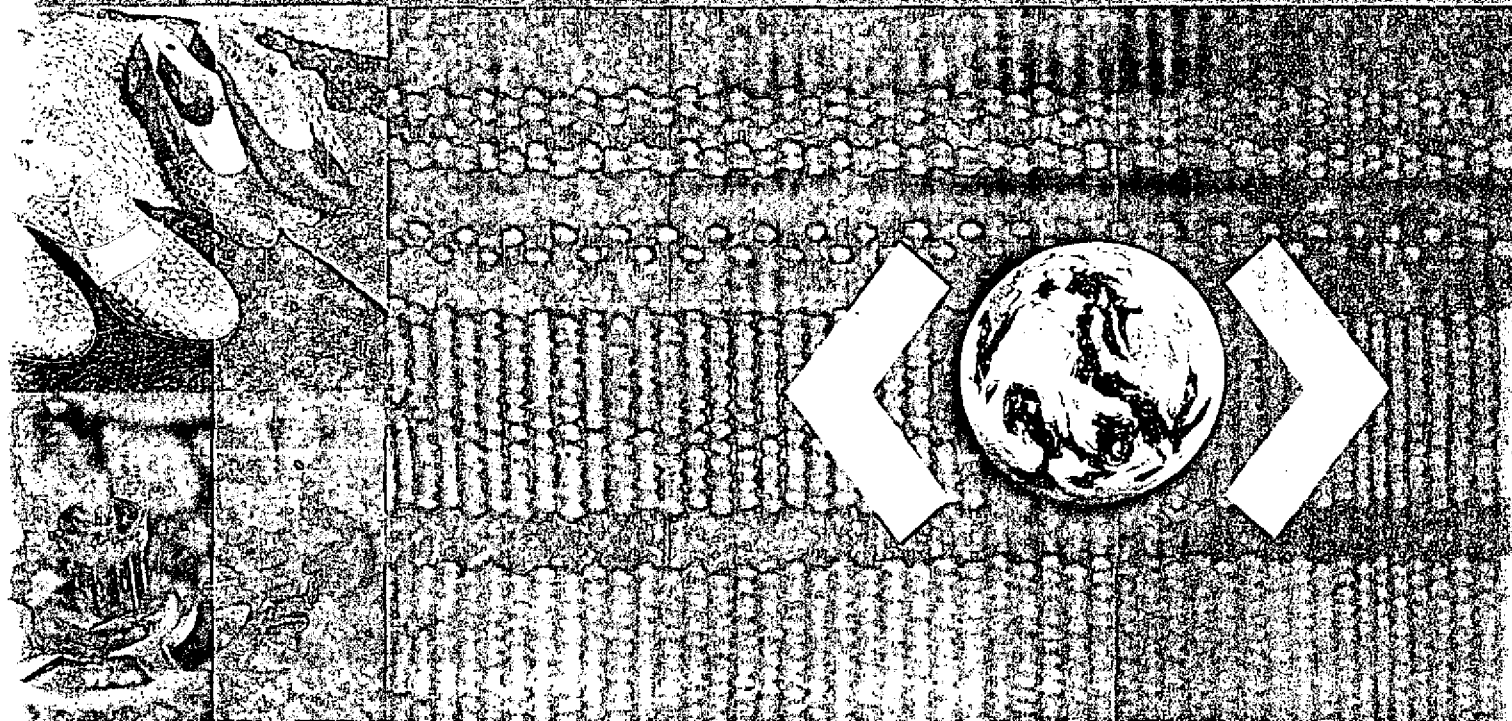
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COMBATING MARGINALIZATION AND POVERTY  
THROUGH INDUSTRIAL DEVELOPMENT

«COMPID»



# Productivity enhancement and equitable development: Challenges for SME development

## Summary



UNITED NATIONS  
INDUSTRIAL DEVELOPMENT ORGANIZATION

# 《COMPID》

COMBATING MARGINALIZATION AND POVERTY  
THROUGH INDUSTRIAL DEVELOPMENT

## Productivity enhancement and equitable development: Challenges for SME development

### Summary

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## INTRODUCTION

The report on *Productivity enhancement and equitable development: Challenges for SME development* is part of the broader research programme, Combating Marginalization and Poverty through Industrial Development (COMPID), of the United Nations Industrial Development Organization (UNIDO).<sup>1</sup> The central aim of the report is to analyse the role of small and medium enterprises (SMEs) in the process of increasing productivity—which is a precondition for competitiveness, economic growth, sustainable employment creation and higher wages—and the possible trade-offs with equitable development. The findings of this analysis are then translated into practical conclusions for SME policy with special emphasis on recommendations for UNIDO's service portfolio.

As is widely recognized, countries with high productivity are able to achieve high standards of living without necessarily losing price competitiveness. This is because goods and services produced with more productive workers can be sold at lower prices, and therefore allow for high wages. If goods and services are offered at competitive cost, demand (and market shares) tends to increase. At the same time, high wages increase motivation. They also allow a broader range of workers—women in particular—to participate in the labour market (Inter-American Development Bank [2001]), thus further increasing the income of households. Countries with high productivity tend to be wealthier and real wages are usually higher. Productivity growth can be considered, therefore, an important means to reduce poverty.

