BUSINESS ENVIRONMENT AND SME EXPORTS: THE CASE OF CHILE

RESEARCH REPORT

November 2007

This publication was prepared by Management Systems International in collaboration with Weidemann Associates Inc. for the Business Growth Initiative Project and financed by the Office of Economic Growth of EGAT/USAID. This report is also available on the Business Growth Initiative project website at www.BusinessGrowthInitiative.org

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Submitted to:
USAID/EGAT/EG

Contract No.:
EEM-C-00-06-00022-00
November 2007

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EXECUTIVE SUMMARY

The purpose of this research piece is to examine the relationship between the business environment and SME export performance in Chile. While its features of political economy are unique, Chile offers programmatic lessons for donor interventions in other settings. Its experience with public-private dialogue is indeed rich. The country also demonstrates how reforms in the business environment are of limited impact when they are not accompanied by measures that expand the provision of financial and business services to SME firms.

While government's zeal for inspections, too many municipal licenses, the existing labor legislation and environmental regulations are recognized as problematic, SME firms acknowledge that, in general, the business environment is friendly to private enterprise expansion in domestic and foreign markets. Neither macroeconomic policy nor the legal and regulatory framework contains elements that severely constrain the capacity of firms to run operations and undertake planned investments. Lack of timely access to financial services at reasonable cost is recognized to be a far more important obstacle. Only 17% of SME firms obtain credit from commercial banks. Those that successfully export are included in this group. The majority obtains credit from suppliers and informal sources.

The government offers support programs to boost SME competitiveness and improve access of SME firms to foreign markets. The programs are demand-driven and conducted in a transparent and efficient manner, but are not accessed by the majority of the firms. To mitigate this problem, the government makes extensive use of ad-hoc private-public committees that are purposefully established to analyze problems that impinge on the profitability of the SME sector and propose regulatory norms and programs to address them. Early this year, private-public committees have been set up to analyze problems related to market access, use of the support programs, finance, labor legislation and SME associations. On this latter point, it is acknowledged that the majority of SME firms are not properly represented by associations. The government then also offers programs aimed at strengthening the associations.

The number of SME firms engaged in export transactions, and their dollar value has been increasing, but their relative contribution to total exports hovers between 3% and 4%. This indicator, however, may be deceiving, because the data does not capture SME indirect exports through clusters and value chains. Furthermore, the official definition of small and medium enterprises uses the criteria of annual sales with ceilings that are way too low in comparison with those used by other countries of the region with larger and smaller economies, such as Argentina (among the former) and El Salvador and the Dominican Republic (among the latter). The implication is that SME export activity may be more dynamic and significant than what is officially reported.

INTRODUCTION

For the last two decades, Chile has been considered the stellar economic performer of Latin America. Following decades of application of intensive and extensive state-led economic policies, in the late 1980's the country undertook a radical stabilization and structural adjustment of the macro economy. Measures introduced were aimed at reducing monetary subsidies, eliminating price controls, setting non-inflationary monetary targets by an institutionally reformed, autonomous Central Bank, restoring fiscal discipline, selling off state-owned companies, fostering more competition in financial markets, opening the economy to foreign investment, and removing tariff and non-tariff barriers to international trade. These pro-market policies drove the economy along a more sustainable, non-inflationary growth path and spurred a vigorous expansion of exports and imports. Complementing these macroeconomic reforms, the government also focused on introducing economic and institutional measures to foster a more rapid and sustained development of domestic private enterprises. These measures have had a direct impact on the business environment, and include interventions that relate to the ease of business entry, the efficiency of good, factor and financial markets, the simplicity and fairness of the tax regime, and last, but not least, the adequacy and reasonableness of trade requirements and procedures for transactions across international borders.

