The Role of the Small and Medium Enterprise Sector in Latin America and Similar Developing Economies

by Albert Berry

Abstract

The current economic setting in most Latin American countries suggests that, if the small and medium enterprise (SME) sector does not perform well during the next couple of decades, overall economic performance will also be unsatisfactory, especially in the areas of employment creation and income distribution. No other major sector has the potential to generate a large amount of adequate-income jobs. Experience of other countries has proven that this sector can play a central contributing role, under proper conditions and with adequate support. Various types of evidence from the countries of the region suggest that considerable potential is present in their SME sectors. But both experience elsewhere, and economic logic, imply that a strong and coherent support system will be necessary if that potential is to be reasonably fulfilled. Such a system has been notoriously absent in most Latin American countries in the past. Countries which fail to rectify this lack may suffer serious social and economic consequences. The parallels between the economies of many Latin American countries and various others around the developing world (e.g. South Africa, Philippines), both in economic structure, recent growth performance and level of inequality, suggest that many of the conclusions applicable to Latin America are relevant elsewhere as well.

Introduction

This paper makes the case that the performance of the small and medium enterprise (SME) sector will be pivotal to overall economic performance in Latin America over, at least, the next decade or two. The main reasons for the importance of the SME sector in Latin America are (i) the high level of income inequality in most countries of the region, associated in part with the dualistic character of the economy, in which a high share of capital is invested in the large scale sector where relatively few jobs are created, leaving the rest of the labor force to work with a much lower capital-labor ratio; (ii) a recent period of slow growth, especially characteristic of the 1980s

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during the debt crisis but, also in lesser degree of the 1990s; (iii) a shift towards a greater degree of openness and a generally greater role for the market in the allocation of resources; and (iv) a higher level of fiscal prudence than before, associated with the need to keep inflation under control in order to participate more successfully in the international economy. It is argued below that this set of conditions makes the performance of the SME sector more important than it would otherwise have been.

Each of the conditions just mentioned applies also to a number of other developing economies, perhaps most notably in South Africa. The level of income inequality in South Africa is comparable to the more extreme cases in Latin America, growth has been slow over the last couple of decades, and a shift towards a more market-oriented strategy is a feature of current policy.

The 1980s, often referred to as a lost decade in Latin America, left major challenges on the growth, employment and income distribution fronts throughout the region. Though the region's growth rate has gradually increased during the 1990s it has not yet recovered the levels of the 1950-80 period under the earlier import substitution paradigm. Although the job creation task has eased somewhat in the wake of falling population growth rates, the combination of unemployment and underemployment has remained serious. The associated problem of income inequality has been accentuated in most countries, probably by some combination of the economic downturn itself, the economic reforms and the process of technological change.

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The trends of the 1990s present a more positive prospect on the growth front than they do with respect to employment and income distribution. With so many changes in the development setting over the last couple of decades—the policy framework, the debt crisis, the globalization process, and the pattern and pace of technological advance, it is impossible to predict with any accuracy how these indicators of performance will behave in the coming years. There are strong empirical and theoretical grounds for worry. On the empirical side, the central fact is that most Latin American countries have suffered a moderate to sharp increase in the level of income inequality.[1] This almost always coincided with the introduction of the economic reform package and, usually, also with the economic downturn (these two phenomena occurred together in many cases). A typical component of the increasing income inequality is a widening gap between more skilled and less skilled workers, a gap which, in a number of countries, was declining over a previous period but then started to expand again.

There are a number of conceptual or theoretical grounds for the prevalent pessimism about employment and distributional trends. Early simplistic assessments of the likely distributional outcomes of trade (especially) and other types of liberalization were sometimes quite optimistic, mainly based on the idea that Latin America was a labor abundant region, so its workers would be the special beneficiaries of expanding trade[2]; but the evidence thus far has mainly contradicted these predictions. As a result, greater attention has been given to the possibility that most of the Latin American nations do not, in fact, have their comparative advantage in products which are intensive in the use of unskilled labor, but rather in various types of more skilled labor and in natural resources, both of which are typically distributed very unequally. Under either of those situations, increased trade is likely to have a negative impact on income distribution. Other analysts have argued that the rapid pace of unskilled labor-saving technological change is behind the observed pattern of increasing inequality. Each of these interpretations puts the emphasis on how the demand for labor has evolved, rather than on how the labor market functions. The implication is that, to the extent that inadequate growth of labor demand did not manifest itself in low wages of those towards the bottom of the pyramid, it would instead show up in unemployment or underemployment leading to the same final result—low incomes.