All over the world, SMEs are being supported on the grounds that they make substantial contributions to productivity growth and, consequently, competitiveness and aggregate economic growth. In addition, SMEs are believed to be especially effective job creators and enjoy the reputation of being sources of income, providing training opportunities as well as important basic services for disadvantaged people. SME promotion can be viewed, hence, as an important trigger for poverty reduction both indirectly, by adding to productivity and overall economic growth, and directly, through the immediate contribution of SMEs to employment and income generation, skill upgrading and the decentralized provision of goods and services.

The report scrutinizes some of these assumptions. Do SMEs really make substantial contributions to productivity growth? Or, more specifically, are SME-based economies more productive than those characterized by large enterprises? Do countries with a high share of SMEs grow faster? What is the role of SMEs in the production system, for example, in the interfirm division of labour with large enterprises? Is GDP growth more equitable and does it reduce poverty faster, if the economic structure is characterized by small enterprises? Are SME-based

<sup>1</sup>COMPID includes the following five projects: (a) Supporting industrial development: overcoming market failures and providing public goods; (b) Technological development in low-income countries: policy options for sustainable growth; (c) Industrialization and poverty alleviation: pro-poor industrialization strategies revisited; (d) Productivity enhancement and equitable development: challenges for SME development; and (e) Social capital for industrial development: Operationalizing the concept.

economies more labour-intensive and socially inclusive? Apart from employment creation, to what extent do SMEs make other contributions to equitable development, for example, developing the skills of the poor or broadening the tax base? The report looks at experiences of both *developed and developing countries*. Although the ultimate aim is to draw policy conclusions for the latter, the comparative perspective provides important general insights into the dynamics of private sector development.

Many studies, especially from a microeconomic point of view, identify SMEs as important drivers of productivity-enhancing innovation. However, a cross-country analysis shows that the share of SMEs in an economy is not clearly correlated with the rate of productivity growth. In fact, countries with a very different mix of small and large enterprises may be equally competitive and have a similar record, in terms of productivity and economic growth. With regard to job creation, findings are equally ambiguous. On the one hand, especially in least developed countries and rural areas, micro- and small enterprises employ a huge percentage of the workforce and offer opportunities for poor population groups. On the other hand, much of the microeconomic research undertaken casts doubts on the assumption that SMEs are particularly effective job creators, especially if *net effects* (job creation minus destruction) are considered (Davis, Haltiwanger, Schuh [1993]).

Given this heterogeneity of empirical observations, the report takes a closer look at the contribution of SMEs to productivity enhancement and equitable development. It argues that the explanatory power of quantitative cross-country analysis is limited because aggregate data fail to capture the diversity of manifestations of SME, namely, they have very different origins, *fulfil dissimilar tasks in their respective economic environment and make highly diverse contributions* to productivity growth and employment. It is, therefore, necessary to differentiate between the various types of SMEs, for example, whether they are formal or informal, innovative or restricted to routine activities in traditional markets, whether they have been created to exploit a promising business idea or to provide a minimal additional income in situations of distress, whether they compete with scale-intensive mass production or specialize in niche markets.

Chapters I and II review and summarize the existing literature on the contribution of SMEs to productivity growth and equitable development, respectively, in both developed and developing countries. Taking the findings of those two chapters into consideration, Chapter III then analyses selected policy instruments and outlines a growth- and development-oriented SME development strategy for low-income countries.



## I. THE ROLE OF SMES IN GENERATING PRODUCTIVITY GROWTH

Productivity growth is an important factor for creating public welfare and reducing poverty. It requires a different, or more efficient use of factors, presupposing that factors are reallocated in the production process. In short, productivity growth implies innovation.

The main drivers of productivity growth and innovation are entrepreneurs. Entrepreneurs seek to increase their profits by searching for opportunities in novel value-generating activities. Innovation enables enterprises to achieve higher profits ("innovation rents"), because it temporarily creates barriers to entry, thus limiting competitive pressure and allowing innovators to escape from price-based competition. The greater the barriers to entry, the higher the levels of profitability. Therefore, innovative enterprises are better able to invest and grow. The constant process of trial and error, selection and learning, continuously generates more productive ways of doing things, replaces less efficient business models and enterprises and, thus, makes the economy more competitive.

Innovation, in this sense, is a novelty that offers entrepreneurs opportunities to make above-average profits. Consequently, innovation is always related to a given context. Especially in the context of low-income developing countries, it must be borne in mind that innovations not only include changes in process technology, but also the introduction of new products, or the customization of their design to the demand of new customers, as well as any organizational improvement, which are all frequently based on imitation. Tapping into the world's pool of existing technologies and managing the process of technology appropriation are, therefore, much more important for developing countries than science-based original inventions.

While it is apparent that entrepreneurial trial and error advances innovation, the contribution of SMEs, in particular, is less clear. Although some sources claim that SMEs serve as vehicles for innovation and change, empirical evidence is not so straightforward. In OECD countries (for which the most reliable and comparable data are available), the size distribution of enterprises varies enormously among countries with a similar economic performance. In Italy, for instance, large enterprises employ only 17.8 per cent of the manufacturing workforce and contribute only 27.4 per cent to value added, compared with 39 per cent of employment in Germany (54.5 per cent of value added), and 44.9 per cent of employment (40.8 per cent value added) in the United Kingdom of Great Britain and Northern Ireland (Schmiemann [2002]). While data on developing countries are less reliable, available evidence casts similar doubts on the assumption that there is a clear correlation between the size of the SME sector and economic performance.