While the application of macroeconomic reforms rapidly turned Chile into one of the most open economies of the world, the micro economic interventions sought to create the conditions to underpin sustained increases in the competitiveness of both foreign and domestic private enterprises operating in the country. A first glance suggests that the country exhibits the features of a true "success story." For example, the 2007 Global Competitiveness Report places Chile among the best 50 economies, with a rank of 27th in the world, by far the best performer in Latin America, and surpassing either high-income countries, such as Spain and Italy, or some with relatively more developed economies, like the Czech Republic, Poland, South Africa and Greece. Likewise, it is highly significant that according to the Business Environment Ranking published by The Economist Intelligence Unit, Chile ranks 19th among 60 economies, besting high performers such as Japan, South Korea, Spain, Malaysia and China. Finally, the 2007 World Bank's Doing Business Report ranks Chile 28th in the world with respect to the ease of doing business.

These indicators, however, mask a more complex reality. For one, Chile has yet to dispel, once and for all, dependence in exports of primary goods – agriculture and mining. In fact, and notwithstanding the inroads that have been made with the development of non-traditional exports – largely composed by lightly industrialized natural resource-based products, such as processed fruits and seafood, wine, wood furniture, and so on – commodities still weigh heavily in the composition of Chile's total exports. If anything, the extraordinary commodity boom experienced in world markets since early this decade is a factor that blocks the road to more vigorous export diversification.

Objective of the Report

This report will focus on issues associated with firm access and participation in non-traditional export markets. Put simply, the report seeks to shed light on the type of business enterprise – micro, small, medium and large -- that drives and partakes in the benefits of Chile's export boom. Clarifying this issue is far from unimportant, as the experience of Italy demonstrates. The dynamic participation in world exports of this country is anchored, to a certain degree, in policy instruments that allow for equal access of opportunities for large and small private enterprise alike, and in institutional mechanisms that facilitate business cooperation and "joint" undertakings among firms of any size.

As regards the Chilean case, opinions vary. Some experts, while conceding that the SME sector has participated in the export boom, believe that this participation is not relatively important, and that the small weight of the SME sector in total exports is explained more by firm-related inefficiencies than by unfair or misguided policies. Others point to signs of more significant SME export potential that can be realized with focused interventions that, at the same time, could be instrumental in propelling stronger commercial linkages between small producers and larger export companies.

This report seeks to connect Chile's reforms in the business environment with its positive performance in international trade. Broadly defined, the business environment must be understood as the aggregate of government laws, regulations, policies, practices, implementations, and enforcements that – individually or collectively – encourage or discourage, help or hinder, and/or expedite or impede the establishment, promotion, operation, growth, or closeout of private businesses, including large, medium, small and micro enterprises that operate indistinctively in the formal and informal economy. In general, the business environment impacts businesses of all size directly through (a) the overall direction, balance, and degree of stability of the macro economy; (b) the quality of microeconomic management, that is, the policy, legal and regulatory frameworks that underpin private business operations; and (c) the organizational and administrative capacities of public agencies in charge of enforcing regulations.

The objective of this report is to identify the principal business environment-related microeconomic and institutional factors that have underlined Chile's export expansion and, more significantly, to determine the role such factors have played in either smothering or triggering new business opportunities in export markets for small and medium –sized enterprises (SME). It will attempt to find answers to the following questions:

- Has there been a surge of exports from SME firms and, if so, how significant has it been?
- What are the most important economic and institutional elements of the business environments that underline good SME export activity or retard a more successful performance?
- How effective has been the role of public, private sector and civil society institutions in fostering an export surge from SME firms, and how important has been the role of public-private dialogue?
- What are the lessons learned from the Chilean experience that can be useful for project design in other settings?

Methodology

The report relies on: (a) analytical review of research papers and articles that focus on the factors that explain Chile's export performance and that of the SME sector in particular; and (b) interviews with experts of the donor community based in Washington DC, and (c) telephone and e-mail exchanges with Chilean professionals working in state agencies and with representatives of Chilean exporters and business associations. All research activities and preparation of the report were conducted during the first quarter of 2007

Following a discussion of the economic and institutional elements that have underlined Chile's overall good export performance, the report will focus on how dynamic the participation of SME firms has been to propel this effort. Subsequently, business environment-related policies and regulations that condition the capacity of SME firms to successfully compete in foreign markets are analyzed, and the effectiveness of public, SME tailor-made interventions, discussed. Finally, an attempt is made to extract relevant lessons that can be applied in other settings.