The special role or task of the SME sector relates to its position in the middle of the spectrum of sizes and capital intensities in an economy. On average, the labor demand curves of larger, more modern firms, start higher than those of smaller, less modern firms but are also steeper (less elastic).[3] This reflects the fact that in firms using modern technology, the productivity of labor is quite high for the few workers required to complement a given amount of capital (hence the curve starts high) but since only a few workers are needed it falls steeply. Such firms can pay a few workers quite well but are not interested in hiring a large labor force.

At the other end of the spectrum is the microenterprise sector with its low and relatively flat labor demand curve, signalling the expandibility of the informal sector of many economies, albeit at low levels of productivity and income.

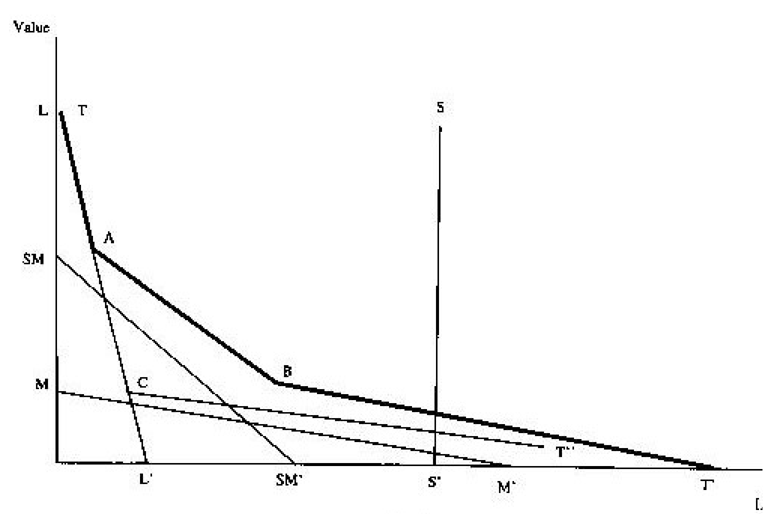

Fig. 1.

In Figure 1, the labor demand curves of large enterprise (LE), small and medium enterprise (SME) and microenterprise (ME) are portrayed as curves LL', SMSM', and MM' respectively. The total demand curve (TT') for labor is the horizontal summation of these three curves, shown as the heavy line in Figure 1. Most of the potential employers at very high wages on this total demand curve are modern firms, the bulk of the middle of the TT' curve corresponds to the demand of SMEs, and the majority towards the bottom of the curve are quite small, low technology microenterprises. Were there enough of the complementary factors (capital, natural resources) to generate a TT' curve far enough to the northeast in the figure to cut the labor supply curve (SS') at a high wage, this would, of course, be desirable. Such is the case of the developed countries, where the main component of the TT' demand curve corresponds to the relatively capital intensive, high-technology firms which make up the modern sector. In developing countries, the availability of complementary factors is too limited, and hence the size of the modern sector too small for this outcome to emerge. Under these conditions, a country which allocates a high share of capital to the very modern sector is likely to have the majority of the population working with very little capital and hence low labor productivity (demand for labor). The equilibrium wage would be quite low; workers in the modern sector would probably be able to bargain away some of the profits in that sector through labor legislation or collective bargaining. Another economy, endowed with the same amount of labor, capital and other non-labor resources, but allocating more of the capital to the SME sector and less to the LE sector, would have a labor demand curve which was lower for small quantities of labor (i.e. at points closer to the vertical axis), but higher for larger amounts of labor. It would therefore normally have a higher equilibrium wage than the first economy, though perhaps less very high wages of the type resulting from favoured workers bargaining away some of the very high profits of favoured sectors. In most cases the lowest part of the demand curve is in effect a demand for own-labor on the part of low income self-employed people. The paid wage rate for hired workers in LE and in SME will be higher than these individuals can generate as own income.

To better understand the important role which SME plays in today's Latin American economies, it is useful to distinguish the labor demand associated with each of five separate sectors of the economy – agriculture, the public sector, the large-scale private (non-agricultural) sector, SMEs, and microenterprises, rather than just the three size-based categories mentioned above. Agriculture, while still important in most countries, has been and will continue to lose relative importance as a source of employment, even though in a few cases the economic liberalization might have the effect of temporarily reversing this natural process. In a number of cases, new agricultural exports will not be significantly employment-creating, a pattern repeated over the last half-century in parts of Brazil, in Paraguay, in much of Central America, and so on.[4] On average it is unrealistic to expect this sector to create large amounts of very remunerative employment.