Whether and to what extent SMEs are important for innovation, productivity growth and competitiveness depend very much on their role in the overall production system. Some SMEs clearly play an important complementary role in the industrial structure of a country and they are important drivers of structural change. In many developing countries, however, a large



number of SMEs face significant challenges in maintaining their competitiveness as a result of outdated business models and serious disadvantages of scale leading to low productivity levels. In short, SMEs make substantial contributions to productivity growth, strengthen the competitiveness of the overall industrial structure and enhance GDP growth (only) when they generate positive externalities, especially via:

- *Innovation:* This creates new markets or enables one to pursue new ways of doing business. Changing market conditions entail a continuous adaptation of industrial structures. New enterprises introduce new products and processes. Some established ones might be unable to compete and, therefore, disappear from the market, allowing better-adapted enterprises to take their place. In competitive markets, between 5 and 20 per cent of the enterprises enter and exit the market each year. Some small enterprises may become big, while some of the large ones may either fail, or decide to shed activities and spawn smaller new enterprises. This process of entry and exit, or growth and decline, creates a healthy turbulence and demands a constant search for a more productive employment of resources, leading to structural change;
- *Enhancing the degree of specialization:* Some SMEs complement large enterprises, bringing in advantages of flexibility, lower transaction costs due to close contact with customers, and enhance decision-making. Large enterprises, however, exploit the advantages of scale. In some industries, trade liberalization enhances the advantages of scale-intensive production, crowding out small-scale competitors. In others, on the contrary, changing demand conditions give rise to new forms of industrial organization, which favour small-scale production because of the importance of economies of scope. In these industries, the flexible delivery of a broad range of customized products becomes a key issue. This often means that large enterprises need to restructure and out-source business activities, thus creating new market opportunities for small firms. At the same time, large enterprises usually continue to be important sources of technological know-how and gateways to new markets. This interlocking of specialized small and large enterprises allows the whole system to reap the benefits of specialization and increase productivity.

Competitiveness is, thus, a question of having the right mix of small and large enterprises and an adequate division of labour that combines economies of scale with flexibility and the advantages of specialization. Obviously an optimal combination of small and large enterprises across sectors and countries does not exist. The actual outcome of the industrial structure in a given country thus depends on many individual and location-specific factors. These include technological indivisibilities, market size, the degree of competition or oligopolistic concentration, the existence of administrative barriers to entry for new enterprises, tariff structure, transaction costs, demand conditions and so on.

Even though many factors distinguish the industrial structure of locations, some general differences are more obvious, if developing countries are compared with mature industrial economies. The report identifies the following five main differences with regard to the role of SMEs in the production system:

- *The role of entrepreneurship:* In mature industrial economies, the relationship between entrepreneurial activity and macroeconomic growth is strong. High entry (and exit) rates of

enterprises are healthy for the economy. They accelerate the process of innovation, competitive selection and adaptation to changing markets. Developed countries, consequently, place considerable emphasis on fostering entrepreneurial activity through start-ups. In developing countries, the relationship between entrepreneurship and growth is different. Here, the degree of entrepreneurship usually increases with decreasing per capita income and economic recession often leads to an increase in the number of start-ups. In Zimbabwe, for example, small enterprise entrepreneurship declined as macroeconomic growth rates increased, and vice versa (Reinecke [2002]). Turbulence could thus be high without spurring substantial innovations and macroeconomic growth.

New comparative analyses help to explain the apparent differences between developed and developing countries, demonstrating that the relationship between entrepreneurship and growth follows a U-shaped curve. The lower the gross domestic product (GDP) per capita for a country, the higher the share of entrepreneurship; at a certain point, however, per capita income and the rate of entrepreneurship merges, after which the relationship reverses, and growing GDP per capita levels correspond with growing entrepreneurship levels (Carre and others [1999]).

The distinction between entrepreneurship by “necessity” and entrepreneurship by “opportunity” provides a plausible explanation for this. Whereas “opportunity” entrepreneurs are motivated by an innovative and promising business idea, “necessity” entrepreneurship is basically a response to over-supply of labour. When the economy (including formal sector employment) contracts, poor unemployed people create new microenterprises or become self-employed in order to compensate for the declining family income, even if they see market opportunities for their activities getting worse. Enterprises created out of “necessity” are typically confined to traditional, technologically simple activities with low entry barriers, which translate into over-supply, fierce price competition and very low profits. With the improvement of economic conditions and increasing opportunities for dependent employment, many of these entrepreneurs revert to becoming employees. “Necessity” enterprise formation is especially symptomatic of poor developing countries lacking social safety systems;

- *Enterprise growth and upgrading:* Empirical evidence from different developing regions shows that only a very small portion of the micro- and small enterprises manages to expand beyond a certain threshold, typically around 20 employees, where more systematically organized structures are required. This reflects that small entrepreneurs in developing countries normally have minimal formal education, and high-quality management consultancy services are often not available or affordable. As a result, the layer of medium-sized enterprises is usually weak, a phenomenon commonly known as the “missing middle”. This is an important disadvantage because such enterprises are in a position to combine the advantages of flexibility, quick decision-making, commitment and close contacts with customers with certain scales of production, and can therefore fulfil an important complementary function in many production systems. Medium-sized enterprises (as well as some highly professional small enterprises) normally occupy specific niche markets—often in the “interstices” left over by larger enterprises—and, in this way, expand the specialization spectrum. Such enterprises also help to bridge the gap separating micro- and small enterprises from the modern, large-enterprise sector;