SECTION II

Following the violent overthrow in September 1973 of a democratically elected socialist government, Chile moved radically away from industrialization via import substitution towards a strategy that embraced the principles of comparative advantage. This shift, the most ambitious and first applied in the Latin American region, underlined a sharp redefinition of the role, functions, and policies of the state in the economy. State-led economic policies, including the purposeful manipulation of relative prices that sheltered local industrialists from foreign competition, were discarded in favor of a free market policy orientation that preached the advantages of an open economic regime that put on the center stage private enterprise as a catalyst of wealth creation.

More than thirty years later, Chile shows the healthy signs of an economy that has become more dynamically integrated with the rest of the world. Exports, as is clearly depicted below, have skyrocketed.

Macroeconomic Policy

High inflation was one of the legacies of earlier regimes and in the 1970s, a fixed exchange rate was a key tool to address it. Unfortunately, by 1982, the real exchange rate had appreciated considerably. Exchange rate overvaluation, in combination with plummeting terms of trade and rising interest rates on external debt, led to a severe balance of payments crisis. The economy contracted sharply and hit rock bottom with the collapse of the banking system.1

Within Latin America, Chile is second to none in being remarkably nimble to adapt to changing situations and to correct past mistakes. Probably the most important lesson of the crisis of 1982 was the need to pursue a more pragmatic approach to monetary policy that would allow for the domestic currency, the peso, to float in a wide band around a central rate that the authorities would try to hold constant in real terms. Put simply, more than the need to control inflation, the central objective of monetary policy was the need to keep the exchange rate competitive. In effect since 1983, this “crawling peg” system has been central to the efforts to penetrate foreign markets and definitively is one of the most important factors behind rapid export growth from firms of all sizes.

On the other hand, inflation control was made easier by the strict enforcement of fiscal discipline. It is certainly impressive that since 1985 the economic authorities have managed to run sizeable budget surpluses. Not surprisingly then, Chile has featured macroeconomic stability for the last two decades. At times, this stability has been threatened not, it is important to underline, by a fragile external sector – a historical problem common to most Latin American

[1] In 1982, gross domestic product fell, astonishingly, by 14%. And as part of the program implemented to bail out the collapsed private banks, the Central Bank covered the deposits and purchased the overdue loans from the banks. To finance the rescue, the Central Bank issued debt notes with yields of 7% in real terms. Once the banks were auctioned back to the private sector, they bought Central Bank instruments with real terms above 7%. In combination with a cheaper exchange rate offered to private debtors to pay off their foreign debts, this amounted to hefty losses that the Central Bank had to assume. These losses were carried over for ten years and were equivalent to around 1.5% of GDP for each year.

countries that keep investors watching for the probability of a balance of payments crisis – but, ironically, by an external sector that has become, if anything, too robust. Put differently, Chile pays a price for its success.[2] International indicators of country risk are by now the lowest of the region and approximate those posted by advanced economies. Not surprisingly, the country has become very attractive to foreign investors who, directly and/or indirectly, have played an important role in the expansion of SME exports.