Two other important components of the economy which are unlikely to generate much employment in the short or medium term are the public sector and the large-

Table 1
Source of New Jobs in Latin America,
by Sector: 1970s and 1990s

Source (Sector)	1970s	1990s
Agriculture	10	0-5
Public Sector	20	0-5
Large private firms, Non-Agriculture	25	5
Microenterprise (non-agriculture)	25	60
Small and medium enterprise (non-agriculture)	20	30

Source: Based on data from PREALC, International Labour Office.

scale private sector. The public sector is, in most countries, under a fiscal constraint which impedes employment expansion. The large-scale private sector producing tradables might generate significant employment growth in a few countries, but downsizing has been the more normal accompaniment of liberalization thus far, as firms struggle to raise productivity and competitiveness while introducing labor saving machinery and equipment. It thus appears prudent to assume that employment may be close to stagnant for a while in this sector before normal growth resumes. The rest of the private sector can be disaggregated into the SME segment and the very small firm (microenteprise) segment. Microenterprise plays the very important insurance role of guaranteeing a minimum, albeit quite low, level of income to many people, but it does not have the capacity to generate moderate to high incomes for a large number of people. This leaves SME as the sector which does not require very large amounts of capital to grow, and which, also, should be able to produce good levels of income for many people.[5]

A feel for the nature of the current challenge in Latin America can be gleaned from a comparison of the breakdown of net employment creation among the five sectors just cited between the 1970s—before the debt crisis and the resulting recession, and the 1990s, when the region had once again achieved a modicum of growth (an average of 3.5% over the_decade). In the 1970s net employment creation was spread fairly widely among these sectors, as shown in Table 1. In the 1990s (through 1997 approximately) neither agriculture, nor public sector nor large-scale private sector contributed significantly to total employment creation. The job was thus left to the microenterprise sector and to SME, with the former playing its usual safety valve role when no other sources of employment were unavailable.[6] Clearly it is not possible to expect the microenterprise sector to continue to carry such a large share of the employment-creating function without the average incomes associated with that sector's jobs dropping. No doubt this fall was a factor in the widespread increases in inequality in Latin American countries over this period.

The more basic distinction being made in the above discussion relates to the level of firms' technology and productivity rather than their size. A country endowed with a moderate level of resources per person needs to allocate a large amount of those resources to medium level technologies, unless it wants to have a very unequal distribution of labor across the available capital. Where a few workers are able to achieve very high average productivity because they work with a lot of capital, the productivity of the rest will be low because they are starved of capital. With a few exceptions, size of enterprise is closely correlated to level of technology. Thus, countries with only moderate levels of resources per person should normally have a lot of SMEs, since, if they allocate too much capital to LE, there will be too little left over to complement the large amount of labor which then will mainly be forced into very low productivity microenterprise. In some developing countries large firms seem to be able to operate without excessively modern technology, but this has not been a hallmark of Latin American development. In some countries, especially more developed ones, a fair number of quite small firms do achieve high levels of productivity through high levels of capital and modern technology. But this is very much the exception in middle level developing countries like those of Latin America. In short, most middle technology firms are also somewhere in the middle of the size range.

The Key Question-How Important a Role Can SME Play?

It is a straightforward logic which suggests that an economy's performance will be better, both in terms of output and of income distribution and employment generation, if it focuses a sizeable share of its resources on technologies of medium capital intensity, rather than allocating nearly all of the capital to a few workers employing quite modern technologies and almost none to the rest of the labor force. All countries may be expected to benefit from allocating some resources to that middle range of technologies. But the important question is how much difference it makes in quantitative terms whether an economy dedicates a lot or only a few resources to such technologies. Also, it must be recognized that, just as potential growth will be lost if too few resources are directed to the SME sector, the same may occur if too many are, since the payoff to the last resources added will be small. The SME sector's contribution to economic performance could in principle be improved either by raising the internal efficiency of the resources already employed within it, or by changing the share of the economy's resources employed by it.

Viewing the trade-off between use of resources in SME and in other ways, gives a static perspective on efficiency of allocation. But dynamics are equally or more important, including both the implications of the size of the SME sector for savings, investment and technological change—what we may call the growth implications, and also the dynamics of adjustment when an attempt is made to reshuffle the structure of the economy (by size in this case). Those dynamics may involve path dependency; though the role of SME might, for example, have been a large one had a path conducive to that outcome been followed, if the opposite path was pursued for too long this option may become unavailable.

The Overall Contribution of SMEs and its Potential Under Liberal Trade

Recent literature from virtually all parts of the world emphasizes the important contribution which SMEs can make to an economy's strong overall performance, whether it be the United States[7], Japan[8], Developing East Asia[9], Africa[10], or Latin America. For the most part, the increasingly positive reassessment of that role owes itself to a combination of better recognition of the scope of SMEs in economies and a more careful thinking through of the role of firm dynamics in economic structure and performance. It has been recognized that some of the world's best performing economies, notably Taiwan and Hong Kong, are very heavily based on small enterprises. A few experiences from Latin America suggest that the SME sector can be a major source of dynamism, as in the case of Colombian manufacturing from the late 1960s to the early 1980s [11]. But the cases where the SME sector has played a major role in Latin American countries are still few.

