



## Support for Smaller Enterprises

**T**HE BANK HAS OFTEN SUPPORTED SMALL AND medium-size enterprises (SMEs) to encourage employment of lower-paid wage earners and to diversify and broaden the base of an economy. The strategy for smaller enterprises has generally been to ease the scarcity of term finance by providing funds and improving the banking system's ability to lend to them. Thought to be labor-intensive, especially outside the major urban centers, small firms would create jobs at a low cost, which would improve the distribution of income and alleviate poverty. All wonderful outcomes.

But such outcomes are rare. Smaller enterprises can be less labor-intensive and less efficient than larger firms. Access to finance is a problem. And the Bank's financial sector policy, with Operational Directive 8.30 in 1992, reduced lending to SMEs. The presumption of the directive was: it is better to let commercial banks decide their clients than to restrict the size of firms receiving Bank funds.

In the past year, the directive was revised, in part to allow a more flexible consideration of the Bank's approach to the financial sector. Here we explore that presumption for support to the Philippines, Ecuador, and Sri Lanka. Our analysis represents the first time that detailed empirical findings of the results on the ground were adduced for Bank SME support. Did the circumstances of some economies make it desirable to channel funds to smaller enterprises? Did the mechanisms of support result in funds getting to needy beneficiaries? Or should Bank support have left it to the banking sector to identify and assume the risks of lending decisions?

- Support for small and medium-size enterprises in the Philippines shows that SMEs can be effective in creating jobs, but they are unlikely to reduce poverty, boost exports, or shift the location of industries, which were all stated objectives of Bank support.
- In Sri Lanka, too, SMEs were a good vehicle for creating jobs—especially important in an economy undergoing restructuring. Direct support to Sri Lankan SMEs has gone a long way toward improving the prudential soundness of the banking system (as it also did in the Philippines).



- In Ecuador, however, support for SMEs used the wrong instrument: long-term credit at fixed interest rates. The results: fewer jobs, little financial development, and only slightly better access to credit.

### Philippines—reasonable success

Between 1976 and 1992 the Bank provided the Philippines with \$180 million to finance SMEs through four consecutive lines of credit, with the Asian Development Bank contributing \$100 million to the fourth. All four were retailed as subloans to eligible SMEs, financing about 2,600 subprojects and generating 64,000 jobs. (The average subproject was almost \$70,000, with an average maturity of more than five years.)

Bank support for SMEs in the Philippines may have resulted in more jobs, but these did not benefit the very poor. No gain in productivity was noted over firms that did not receive Bank credit. Nor was any increase recorded in these firms' exports. In short, support to SMEs in the Philippines resulted in more "middle class" jobs, but these were not as productive as those provided by larger firms.

Intermediaries supported subprojects with high economic and financial returns. For 170 subprojects, the rate of return on assets was 12 percent.

Firms also exploited the fluctuations in interest rates from quarter to quarter, by prepaying their loans when rates were high and obtaining loans when rates were low, revealing that firms had both adequate liquidity and access to the banking system.

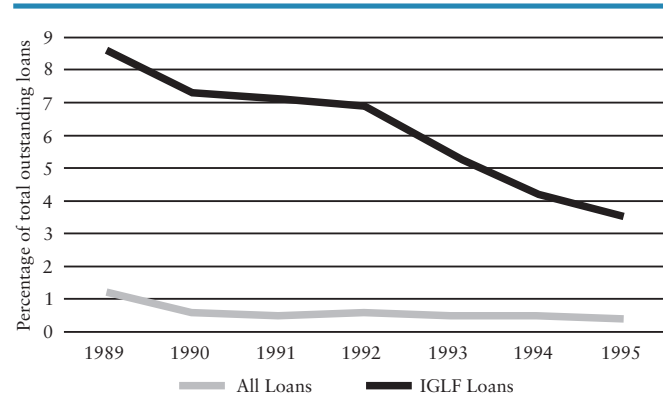
World Bank–assisted Philippine SMEs have greater indebtedness than similar firms in other parts of the world. These firms had little difficulty in tapping credit by the mid-1990s. Moreover, because the repayment record of SMEs is considerably better than that of larger firms (see figure 1), SMEs pose a reduced credit risk to the commercial banking sector. Budget costs were low and did not expose the government to risks; instead, the projects helped reduce the government's risk exposure.

Also, the allocational effects of the directed credit channels do not appear to be large. Technical efficiency is slightly lower at SMEs than at larger firms, so the restrictions on credit use can result in some misallocation of resources. In addition, the technical assistance provided directly to SMEs had no significant impact—more the result of program scale and structure than content—so when the better portfolio performance and diversification of the banking sector are considered, the forgone technical efficiency is a small price to pay for a relatively effective jobs program.