- *Technological capabilities:* Production systems in developed countries are characterized by relatively advanced technological capabilities. Even though these capabilities are often located mainly in large enterprises, a significant number of SMEs have the ability to adopt complex technologies or even create new technologies and invest in research and development. In developing countries, the vast majority of SMEs are low-technology enterprises focusing on routine operations, with limited technical capabilities, mainly copying locally established means of doing business and using mature technologies as blueprints. Moreover, entrepreneurs often do not perceive the need for innovation. This is not a surprising feature for the large number of micro- and small enterprises which have been created because of an immediate need for survival and because they invariably lack crucial resources, such as finance, human capital, technological and market information. However, even medium-sized enterprises rarely create technology, employ a significant number of engineers, or systematically seek innovations. This is due not only to supply-side constraints: it also reflects the low demands of domestic markets;
- *Export competitiveness:* In most developing countries, the production of exported goods is predominantly borne by larger enterprises. Only a few SMEs export regularly. This holds true especially for countries in Africa and Latin America, while some of the export-oriented economies in Asia constitute remarkable exceptions. While in China (including Taiwan Province of China) and the Republic of Korea, SMEs contribute more than 40 per cent to the export of manufactured goods; the SME share in some countries in sub-Saharan Africa is lower than 1 per cent. The overall disappointing export performance of SMEs in developing countries is a reflection of the productivity gap between small and large enterprises. With the exception of some export-oriented countries in Asia, SMEs tend to focus on local markets and only see exports as additional, secondary markets, often to balance cycles of economic slowdown in their home markets;
- *Interaction between large and small enterprises:* In mature industrial economies, SMEs and large enterprises specialize in a complementary way. Here, small enterprises act primarily as suppliers, franchise or service providers for medium and large enterprises, or they specialize in niche markets for customized goods. Only a few SMEs try to compete in the production of mass-produced goods. Owing to their specialization, SMEs fit into competitive value chains and contribute to the efficiency and competitiveness of the whole system.

The situation in developing countries, in general, is different. Here, SMEs are mainly dedicated to petty trade, personal services, traditional crafts and basic manufacturing activities, for example, garment and shoe production or furniture making, where they compete with mass-produced products and services. Due to insufficient economies of scale, such SMEs are exposed to strong displacement competition by large local enterprises and large-scale imports. Only a small proportion of SMEs belongs to the group of complementary SMEs, which includes providers of niche products as well as specialized suppliers for large industry. Supply chains are usually short and involve few SMEs, reflecting the shortcomings of these enterprises with regard to price, quality, volume and reliability. Likewise, other forms of small-large enterprise cooperation, such as franchising, joint ventures and technology licensing, do not appear to be as widely used as they are in developed countries. In general, small and large enterprises in developing countries do not use their comparative advantages efficiently, and often fail to exploit the potential synergies of cooperation. In addition, such industrial organization limits the scope for technology transfer from large to small enterprises.

These differences explain why cross-country regressions show that a large SME sector by itself is not a source of competitiveness and does not enhance productivity and economic growth. The extent to which SMEs contribute to productivity growth largely depends on specific characteristics and their role within the respective national production system. SME policy, therefore, should emphasise promoting enterprises, which innovate and open up new markets, to generate externalities and enhance national competitiveness.



## II. THE CONTRIBUTION OF SMES TO EQUITABLE DEVELOPMENT

While growth is a major objective of economic policy, other goals, such as equity, are equally important. In the context of developing countries, the political objective of generating equitable development relates, in particular, to poverty reduction. Poverty and inequality are very closely interlinked. Given a certain mean income, the more unequally this income is distributed, the higher the number of people that will live in poverty.

There is a great deal of consensus in economic theory and development policy on the fact that growth is necessary to reduce poverty. Unless aggregate income increases, the income levels of the poor will not rise significantly. To make development equitable, the poor ought to have at least a proportional share in income growth (this would leave equity levels unchanged) or their share must be raised, thus leading to a more equal income distribution (“pro-poor growth”).

The extent to which the poor are able to benefit from economic growth basically depends on the initial level of inequality. The growth elasticity of poverty alleviation—the percentage to which the poverty rate alters, given a 1 per cent change in average income—is higher if inequality was initially lower and is reduced further. This has been empirically validated mainly for inequality in assets, but also—to a lesser extent—for inequality in monetary incomes. The political message is evident: growth is a necessary economic condition for poverty reduction, but equity needs to be enhanced through measures that strengthen the chances of the poor to participate in economic development.

Furthermore, unequal chances of economic participation impede the efficient allocation of resources. Poor people often have lesser chances in life than the rich, because they do not receive as good an education, or because their access to loans to start a business is not as easy, or because they cannot afford the insurance required to undertake risky investments. It is, therefore, plausible to assume that an economy with an unequal distribution of opportunities tends to underutilize its aggregate productive potential. To overcome this, addressing equitable development by mobilizing productive resources of disadvantaged groups, for example, small informal sector enterprises, may contribute to aggregate growth.

However, empirical analysis does not support a clear causal relationship between growth, equitable enterprise structures with a high SME share and poverty reduction. Although it is frequently claimed that SMEs make the most significant contribution to job creation and, in times of crisis, informal microenterprises make up a buffer to provide poor people with a basic income, econometric cross-country studies show that there is neither clear evidence of a high share of SMEs contributing to economic growth nor is there evidence that SMEs reduce poverty (Beck and others [2003]). Moreover, one must take into account that poverty is not only the lack of sufficient pecuniary income, but has other dimensions, including

social exclusion, vulnerability and the deprivation of political rights. Thus, it is necessary to take a more qualitative and detailed approach in line with up-to-date multidimensional poverty concepts.