Most of the especially successful economies where SME has played a demonstrably large role have also been outward-oriented East Asian countries. They have been very successful at linking the SMEs to the export process, through some combination of direct exporting by smaller firms (often through relatively small intermediary agents, as in the case of Taiwan) or subcontracting by SMEs with bigger firms, as in Japan over a long period, and in Korea with increasing intensity since the mid-1970s. This record of achievement under export orientation is particularly attractive to the countries of Latin America at present, given the challenge to succeed in a more open context and to do so on both the growth and the distribution fronts.

The Economic Context of SMEs

Before considering how public policy may encourage a strong performance from SMEs, it is necessary to have a reasonable understanding of their setting and, hence, of their problems and needs. Like other firms, SMEs exist in networks of suppliers, buyers and competitors. More than larger firms, which at least have the option of handling many of their needs in-house, SMEs rely on other firms or institutions for their inputs, for the training of their workers, often for help with their marketing needs, and so on. One can distinguish three broad groups of SMEs according to the nature of their relationships with other firms: those which are subcontractors (usually, but not always with larger firms); those which are members of "clusters" made up mainly of small firms; and those which are more or less independent, in that they fall in neither of the above two categories. Its needs vary considerably according to which of these groups an SME falls into or comes closest to. Subcontractors can receive considerable help from the contractors with which they do business; members of clusters tend to satisfy a number of their needs by collective action—e.g. in the areas of marketing, technical assistance, training of workers, purchase of some inputs, and so on. Independent firms are, as the term implies, more dependent on themselves.

Many needs are common, regardless of setting. Firms must achieve a certain level of efficiency either to have success as independents or to qualify as candidates for one of the other two arrangements. Contractors are not willing to invest their time or efforts with subcontractors which are not close to being efficient producers. A cluster must have a high level of collective efficiency if it is to compete in world markets, as many of the most effective clusters do. At present, interesting efforts are being made in Latin American countries to facilitate large-small firm links, to develop denser subcontracting systems and to foster effective collective action among SMEs in areas like exporting, purchasing of inputs, etc. These developments are encouraging and indicative of creativity, but it is also clear that they would have to be multiplied many times before they could be expected to convert the SME sector into the needed element of dynamism for the economies of Latin America.

Regardless of the context in which an SME finds itself, it is increasingly likely that its success will depend on ability to participate effectively in international trade, either as direct or indirect exporter, or as successful competitor with imports. It is thus important to consider what policies help SMEs to achieve success of this sort.

Public Policy vs Exogenous Factors in the Performance of SMEs

There is considerable hope that SMEs, with ready and willing entrepreneurs, can succeed in an increasingly competitive world, especially if policy is supportive and effective. The increasing prevalence of flexible specialization has persuaded many analysts that smaller firms will play an increasing role in the industrial structures of the future. The major role of SMEs in employment creation in Canada, the U.S.A. and a number of European countries over the last couple of decades appears to support this view.[12] Closer to the Latin American countries in terms of economic structure and level are the experiences of several of the East Asian countries, especially Japan, Taiwan and Korea. Japan is the prototype of an economy in which SME plays a major role, principally via subcontracting with large firms, which tend to be engaged in international trade. Taiwan is the prototype in which the SME sector plays a pivotal role by itself, without the high level of dependence on large firms which characterizes the Japanese model. Many students of the Taiwanese experience believe that its outstanding success in achieving both dramatically fast growth and perhaps the lowest level of inequality of any developing market economy are substantially attributable to this dominant SME role.[13]

Although it is difficult to be very precise quantitatively, the evidence alluded to above does suggest that the SME sector can be significantly important in an economy, and that when it does so, both the growth and the income distribution performances can benefit greatly. One outstanding question remains — to what extent can such impressive success be assigned to exogenous factors such as wealth of entrepreneurial talent, a culture which favours the business characteristics that are friendly to the development of SMEs, a topography conducive to a dense network of small firms, or a history which did not produce a lot of large firms? In other words, how much of the experience of a country like Taiwan is plain luck, and hence could not be repeated even by the most astute and well executed policy in some other country that did not share the same institutional features which helped down that particular road.