### Sri Lanka—creating jobs

Between 1979 and 1991 the Bank provided Sri Lanka with \$110 million in financing for SMEs through four

**FIGURE 1: Much Lower Arrears**



Source: BSP and ADB data.

credits. The Asian Development Bank (ADB) provided parallel financing of \$45 million for the last two projects and, in June 1997, approved a third project for \$55 million. As with the loans to the Philippines and to Ecuador, these were accompanied by economic and sector work, policy dialogue, and policy-based lending designed to affect the environment for smaller firms.

The strategy in Sri Lanka had three major objectives. First, engage the government in a dialogue about the efficacy of economic policies for trade, and the appropriate roles of the public and private sectors. Second, work with the government to restructure the financial sector from one that serviced a centrally planned industrial economy, favoring large enterprises, into one that responded to the needs of entrepreneurs. Third, generate jobs, so that Sri Lanka's unemployment problem could be addressed cost-effectively.

The credits and the attention given to the policy distortions that impeded the financial sector helped develop a more diversified, private sector–oriented economy. They also helped generate a more effective financial infrastructure and a significant number of lower-paying jobs. Employment at assisted firms increased by more than 8 percent a year—more than three times as fast as general employment growth. This translates into about 22 additional employees per firm, and the value added of their employees was almost 20 percent higher than employees elsewhere, where employment increased by less than 6 percent a year.

Assisted firms also increased their labor intensity at a greater rate than other firms. Unlike the situation in many other countries, credit was directed to firms that were truly credit-constrained, lifting a major impediment to productive investments. Moreover, access to credit, both for assisted firms and others, improved substantially as financial liberalization took root, and Sri Lanka became an important manufacturing producer among low-income countries.

On the positive side, assisted firms employed more lower-wage workers. Most of the smallest firms became

larger, graduating faster than their counterparts in other countries. Beneficiaries were diffused outside the heavy industrial concentration in the capital.

On the negative side, 40 percent of assisted firms (which produced largely for domestic markets rather than for export) went out of business within eight years of borrowing. (Similar exit rates are observed in other developed and developing countries.) The high failure rates did not result in significant losses to the lending institutions, but they indicate that the employment effects of Bank support are overstated.

One important reason for SME credits to Sri Lanka was to accelerate the creation of a financial system that would provide information on the performance of private firms. When such a system of intermediation exists, entrepreneurs can mobilize resources more easily, as well as garner rewards for undertaking high-return investments. Until such a system is established, financial institutions will have fewer incentives to invest in the capacity needed to provide this service, which retards financial development.

*How did the credits affect the profits and outreach of intermediaries?* Bank support contributed to an expansion of funding for the most promising activities—and to a general deepening of the financial system. Interest rates became market-determined, varying with the riskiness of borrowers. An effective repayment system was also established under the credits, with recoveries ultimately at commercial rates. Most intermediaries improved their financial positions. The second-tier development finance institution in the program was privatized, and the intermediaries expanded their own lending to SMEs and microenterprises. Indeed,

by some measures, it appears that SMEs in Sri Lanka now have as much access to credit as do the SMEs in developed economies. While the state commercial banks continue to suffer from overstaffing and government interference, their progress in institutional performance indicators has been substantial.

*Fewer policy impediments.* Sri Lankan firms now have more access to finance, particularly long-term finance, than they did 10 years ago. And the financial infrastructure to underwrite, monitor, and fund profitable investments has unquestionably been established. The financial environment has improved significantly, and it is likely that the Bank's policy dialogue contributed much to this advance.

### Ecuador—a record of failure

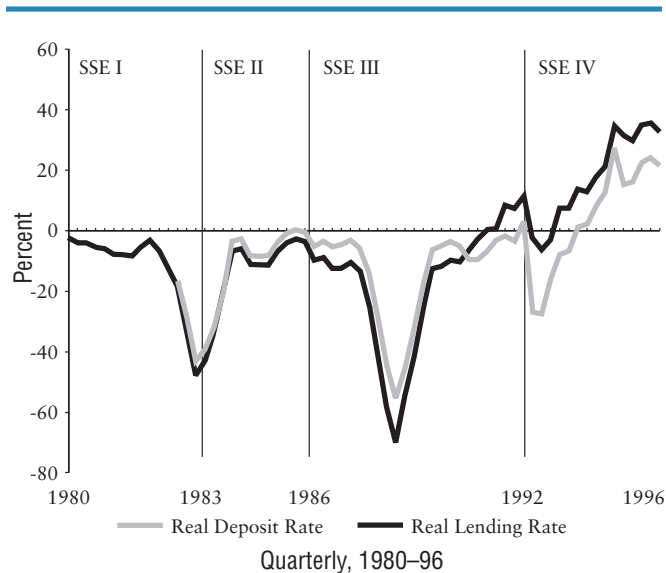
Beginning in 1980 the Bank lent \$140 million for four projects to finance lines of credit for more than 16,000 small enterprises. The first two (in 1980 and 1982) focused on creating an apex institution and establishing interest rate spreads attractive to commercial banks. A new government in 1984 embraced the shift to a more market-oriented development strategy, and with the initiation of financial sector adjustment lending, the third loan, in 1986, incorporated financial sector policy conditionality. The fourth project, approved in 1990 (during a period of stabilization and adjustment), introduced adjustable interest rates for subprojects. The aim was to reach market-determined commercial bank rates. Positive real interest rates were finally achieved (see figure 2) in the 1990s.