The four main mechanisms through which SMEs contribute to equitable development are identified as follows:

- *Employment and income:* In most developing countries, SMEs employ the highest percentage of the workforce. In some countries in Africa, micro- and small enterprises employ twice as many people as large registered enterprises. Moreover, SME employment, especially in the informal sector, tends to increase, while employment in medium and large enterprises and also in the public sector declines. In 9 out of 12 countries in Latin America, the percentage of persons employed by micro- or small enterprises increased between 1990–1991 and 2000. Employment generation by SMEs is sometimes especially pro-poor because such enterprises provide employment and income in regions and economic sectors where most of the poor live and where few other employment opportunities exist. For example, non-farm activities (which are mostly in micro- and small enterprises) currently contribute 42, 40 and 32 per cent of rural household incomes in Africa, Latin America and Asia, respectively, and show a tendency to increase (Davis and others [2002]). Rural SMEs, therefore, contribute to a more decentralized pattern of industrial development.

In addition, SMEs are important employers, especially for population groups that encounter difficulties in securing employment in the formal labour market. These include, inter alia, persons with low educational and skill levels, women who take care of their families, children, the elderly and handicapped. However, two points must be emphasised: first, much of this employment represents self-employment and small-scale activities with a rather low potential for technological upgrading and growth. Exit rates can at times be higher than entry rates, so that the net employment effects of the small-scale enterprise sector can be negative at a given point in time. Secondly, all available evidence suggests that jobs in small enterprises, though often the only ones available to members of these groups, can be significantly less productive, less remunerated, less secure and less unionized than jobs in larger enterprises;

- *Human capital formation:* Improving the human capital endowment of the poor has both growth-stimulating and poverty-reducing aspects. Poor people have only limited access to vocational educational institutions and professional training courses. On-the-job training in micro- and small enterprises, including informal apprenticeships, therefore, is particularly important for them. Micro- and small enterprises not only employ a significant number of informal apprentices, they also absorb a large number of family members and others of a similar status. Informal training is often a precondition for obtaining a job in more lucrative areas of a given sector, and this, combined with further on-the-job experience, constitutes a good basis for self-employment.

It is interesting to note that entrepreneurs in Africa actually consider apprenticeships to be the most important learning experience, even more important than schooling and other forms of education. Approximately 70 per cent of all workers in Africa in the urban informal sector have been trained through traditional apprenticeships. However,

the limitations of informal training in micro- and small enterprises need to be considered. Small enterprises invest less in training than large enterprises, most of them are confined to undemanding activities with low barriers to entry, and most entrepreneurs do not have a comprehensive vocational education. Under these circumstances, apprenticeships usually lead to copying traditional low-skill activities rather than creating the knowledge base for innovative (and thus growth-enhancing) activities. This calls for an increased supply of formal training or, alternatively, the reorientation of informal skill upgrading schemes towards innovation-oriented contents;

- *Provision of basic goods and services:* SMEs play an important role in providing basic goods and services to the poor, especially in marginalized rural regions and deprived urban quarters that (due to low levels of demand and high transaction costs) are not fully integrated in the distribution networks of large enterprises. As argued in the report of the United Nations Commission on the Private Sector and Development “Unleashing Entrepreneurship: Making Business Work for the Poor” [2004], the private sector, and especially small-scale entrepreneurs located in marginal rural areas as well as in deprived urban quarters, have a crucial role to play in reaching the “bottom of the pyramid” consumers, or the over four billion people living on an annual income of less than US\$1,500.

In many developing countries, for example, only a small segment of the population has access to large-scale public utilities, and usually the poorest do not benefit from public services at all. In most cities in developing countries, for instance, more than half the population is supplied with basic water services from sources other than official utilities (Solo [1998]). Taking the above shortcomings into account, there is considerable scope for small-scale provision of basic services, such as water, sewage and electricity. The same applies to manufacturing; where about 25 per cent of informal SMEs in developing countries are engaged, mostly producing basic consumer products for low-end markets;

- *Public revenues:* Equitable development needs public revenues. In particular, poverty alleviation in developing countries requires substantial public investment in health, education and infrastructure. This investment has to be financed in some form; taxation is one major source. SMEs are—at least potentially—important taxpayers. In developed countries, these enterprises are very often a major source of tax revenues. While in developing countries they are probably less important, they nevertheless make relevant contributions to the revenues of decentralized authorities.

In short, SMEs make equally important contributions to equitable development and productivity growth, but again the heterogeneity of the sector must be taken into consideration. It is sometimes argued that there are tradeoffs between the SMEs’ contribution to increasing productivity and to achieving a more equitable income distribution. This is due to the fact that higher productivity may reduce the demand for labour, if the respective enterprise (or sector, country or region) does not manage to capitalize on its productivity gains and increase its sales. Furthermore, rationalization is often effected at the expense of unskilled workers, and labour markets tend to demand relatively more highly skilled workers. As a result, the rate of unemployment may increase and wages may decrease, especially among the poorest segment of the workforce.

In the long run, however, there are no trade-offs. On the contrary, if economic growth is the most important *single factor for boosting employment and income opportunities for the poor*, as well as for ensuring the provision of basic services and social protection, and if productivity growth is a precondition for sustainable competitiveness and economic growth, productivity growth is definitely necessary to achieve equitable development.