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There has been a good deal of scepticism in Latin America as to whether the region, given its different institutional and cultural background, could achieve such success. Such scepticism needs to be taken seriously, yet not overdrawn. As well, any judgments regarding the impact of policy must be qualified, since there are few experiences which provide good tests of what a concerted and well-organized attempt to support strong SME growth can do. The experience of Korea since the mid-1970s comes closest to being such a test, and the lessons it suggests are interesting and encouraging. As of the early 1970s, its industrial structure was more similar to such Latin countries as Brazil and Mexico than to that of Taiwan. This was especially true in the sense of its being dominated by large, vertically integrated firms, which did relatively little subcontracting. Consequently, the SME sector was much less important than in Taiwan or Japan. Since that time, however, Korea has moved very rapidly in the direction of those countries, with SME output and employment growth being very fast, such that its share of those two variables in the manufacturing sector has risen rapidly.[14] At the same time the level of inequality in the country has diminished. Most of the SME growth has been due to a rapid increase in the density of subcontracting, i.e to a move towards the Japanese model of industrial structure.

This experience is relevant to the Latin American context: in an East Asian country with considerable structural similarities to the traditional Latin pattern, a rapid increase in the role of SME can be achieved when conditions are right. In the Korean case, the sharp shift of structure was due in part to an increase in competitive pressures associated with the appreciation of the yen in the mid-1970s and of the won with it, and to a concerted effort through public policy to expand the role of SMEs. Both these conditions could be approximated in Latin America. The opening to international trade will have an effect somewhat parallel to the appreciation of the Korean currency; in fact many people believe that the relatively low level of subcontracting in most Latin countries has been in part a product of the high levels of protection. The second condition, a well designed and vigorous set of policy supports, is at the disposal of these countries if they take up the challenge seriously enough. A well-designed policy package is not expensive, but it does require a level of serious dedication which has been for the most part absent in the past.

It is important to recognize the potentially great difference between success and failure in integrating SMEs directly and indirectly into the world economy. Potential failure is implicit in the fact that integration with the world economy can be a daunting prospect for small firms, and a quick reduction of import barriers can decimate some SME sectors, especially when the real exchange rate is allowed to fluctuate, creating periodic waves of imports. Although SMEs often live by their flexibility and agility, many of them are at the same time vulnerable to major external shocks. One of the challenges to effective support policy is an understanding of this fact and its implications in a given country. But success has been achieved both by whole countries like those mentioned from East Asia and, within Latin America, by internationally competitive clusters of firms from various Latin American countries as well as by competitive industries which draw some of their strength from a considerable amount of subcontracting.

Which Polices Help the Most to Induce a Strong Performance from SMEs

The SME sector is a very heterogeneous one. Therefore, it should not be expected that the same policy package would be optimal across branches, countries at different levels of development, types of SMEs (subcontractors vs. those which are part of clusters; producers of tradables vs. producers of non-tradables, etc). It must also be recognized that in some areas our understanding of what good policy may be remains incomplete for lack of policy experiments and careful analysis. These caveats aside, a number of important conclusions are now possible.

It must also be recognized that in some areas our understanding of what good policy may be remains incomplete for lack of policy experiments and careful analysis.

First, it is necessary to recognize that for the most part Latin American countries are not among the leaders in the overall quality of their support systems for SMEs, though in some cases individual elements of support are solid or promising, and in others interesting experiments are taking place. The fact that an effective system involves participation from diverse branches of government and from private collective institutions which are not uniformly strong in Latin America imposes a real challenge to the quick development of strong systems. In the systems which function well around the world (of which Taiwan and now Korea are examples) there is generally good coordination among the purveyors of different services and the institutions which help to determine the context for SME performance.

One of the probable reasons for the presence of successful clusters of SMEs in countries where overall SME development is not particularly dynamic lies in the fact that the needed degree of coordination among the elements of a good policy package is often easier to achieve at the local rather than the national level. At the national level, policy making is currently most often dominated by macro concerns and macroeconomic specialists (in the Central Bank, the Ministry of Finance, etc.). With the increasing specialization over the years among the branches of economics, this has meant that those in charge of the main levers of policy are unfamiliar with the varying situations and needs of specific groups of firms defined by sector or, as in the case of SMEs, by size. For informed, effective policy-making at the national level this hurdle must somehow be overcome. More complete knowledge among the decision-makers would help; so too would the more frequent presence of representatives of the SME sector at the policy-making table. In most countries their political voice is muted. In the great SME success stories, like Taiwan, it is strong. At the local level neither the macroeconomic focus of decision-makers nor the absence of SME voice is such a problem, and there are the added advantages that the various firms and local policy makers tend to share a desire to see the region succeed, and that their personal acquaintance makes collaboration easier.