As depicted in Table 2-1, sound and predictable management of the macro economy has resulted in sustained increases in output and GDP per capita, and in declining inflation rates. It is important to point out that the management of the economy is not tilted to one sector or another. Put simply, and unlike the experiences of Asian countries like Japan, South Korea and Taiwan in their historical periods of rapid economic growth, the Chilean case is devoid of examples of sectors that were purposefully targeted to spearhead an accelerated process of export-led industrial growth. In Chile, economic policy has faithfully followed the dictum of comparative advantage. It has been neutral, applied equally across its regions, and to all enterprises independent of their size. In this context, the SME sector has therefore not been preferred. While, as will be described later, SME firms benefit from the existence of public programs that support improved competitiveness and penetration into export markets, the direction of policy is to avoid market distortions at all costs. Consequently, the SME sector has not been recipient of special lines of targeted and subsidized credit nor, for example, has it been given special concessions in the form of fixed quotas on public procurement or government-imposed exclusive rights to manufacture certain products for selected markets. But that the sector has benefited in more lasting ways, as evidenced by expanding market opportunities domestically and internationally, and by the benefits of operating in a milieu permeated by single-digit, low inflation rates, should be beyond doubt.

TABLE 2-1: GDP, GDP PER CAPITA, AND INFLATION (CPI)

	1980	1985	1990	1995	2000	2005
GDP (constant 2000 billions of US dollars)	28.1	29.4	40.7	61.8	75.8	93.9
GDP per capita (constant US dollars)	2,520	2,432.	3,093	4,295	4,917	5,747
Inflation, consumer prices (annual %)	35.14	29.46	26.03	8.24	3.84	3.05

Source: World Bank Development Indicators 2006

[2] The price is associated to potential foreign exchange rate-induced loss of competitiveness. To illustrate, since 1986, foreign capital has flowed in droves, lured by the prospects of a stable economy and a friendly business environment. In the early to mid 1990s, these inflows underlined appreciation pressures on the exchange rate, and this in turn imperiled the competitiveness of local firms in foreign markets. The Chilean economic authorities reacted deftly, stimulating more long-term foreign direct investment and discouraging at the same time portfolio investments with characteristics of "fly-by-night" capital. In doing so, they went "against the grain", oblivious to foreign and local experts who decried strict imposition of capital controls. Yet, the Mexican crisis of late 1994 which shook the foundations of the large economies of the region, but that left Chile spared, proved them right.

And yet, there is another "price" that the rest of the Latin American countries, if they could, would welcome to pay: since the late 1990s, Chile has become a net creditor to the Inter American Development Bank, the leading multilateral lender to the region.

Microeconomic Policy

Chile has made great strides in improving the clarity, transparency, stability and predictability of laws, regulations and procedures that firms must comply with in order to start and run their business operations. In Chile, spending considerable senior management time to clarify, let alone negotiate, regulations with government officials is virtually unheard of. Business costs associated with crime, violence and terrorism are very low by regional standards. And it is the country with best anti-corruption indicators in the region.[3] In general, firms of all sizes find that their "costs of doing business" are not that high, that is, that they can conduct business operations in an economic milieu that is not cursed by high transactions costs. As will be discussed more thoroughly, the business environment is underlined by the presence of a "good" regulatory framework that helps enhance the competitiveness of all firms and, consequently, their ability to successfully compete in foreign markets.

Chile ranks high in the world as regards the "ease of doing business." As can be inferred from data depicted in Table 2-2, Chile ranks within the world's top one-fourth in seven of the ten ranking factors of the World Bank's Doing Business Report. Exceptions are the regulations on closing a business, enforcing contracts and employing workers. Regulations to protect investors clearly stand out. In this critical business area, Chile outperforms 89% of all countries in the world.

TABLE 2-2: EASE OF DOING BUSINESS RANKING 2007, CHILE (1= BEST, TOTAL: 175 COUNTRIES)

Starting a Business	32	Protecting Investors	19
Dealing with Licenses	40	Paying Taxes	37
Employing Workers	58	Trading Across Borders	44
Registering Property	30	Enforcing Contracts	73
Getting Credit	33	Closing a Business	107