### **III. FROM ANALYSIS TO PRACTICE: SME POLICIES FOR LOW-INCOME COUNTRIES**

The preceding analysis on the role of SMEs for enhancing productivity growth and making development more equitable has considerable implications for practical policy. Nevertheless, it helps to better define priorities and to identify aspects that do not receive due attention in SME programmes. In some cases, it challenges the traditional practices of SME promotion. The final chapter of the report translates the findings contained in the previous chapters into practical SME policy, with special reference to the conditions prevalent in low-income countries, and draws conclusions for UNIDO's service portfolio.

What are the most important policy conclusions? First of all, SME development depends largely on a business-friendly environment, emphasising the rule of law, fair competition, as well as low levels of red tape and corruption. One of the most important challenges is to overcome policy distortions that hinder enterprises from entering the market and constrain their growth. Such distortions fall relatively heavily on small enterprises. A good overall private sector policy is, therefore, much more important than specific measures for SME promotion. However, there is a case for policies addressing SMEs in particular. SMEs face difficulties in obtaining credit and relevant information. They also lack the necessary resources for systematically making use of institutional and interfirm networks.

SME policy needs to balance targeted interventions aimed at creating employment opportunities for poor population groups, especially in rural areas, and extending support to more promising activities and clusters of enterprises, which are potential drivers of future economic growth. The report stresses the limitations of short-term interventions aimed exclusively at alleviating the social cost of structural change. It recognizes that it may be pertinent to assist poor communities through programmes aimed at creating or preserving employment in traditional micro- and small enterprises, even if the respective activities are not sustainable in the medium term.

It is important to note that such attempts to stabilize activities with limited competitive potential are costly, and may retard necessary labour movements and other adaptations of society and its institutions. Hence, SME policy is not a good substitute for social policies. To temporarily sustain the livelihoods of the poor or reduce their vulnerability, other policy measures may be more effective and can be targeted directly to indigent people. The primary concern of SME policy should be, therefore, to support a socially inclusive pattern of economic development that lays the foundations for sustainable growth.

SME programmes should emphasise the promotion of activities that explore new business ideas ("opportunity entrepreneurship"), that increase profitability by penetrating unexplored markets, and that deepen the interfirm specialization of labour, and thus generate positive externalities and raise productivity levels. The focus should also be on integrating SMEs with the rest of

the economy, for example, promoting interactions between small and large enterprises. The analysis highlights the need to focus on systems of knowledge generation and diffusion, rather than on the quantitative expansion of industrial infrastructure or the size of the industrial workforce only.

What are the consequences of these general observations for UNIDO's portfolio of SME promotion policies? On the whole, UNIDO's policy documents and service modules for SME promotion coincide with the main policy conclusions of the report. The latter are also very much in line with UNIDO's Corporate Strategy, which highlights the need to strengthen the SME sector's contribution to growth, specialization, innovation and exports. In accordance with these goals, UNIDO's technical assistance services have been grouped into eight service modules. These modules comprise, inter alia, advice on industrial development policies and strategies, promoting investment and technology flows into the productive sectors, entrepreneurship development (with emphasis on rural and women entrepreneurship), networking and clustering among SMEs, strengthening of agro-based and agro-related industries and developing renewable sources of energy for productive use. Given the wide range of services offered through UNIDO's portfolio, it is not necessary to introduce any entirely new supporting measures.

Against the background of the earlier analysis, however, certain suggestions are made, which could further increase the efficiency of UNIDO's policy tools. As a general observation, it may be appropriate to:

- Assess whether projects pay sufficient attention to the general trends of structural change. To avoid reinforcing unsustainable production structures it may, in some cases, be pertinent to place more emphasis on adaptation to changing framework conditions and innovation. Occasionally, it may even be necessary to disrupt path-dependent local business traditions. Benchmarking against successful competitors, addressing new demands of poor consumers, enhancing linkages and spillovers between "modern" and "traditional" activities, public-private partnerships with change agents, for example, foreign investors, repatriates, non-profit organizations, innovation contests and awards are some areas where further work may be needed;
- Focus more strongly on the policy level. UNIDO enjoys a unique position, as a multilateral organization, which enables it to use to the fullest extent the policy know-how generated within its global forum function for advising governments on high-level industrial and SME policy-making. However, cooperation with a number of countries is limited to microlevel interventions with a relatively low outreach.

With regard to specific policy areas, the following suggestions are presented in the report:

- *Policy formulation:* UNIDO, as a multilateral organization, has the comparative advantage of supporting governments at the sector policy level. UNIDO assists developing countries in drafting and implementing industrial development strategies, SME development policies and similar policy-related endeavours. In doing so, UNIDO can help countries to design policies and programmes that are geared towards innovation and long term competitiveness and at the same time contribute to more equitable development. To enable developing countries to cope better with structural change, partners may be assisted in developing monitoring systems to analyse trends with strong impacts on SME develop-

ment, such as the emergence of new quality, environmental or logistics standards, the possible substitution of traditional local industries by imports or new large-scale producers, and the ongoing expansion of supermarkets as the leading marketing channel for SME products. In addition, UNIDO could draw on a number of participatory methods to identify competitive advantages and disadvantages of localities or sectors and for stimulating joint action. In addition, assistance should be provided to developing countries that are making efforts to upgrade their policy implementation capabilities and increase the involvement of the private sector in the formulation and implementation process;

- *Simplification of regulatory procedures:* Governments set requirements for businesses and citizens to comply with certain economically and socially desirable standards. Some regulations are necessary to ensure the smooth functioning of the market economy. Others that are redundant should be dispensed with as they unnecessarily increase the costs of doing business. In some developing countries, the amount of regulation and bureaucracy has reached unreasonable levels. For example, starting a business in sub-Saharan Africa in 2004 took 63 days on average and cost 225 per cent of annual per capita income. By comparison, the average of OECD countries was 25 days and 8 per cent, respectively (World Bank [2004a]).