One policy which matters to more and more SMEs as economic integration proceeds is exchange rate management. Colombian SME exporters reported that it was one of the policy areas of greatest concern to them.[15] Although SMEs show various types of flexibility and agility which is often what keeps the survivors afloat, they can be quite vulnerable to certain types of external shocks. In general, they are more so than their larger counterparts, which typically have the reserves (economic and political) to weather storms, and are often more diversified to start with, rendering them less vulnerable to what happens in special small sectors of the market. In the present era, with its inflows and outflows of hot money (volatile short term capital flows) putting pressure (in one direction or the other) on the exchange rate, the risk of damage or death to essentially healthy SMEs (healthy in the sense of their having the potential to be economically productive over a lengthy period) is high.

Most of the other key policies in support of SMEs are more microeconomic in character. Most have as their objective helping these firms to be more efficient and competitive (while at the same time creating relatively good-income jobs). Many simultaneously increase a firm's performance capability and also increase the likelihood that it will be able to enter a useful subcontracting relationship with a large firm or be a productive member of a cluster.

Marketing success constitutes one of the key challenges for many SMEs. A valuable experience for SMEs in many industries is participation in trade fairs—at home and/or abroad, the latter of which can be a good means of penetrating export markets.[16] (Trade fairs also turn out to be an important source of technological learning.) More generally, however, governments' institutional capacity to deliver marketing support is weak in most developing countries. The developing world is littered with failed export support programs and 'white elephant' export institutions. A better approach is intervention with a "light touch" that provides firms with the wherewithal to find buyers for themselves, rather than attempting to substitute for efforts by putative exporters. Export marketing support should also be decentralized and tailored to the specific realities of individual marketplaces so as to be able to respond to the enormous diversity of players and market mechanisms across subsectors. The experience in Colombia exemplifies this. The performance of the national export agency, Proexport (PROEXPO) created in 1967, in providing direct marketing support to SMEs has been less than impressive, judging by the fact that relatively few of the Colombian SME exporters which used collective support reported that it came from PROEXPO.[17] The industry associations, by contrast, show considerable promise in this area, especially those in the leather and (more recently) garments industries. Working closely with their member firms, they have been developing the sort of sector-specific knowledge and skills which cannot realistically be expected from general purpose agencies like PROEXPO. A successful hybrid arrangement which is beginning to take hold is for PROEXPO and other public sector agencies to work collaboratively with industry associations — with the public agencies providing some funding to help organize fairs and assist visits abroad by potential exporters.

Technology upgrading is key to the continuing success of SMEs, especially those which produce tradables. In general, private rather than collective mechanisms are the main external (to the firm) sources of technological capability. In Japan, strong vertical and horizontal inter-firm relations drive the technology acquisition process. Such links are important in many other countries even if less dense than in Japan. Where such helpful private-sector links are limited, the challenge of technological acquisition is a formidable one, and the consequence can be technological isolation and *ad hoc* learning. Yet a number of experiences from outside Latin America (such as that of Korea's engineering-based SMEs) and within it (various industries in Brazil and Argentina, Colombia's craft-based leather and garment SMEs, Chile's wood-processing) suggest that it is possible to successfully surmount this challenge via activist strategies at both the firm and collective levels.

Collective technical support can be "broad-based", contributing to the emergence of an "information-rich" environment, or it can promote "high-intensity" technological learning by supplying technical inputs directly to firms. The former works to enhance the overall availability of usable information, leaving firms to judge what information sources might be most useful, and how they might be adapted to a firm's specific needs. It involves such activities as sponsoring courses on specialized topics; facilitating the use of specialized consultants to a range of firms; and promoting information-sharing among firms. Such support appears to be useful in most countries of Latin America.

Broad-based collective support has been most effectively delivered by decentralized institutions – either by industry associations, independent non-governmental organizations, or local governments in specialized industrial districts. The record of centralized institutions in delivering services is more uneven. The goal of high-intensity collective support is to meet those specific technological needs of firms which are not adequately addressed through other channels. Demand for support along these lines is likely to emerge only at relatively high levels of technological complexity. For countries that lack a record of strong overall performance by parastatals, an effort to establish a high-intensity network of collective technical support, similar for example to Korea's successful system, would appear to be risky. Where assistance is provided collectively, it often makes sense to direct it to groups of clients. Chile has taken the approach of subsidizing privately supplied technical assistance. Sharing the cost of these activities with the client is clearly appropriate. The risk associated with subsidized private supply is that ineffective service suppliers will be induced into existence. It remains to be seen how broad a supply of quality services will emerge in response to such a system.

The impacts of financial liberalization are a source of optimism to those who believe that the public-sector banks which focussed on SMEs were ineffective, and that the private sector could do a better job, especially when interest rates were brought closer to equilibrium levels so that credit allocation would more likely be guided by which sectors had a strong effective demand for credit.