Source: The World Bank. 2006. Doing Business Report

A healthy climate for enterprise growth logically follows. Enterprise growth is greatly facilitated by an environment where respect for law and regulations commands social acceptance. In fact, Chile boasts of a long historical tradition of respect for the rule of law. In this context, investors can reasonably expect that the "rules of the game" will not abruptly or whimsically be changed by all-too-powerful public servants tempted to accumulate more political power.[4] Furthermore, domestic and foreign investors are becoming increasingly convinced that the economic authorities are truly committed to development goals through the application of market policies, and that the probability of a radical departure from this model, say, following the eventual election to the highest office of a party from the political opposition, is indeed slim. Consensus

[3] In 2005, according to empirical studies on corruption indicators conducted in 209 countries, Chile ranked above 88% of them. (**Source**: The World Bank: Governance Research Indicator Country Snapshot. Comparison for Control of Corruption Across a Number of Countries, 2004).

[4] Since the installation of democratic regimes in 1990, discussion of economic policy has become more open to the public, checks and balances have been strengthened, and a general drive to demand accountability of public servants is pushed by organizations of civil society.

on economic goals is the rule. Certainly, for the last two decades, the country has achieved, by Latin American standards, a remarkable degree of economic and political stability.

To summarize, respect for the rule of law, consensual economic policies, and commitment to further reform are the foundations of a friendly, enabling business environment. Remarkably, Chile ranks 11th out of 157 countries in the Index of Economic Freedom.[5]

Institutional Context

As opposed to so many developing countries across the world, in Chile sustained strengthening of institutions is enshrined in government policy and is taken seriously by authorities irrespective of what political party holds power. Powerful personalities leave an imprint in the institutions they lead, but their decisions normally abide by rules, by-laws and general protocols that are seldom changed at will. Again, this feature of Chilean political economy reflects a cultural disposition to respect the legality of social arrangements.

The capacity of public institutions to deliver high-quality services is a key determinant of economic growth. In Chile, generally, laws and regulations are tailored to the institutional capacities of regulators to administer and enforce them. They strive to do so with efficiency. Significantly, the country scores 1.40 in the Regulatory Quality Index, a score that is typical of advanced, industrialized countries.[6] That public institutions in Chile perform well is also evidenced by the fact that the country has the highest score among Latin American countries in the Public Institutions Index.[7] Consequently, and not surprisingly, Chile also exhibits the highest score in government effectiveness in the region.[8]

Within the public sector, the most important agencies that provide support services to SME firms are the *Corporación de Fomento de la Producción (CORFO), Pro Chile* and *Banco Estado* (See Box 2-1). As revealed in later sections of this report, some of the programs they offer certainly have a positive impact on the competitiveness of SME firms and on their capacity to penetrate foreign markets.

As regards the private sector, chambers of commerce and business associations are predominant features of economic life in Chile. Some of these associations, like the *Confederación de la Producción y el Comercio (CPC)* and the *Sociedad de Fomento Fabril (SOFOFA*) are certainly strong and with capacity to constructively engage the public sector in the design of economic and financial policy. The reach and influence of SOFOFA is particularly impressive. This association is divided into 46 sector chapters and eight regional branches with a membership of 2500 enterprises that represent 80% of Chile's industrial activity, 30% of the country's GDP, and 45% of its exports. SME firms have also set up their own associations that

[5] The Heritage Foundation's Index of Economic Freedom examines the restrictedness of economic activity in a country by measuring conditions in 10 areas: business, fiscal, financial, monetary, corruption, trade, government interference, investment, property rights, and labor.

[6] The range of scores is between –2.5 and +2.5, with higher scores indicating better performance. The World Bank's Regulatory Quality Index measures the "market-friendliness" of countries by examining the degree of government-induced market distortions and the burdens imposed by excessive regulation. It is a useful proxy to determine the commitment to create an business environment that fosters trade and foreign investment

[7] The World Economic Forum's Public Institutions Index combines both a contract and law index and a corruption sub index. It measures the extent of impartiality in the interactions between the public and private sectors.