Simplifying regulations may stimulate enterprise entry and exit, and are thus crucial for increasing productivity. They could also reduce artificial barriers to the growth of enterprises. Very often owners of small informal enterprises deliberately keep their business small, partly to evade taxes, but also to escape bribery and arbitrary treatment by public servants. Deregulation, together with increased accountability of public institutions, guarantee transparent and even-handed implementation of regulations and can be expected to lead to higher productivity. At the same time, its outcome may often be pro-poor, as it encourages microentrepreneurs to take up new and/or formalize existing income-generating activities.

Given the relevance of this topic for both productivity enhancement and equitable development, it is recommended that UNIDO expand strategically its activities in assisting countries in setting up government units for administrative simplification, collecting data on existing procedures related to SME development, benchmarking national regulation against the best international performer, eliminating unnecessary procedures, setting quantitative targets in the number of licences and the processing time, and establishing one-stop-shops for administrative simplification;

- *Entrepreneurship development:* The report highlights that in most developing countries a large number of people are self-employed. However, a good part of self-employment results from the necessity to generate a modest income in the short term, substituting for unavailable dependent employment, rather than from promising business ideas and deliberate strategies to create expanding businesses. Obviously, this situation may even aggravate problems of overproduction, especially if these entrepreneurs fail to identify and cater to additional demand. Policy makers should stimulate, therefore, the development of a growth-oriented entrepreneurial class that can identify and implement viable business ideas based on their own market analysis and pursue them in an overall conducive environment, created by the government.

UNIDO has gained considerable experience in promoting rural and women entrepreneurship. With over 70 projects implemented over the past ten years, the programme has created a considerable number of new jobs, mainly in simple small-scale activities in least developed countries. The programme seeks to support the transformation and diversification of micro- and small enterprises to growth-oriented activities and to integrate them into the mainstream economy, as part of its so-called “bottom-up growth strategy” (UNIDO [2003]). This service should seek to maximize its outreach and should link up its technical cooperation experiences more to global forum activities and feed into policy formulation.

In addition, UNIDO may consider broadening its service offer for entrepreneurship development to specifically target innovative growth-oriented entrepreneurship, such as students, scientists, managers and repatriates and civil servants with international technological or business experiences. Such special entrepreneurship development programmes may raise awareness for innovation and create incentives for high potentials to search careers in the private sector. Towards this aim, UNIDO may help to introduce business plan competitions as a means for selecting promising innovative business ideas, preferably in alliance with strong private sector partners, such as leading banks or media companies, and to establish business incubators for promoting spin-off enterprise creation from universities and similar institutions. Moreover, considering the lack of medium-sized companies in many developing countries, specific programmes addressing the needs associated with firm growth and internationalization may be important to complement start-up promotion;

- *Clusters and business linkages:* Business linkages are important elements of competitiveness. Cooperation allows enterprises to reap economies of scale and scope. Geographic clustering of enterprises makes it easier to obtain externality gains and facilitates collective action of local economic agents but, at the same time, increases rivalry among enterprises, which is another important driver of innovation and competitiveness. Services to promote clusters and business linkages, therefore, rank high on UNIDO’s agenda. Cluster development has become one of UNIDO’s flagships in SME promotion. In addition, UNIDO has recently gained international recognition for pioneering efforts to build strategic alliances with large corporations.

The focus of the SME cluster and networking development programme is on promoting networking among small enterprises, both horizontally within a given locality and vertically towards product buyers and providers of support services. Projects span over a large range of products, from handicraft products for domestic consumption to tradable products aimed at the global market. In terms of the analysis above, networking activities should be aimed at breaking away from conformity and path-dependency. Considering the process of globalization of the world economy, special emphasis should be placed on the sustainability of clusters, especially in terms of their preparedness to fend off the emerging competition from foreign producers. For UNIDO’s network facilitators, this may at times require greater emphasis on enhancing large firm–small firm interactions, as is already happening in the Business Partnership and the Supply Chain Development programmes, which strongly focus on the role of transnational corporations and other lead firms as sources of knowledge and strategic partners.

The main focus of the Supply Chain Development programme is on matching supply and demand by providing technical information. However, as the record of matchmaking programmes for subcontracting services, for example, databanks and fairs, around the world suggests, information failure is not the main bottleneck. UNIDO would be well advised, therefore, to continue pursuing a more integrated approach, building up trust and actively involving large customer firms in a long-term process of upgrading their supplier base. UNIDO's recent supplier upgrading programmes already adopt this approach;

- *Agro-industrial development:* The economies of most developing countries are still to a great extent rural and agriculture-based. Most of the world's poor live in rural areas and are engaged in agriculture. Moreover, the relative importance of agriculture tends to decline as countries develop, even though the increasing interest in ecological sustainability is creating new opportunities in fields such as emission trading, recycling of resource materials, biodegradability and biofuels. Developing countries, therefore, need to embark on strategies that add value and diversify rural production towards manufacturing, trade and services. Policies that encourage investment in the rural non-agricultural sector may be the most efficient way to reduce poverty and vulnerability of rural households as they could mitigate the impact of bad harvests or falling commodity prices. In addition, non-farm employment provides income opportunities for women in rural regions, thereby decreasing gender inequalities. The diversification of rural non-agricultural development also slows down rural-urban migration and reduces regional income disparities.