Access to credit in the healthy evolution of the SME sector has been controversial, both with respect to whether the lack thereof is typically one of the major impediments to SME success, and with respect to whether financial liberalization is more likely to improve access or weaken it. The evidence is thus far ambiguous on both counts. There is little doubt that many SMEs could grow more efficiently with better access to credit, but it is less clear what sort of performance can realistically be expected of a financial system in terms of allocating such credit to the "right" borrowers. Perhaps the only valid generalization is that a financial system will work better when it has better designed rules to guide lending to SMEs, and more SME-specific personal expertise, that is, more people who have enough understanding of and feel for the context of SMEs to be discerning lenders. Not too many institutions in Latin America or elsewhere in the developing world have performed impressively in this regard.

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Research by Jaramillo et al [18] on Ecuador led them to conclude that the process improved the access of smaller firms to private sources of credit. Survey evidence reported by Levy et al (1999) for Colombia (and Indonesia) indicated that smaller and generally less well placed SMEs relied more heavily on public sector banks while their better placed counterparts drew more on the private banks.[19] It seems likely that the access of small and otherwise disadvantaged SMEs to external sources of finance, and especially to bank loans, depends heavily on the degree of development of the financial markets. In countries like Japan it is relatively good, while in most Latin American countries it is considerably less so.

Another significant difference between better financial systems and weaker ones involves the performance of credit guarantee systems. Such systems work relatively smoothly in Japan, in part because it is primarily operated by local associations (which naturally have better information than outsiders on the reliability and credit-worthiness of various possible borrowers in their geographic area), and in Korea where, because the guarantees are only partial, banks have considerable incentive to be careful, both in their credit evaluations and in credit collection. In both these countries default rates have been kept to manageable levels. By contrast, and especially in their early stages, several of the Latin American schemes (e.g. that of Colombia) have suffered major incentive and other problems, producing high rates of loan default, often accompanied by long delays by the guarantee system in compensating the banks making the defaulted loans. As a result, lending institutions have often become leery of extending credit to SMEs, except where strict collateral requirements could be satisfied, more often the case with the larger and better-endowed SMEs. The insistence on collateral, even when the loans are guaranteed, tends to defeat the purpose of the guarantee system.

Support for appropriate education and training is another important element of an effective support system for SMEs. It is often notable that training institutions play a significant role in the development of such SME clusters as Novo Hamburgo in Southern Brazil[20] and Rafaela in Argentina.[21] SMEs do not and cannot be expected to supply most of the needed learning in-house, both for lack of resources and out of fear of "poaching" by other firms. Most of Latin America's vocational training institutions and systems were originally designed to take care of the needs of larger firms. Increasingly, it is recognized that their efforts should now be mainly focussed on SMEs.[22] Encouragement of SME suppliers through public sector purchasing may also play a role, as in the Ceará program.[23]

Several types of support are directed to improving inter-firm cooperation involving SMEs (either among themselves or with larger firms) or to take advantage of economies of scale available by providing services jointly to many SMEs. These are:

(i) support for relevant business associations—sometimes umbrella SME associations, sometimes industry-specific ones, often local ones;
(ii) practically oriented support for large-small linkages, e.g. along the lines of the SEBRAE program in Brazil.[24]
(iii) SME network support programs, of which the Danish Network Cooperation Program and Chile's Proyetos Asociativos de Fomento (PROFOs)-Cooperative Development Projects are good examples;
(iv) subcontracting exchanges designed to bring potential contractors and subcontractors into contact; though it is not clear whether they will often have a large payoff, their modest costs makes them a logical component.

With respect to how to carry out SME support policies, three points deserve comment. First, support should be provided on a group basis where feasible, in order to lower costs and to increase the chances of inter-firm cooperation. Second, the modus operandi of support systems and their components should sometimes be one-shot or time-limited, in order to avoid the creation of permanent bureaucracies, at least until the benefits have been shown to be clearly satisfactory. Thus, for example, subsidies for participation in any given network should normally be time-limited. Finally, it must be recognized that no simple formula has been found to energize the SME sector. Although a good credit system is, no doubt, part of an effective policy package, it is by no means enough. The record with industrial estates, incubators and like ventures is by now long and, for the most part, not very happy. In some situations these mechanisms can help some firms, but there is no empirical basis for believing that they will be a significant part of a good support system and there is all too much evidence that scarce resources can be wasted on them.

To backstop effective SME policy, it is essential that information on the SME sector be collected, organized, and analyzed, so that policy decisions will no longer be taken on the basis of partial, and mainly, anecdotal understanding of the characteristics and needs of SMEs. Related to this is an urgent need for serious monitoring of the programs which are put into place. Many programs will, of necessity, have an experimental character for the time being since so little is known about which instruments work well, in which situations.