*Project results.* The first three projects fell short on all three criteria for development effectiveness: relevance, efficacy, and efficiency. They were not sustainable, they were very costly for the government, and they probably had regressive distributional effects. By providing deeply subsidized credits to borrowers, rather than access to credit, the projects substituted government transfers for borrower finance.

Simply put, the provision of long-term credit at fixed interest rates was the wrong instrument. And even though FOPINAR, the apex institution, was considered one of the most effective institutions supporting SMEs, it had little or no ability to mobilize domestic resources. Providing funds to small firms in a deeply distorted financial system contributed to further distortion.

Employment grew faster in larger firms than in smaller ones that were the targets for Bank credit. Thus, credit was restricted to firms least likely to generate jobs. The high failure rate among the beneficiary firms—only a third of those receiving credit in the early 1980s survived—means that even the limited benefits of the program in job creation diminished sharply over

**FIGURE 2: Positive Real Interest Rates Achieved Only in the 1990s, Ecuador**



time. It should be noted that entrepreneurs received such large subsidies from the Bank's lines of credit and generated so little employment, that it was they, and not their employees, who received most of the income the projects generated. Firms that borrowed under the World Bank lines of credit increased their value added faster than those without Bank credit. But the costs of the subsidies to beneficiaries almost certainly canceled—and may have exceeded—the gains in value added.

Given the negative interest rates during much of the 1980s and early 1990s (as low as minus 50 percent), along with the legislated above-market wages, it is not surprising that the small firms receiving Bank-supported credit tended to be overcapitalized—and less labor-intensive than other firms. Moreover, very small firms appear to be less efficient than larger ones—using more capital and labor to produce the same output.

*Some diversification and decentralization.* Credit to small enterprises has become both more diversified and more decentralized (subsidiary objectives of the projects). More than half of the credit in recent years was targeted to the country's smaller industries and provinces. But it is questionable whether these are relevant objectives for Bank support. A considerable amount of Bank work has shown that providing locational incentives to firms is usually expensive and ineffective.

By the end of the projects, Ecuador's financial system had liberalized and started to grow, but it remains much shallower than those of most other Latin American countries. Continuing macroeconomic turbulence has caused real interest rates to rise above 30 percent. Thus, all borrowers (not just small-scale borrowers) face expensive financing. Although most firms do have access to some credit, access to medium- and long-term credit (more than one year) is rare outside the Bank's projects.

### Three lessons

*SMEs can create more jobs—but don't always live up to other expectations.* Under the right circumstances, support to SMEs can be effective in creating jobs, as was the case in Sri Lanka and the Philippines. Policy reforms could improve performance. But support for SMEs is not likely to have much effect on directly reducing poverty or increasing exports. Nor should it be thought of as a way to shift the location of industry.

*If banks are to learn more about SMEs, and thus to reduce risk, financial products have to be more flexible.* SMEs confront higher real borrowing costs because they are seen as bigger risks—or simply have higher transaction costs—and are priced accordingly. One way to reduce some of these costs would be to establish basic banking links, such as bank accounts or short-term credit. These links can be seen as building blocks toward a more complex banking relationship, such as that implied by long-term loans.

*Good institutions cannot overcome a weak policy environment.* It is essential to have a coherent strategy for removing distortions in the economy—for getting the prices right—before undertaking financial sector lending. The highly distorted economic environment in Ecuador during most of the implementation period—particularly the highly negative real interest rates, along with regulated wages and a heavily protected industrial sector—meant that the loans could not have the desired impact of greater employment. By continuing to provide deeply subsidized credits to borrowers, rather than access to credit, the projects merely substituted government transfers for borrower finance. Reforming the financial sector or relying on sustainable microfinance institutions would have been a better way to provide support for small-scale entrepreneurs unable to get credit.

## Précis

Review or Report: "World Bank Support for Small and Medium Industries in the Philippines: An Impact Evaluation," by Robert Buckley and Edgard Rodriguez, Report No. 18041, June 1998; "World Bank Support for Small Scale Industries in Ecuador: An Impact Evaluation," by Alice Galenson, Robert Buckley, and Edgard Rodriguez, Report No. 17953, June 1998; and "World Bank Support for Small and Medium Industries in Sri Lanka: An Impact Evaluation," by Robert Buckley, Edgard Rodriguez and Dipak Mazumdar, Report No. 16790, June 1997. Available to Bank Executive Directors and staff from the Internal Documents Unit and from regional information service centers, and to the public from the World Bank InfoShop:  
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