UNIDO's agro-industries programme offers technical cooperation and advice for improving the competitiveness, flexibility and productivity of agro-based industries. The programme also seeks to strengthen forward and backward agro-industrial linkages that enhance value-added opportunities and fosters the integration of small-scale agro-enterprises into market-oriented agro-production systems. While the importance of linkages between agriculture and local upstream and downstream activities can hardly be overstated, the programme may consider extending support to rural manufacturing activities which are not directly linked to local primary production, such as activities catering for local consumers, for example, metal working, printing, bakeries and other food production based on extra-regional inputs, or outsourced labour-intensive industries for urban demand, such as garment assembly, weaving, production of souvenirs.

To further enhance the effectiveness of UNIDO's support for agro-industrial value chains, it is recommended that specific attention be paid to strengthening multi-stakeholder value chain initiatives, which is already taking place in some programmes. Multi-stakeholder initiatives involving, for example, processing and trading companies, local business and farmers associations, agricultural research institutions and extension service providers, non-profit agencies and government entities are important for initiating a dialogue and for making a participatory assessment of the strengths, weaknesses, opportunities and threats of specific agro-industrial value chains. Their success depends, to a great extent, on two aspects: a professional and action-oriented process management; and ownership of key private sector enterprises. Public-private partnerships with agro-industrial leading firms have proven to be an efficient instrument for tapping into new markets, upgrading local value chain partners and coping with increasingly strict international standards.

Linking to UNIDO's work on policy formulation, UNIDO could become more active in helping governments to develop and implement comprehensive policy approaches for rural industrialization. This is important because some of the competent Ministries tend to be urban-oriented, while Ministries of Agriculture rarely look beyond agricultural activities. UNIDO is in a privileged position to extend such support, as it not only draws on several decades of practical experience in rural industrialization, but also engages in global forum activities, which enable UNIDO to influence the international development agenda;

- *Technology management*: Technological progress is one of the most relevant factors that can be used to explain differences in growth rates and thus of income levels across countries. Technological development ranks high on UNIDO's agenda; it is an important element in many of its service modules and integrated country programmes. The focus is on technology management, which interfaces production with technology, while the aspect of fundamental scientific research and technological innovation is considered as having little relevance for developing countries. For instance, the former concept of investment promotion has been broadened in order to combine investment promotion with technology promotion. In addition, a network of ten International Technology Centres has been created.

The focus on diffusion and application of technology instead of technological knowledge creation adequately reflects the fact that the innovation hubs of the world are very much concentrated in developed countries, and that important developmental effects can be reached through an accelerated adoption of knowledge created in these countries. However, recently some advanced developing countries have been gaining importance as original innovators, creating opportunities for South-South technology transfer. The instruments of technology promotion developed by UNIDO are potentially important for tapping these new opportunities;

- *Business Information Services (BIS)*: Globalization increases the information requirements of SMEs in developing countries. Market structures are changing rapidly, new agents are advancing into regions that were formerly characterized by traditional structures of production and exchange. At the same time, opportunities arise to integrate into export-oriented value chains that demand compliance with new standards and norms. SMEs face a competitive disadvantage compared with larger organizations, as they cannot afford to allocate significant resources for searching and evaluating relevant information.

UNIDO's BISnet programme brings together information from different sources and converts that information into solutions, with the objective of facilitating the integration of SMEs in national and global value chains. The programme follows a one-stop-shop approach, linking all relevant national and international information sources in Business Resource Centres. These centres constitute physical locations where entrepreneurs can search for and receive business advice and support. They also provide facilities and host training on information and communication technologies for individuals and groups. Accordingly, such Centres should be demand-driven and customer-oriented, include private companies as local partners, and be based on business plans, that is, codified intentions for the long-term financial sustainability of the centres. The main challenge relates to achieving financial sustainability in environments where SMEs are reluctant to pay even for value-added information.

While UNIDO's portfolio of SME development services covers the most important needs, UNIDO has indeed an important role to play in strengthening the SME sector in developing countries. Focusing on the global forum and technical cooperation activities that aim to enhance productivity growth and equitable development, policy recommendations suggested in the report relate more to fine-tuning rather than radical changes. At the policy level, UNIDO, as a lead international agency, could assist governments in low-income and developing countries in drawing up SME master plans, spreading technology foresight, encouraging high-level dialogue on improving the business climate and assisting in the design of industrial strategies for technology and innovation.

At the level of policy formulation and technical cooperation, UNIDO's support could extend to improving specific instruments based on a systematic assessment and a thorough understanding of structural change. SME policy must ensure that firms are not only in a position to cope with changing market conditions but can also upgrade their production capacities with a strong emphasis on innovation and technological learning. Benchmarking against successful competitors, enhancing linkages and spillovers between "modern" and "traditional" activities, new public-private partnerships with change agents, innovation contests and awards are some appropriate tools that should be considered. Increasingly, these principles guide UNIDO's SME policy. If this orientation is consequently pursued, it could further enhance UNIDO's catalytic role in the achievement of the Millennium Development Goals.

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