Notes:

[1] Oscar Altimir, "Income Distribution and Poverty Through Crisis and Adjustment", CEPAL Review. No. 52 (LC/G. 1824-P), April 1994; Albert Berry, "The Inequality Threat in Latin America", *Latin American Research Review*, vol. 32, no. 2, 1997.

[2] Anne O. Krueger, "The Relationship Between Trade, Employment and Development," in *The State of Development Economics: Progress and Perspectives*, edited by Gustav Ranis and T. Paul Schultz (Oxford: Basil Blackwell, 1988)

[3] We abstract here from the heterogeneity of the labor force. The argument presented in the text can be thought of as applying mainly to those lower skill categories of labor which make up the bulk of the labor force.

[4] M.R. Carter, B. L. Barham and D. Mesbah, "Agricultural Export Booms and the Rural Poor in Chile, Guatemala, and Paraguay." *Latin American Research Review*, vol. 31, no. 1, 1996.

lbert Berry "When do Agricultural Exports Help the Rural Poor: A Political Economy Approach," *Oxford Development Studies,* vol. 29, no. 2, 2001.

[5] During the 1980s there was virtually no net job creation in the large-scale private sector. In the 1990s (through 1997) its contribution has once again become positive but it still accounted for at most 5-10% of employment growth, while the public sector's contribution fell to about zero; the great bulk of the new jobs open unemployment.

generated in the informal sector (ILO data supplied by Victor Tokman).

[6] It is interesting to note that, although open unemployment did rise somewhat in the 1980s and fall from its former peak during the 1990s (for the region as a whole though not for each separate country, since growth experience did vary a good deal from country to country) it is clear that the lack of good employment opportunities showed up much more in the number of people in low income informal sector activities than in

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[10] Carl Liedholm and Donald C. Mead, *Small Enterprise and Economic Development:The Dynamics of Micro and Small Enterprises* (New York:Routledge, 1999)p.130.

[11] Mariluz Cortes, Albert Berry and Ashfaq Ishaq (1987). *Success in Small and Medium-Scale Enterprises: The*

Evidence from Colombia, (New York: Oxford University Press,1987),chap 2.

[12] Audretsch, *The Economic Role of Small-and Medium-Sized Enterprises: The United States*, 1998.

[13]John C.H Fei,, Gustav Ranis and Shirley W. Y. Kwo, *Growth With Equity: the Taiwan Case* (New York:Oxford University Press, 1979)

[14] Myungrae, Cho "Interfirm Networks: The Foundation of The New Globalization Economy of South Korea" (paper prepared for the UNCTAD workshop on "Poverty Alleviation through International Trade, Santiago, Chile.,1995)

[15] Brian Levy, Albert Berry and Jeffrey B. Nugent. "*Fulfilling the Export Potential of Small and Medium Firms*" (Norwalk, MA:Kluwer Academic Publishers, 1999) chap 5.

[16] Exporting SMEs surveyed in Colombia, Korea and Indonesia reported fairs as the leading or second most valued collective source of export marketing support in seven of the nine subsectors studied by Levy et al. (1999, pp.232-233).

[17]Although one should note that its primary focus has been on the provision of credit for exporters, an activity which it apparently has undertaken impressively.

[18] Fidel Jaramillo, Fabio Schiantarelli and Andrew Weiss "The Effect of Financial Liberalization on the Allocation of Credit: Panel Data Evidence for Ecuador". (Policy Research Working Paper No. 1092. World Bank Country Economics Department. Washington, D.C: The World Bank, 1993)

[19] Levy et al, 1999. A similar tendency for collective technical support to be more highly valued by "marginal" firms seems to be typical.

[20]Hubert Schmitz "Small shoemakers and Fordist giants: Tale of a supercluster" *World Development*, vol. 23, no. 1, 1995

[21]Aida Quintar, Ruben Ascua, Francisco Gatto and Carlo Ferraro " Refaela: Un Cuasi-distrito Italiano ' a La Argentina'", (Documento de Trabajo CFI-CEPAL no. 35, Buenos Aires, Febrero 1993)

22 Albert Berry and Maria Teresa Mendez "Training in Latin America: Its Impact and Potential for Growth, Employment, Equity and Poverty Alleviation" (Background paper prepared for the World Employment Report, Geneva,1998) Mimeo.

[23]Judith Tendler, *Good Government in the Tropics* (Baltimore:Johns Hopkins University Press, 1997), chap 5.

[24] R Marx, "Quality and productivity in small and medium-sized firms in the Brazilian automotive industry", *IDS Bulletin*, vol. 24, no. 2, (1993) quoted in John Humphrey and Hubert Schmitz, *Principles for promoting clusters and networks of SMEs*. (Paper commissioned by the Small and Medium Enterprises Branch, UNIDO. Number 1, 1995), p.19