[8] The World Bank's Government Effectiveness Index measures the quality of public and civil service, of policy formulation and implementation, and of government commitment to these policies.

have the dual function of providing business services to the membership and advocating the government for the adoption of more friendly policies to their constituents. The advocacy and representation activities are carried out as individual associations, in alliance with others, or articulating positions jointly with SOFOFA.

Export Performance

> **BOX 2-1: STATE AGENCIES THAT SUPPORT SME FIRMS**
>
> **Corporación de Fomento de la Producción (CORFO)**
>
> Established in 1939, CORFO is the economic development agency of the Ministry of the Economy. The agency funds and coordinates programs aimed at increasing the competitiveness of the Chilean private sector and the development of its export capacities. The disbursement and administration of funds and programs are delegated to third party operating agents, ranging from financial companies to private organizations. CORFO remains responsible for their overall supervision, administration, and evaluation. In early 2007 there were 20 private organizations and 12 financial institutions acting as operating agents for CORFO managing 50 programs.
>
> There are approximately 32,000 Chilean companies, mainly SME firms, which benefit from CORFO's programs and subsidies. Support programs amount to $230 million per year, of which 50% is allocated to the support of export associative arrangements, 30% to improve SME quality assurance and competitiveness, and 20% to provide long-term credit lines.
>
> **PROCHILE**
>
> Established in 1974 with the mission of promoting non-traditional exports in foreign countries, this agency is under the aegis of the Ministry of Foreign Affairs. The agency has 12 regional branches throughout Chile and representations in 35 countries across the world. With an annual budget of $22 million, the agency co-finances market studies, publishes catalogues, provides support to firms that want to open branches abroad, and finances their participation in fairs and missions.
>
> **BANCO ESTADO**
>
> Established in 1851, Banco Estado is a state-owned bank whose mission is to provide financial services to under-served clienteles, including SME firms. It operates as a typical commercial bank but with financial technologies tailored to the demand profile of micro, small and medium enterprises both in urban and rural areas of the country. Services are provided in a rapid, personalized, and flexible manner, generally with the best interest rates available. It is well run, as it does not depend on government largesse, and operates profitably.
>
> Banco Estado mobilizes large volumes of savings from large and small depositors alike. A tradition of solvency and good management imprints trust in the population at large.
>
> **Sources**: Respective organizations' websites; Sepúlveda (Undated); and International Trade Center, 1999

Before the introduction of the pro-market reforms, Chile pursued an extreme inward model of economic development. Import quotas and bans, foreign currency controls, a government-imposed low exchange rate for the import of industrial inputs, and high tariffs on the import of consumer goods all combined to give domestic industrialists an exceptionally high rate of effective protection. Under these circumstances, domestic industrialists had no incentive to introduce technological innovations that would reduce unit operation costs, or offer consumers products of higher quality and lower prices. Neither did they feel the urge to place their products in foreign markets. Moreover, these policies penalized growth prospects in economic sectors, such as agriculture, fisheries, forestry and even light manufacturing goods that had comparative advantages vis-à-vis the rest of the world. Typically then, exports were heavily concentrated in commodities, most especially copper and other minerals. All in all, the country had no feasible options to escape from recurring adverse changes in its terms of trade which, at times, were abrupt, and the impact on incomes consequently severe.

The new economic authorities rapidly enacted radical changes. In the 1970s, tariffs were drastically lowered and unified at 10%. But, because the real exchange rate had considerably appreciated, the aforementioned balance of payment crisis of 1982 was all but inevitable. As part of remedies to alleviate the crisis, tariffs were raised to 35% in 1984. After that year however, they were lowered progressively and unified to 6% in 2003. This policy was complemented with the introduction of important export promotion measures. [See Box 2-2].

What has emerged, after more than three decades, is an economic structure that is markedly different, one that, as mentioned before, is one of the most open in the world.[10] As Table 2-3 illustrates, trade as a percentage of GDP has been steadily on the rise. Good export performance is also evidenced by high rates of growth and by trade balance surpluses, measured as percentage of GDP. On the other hand, as indicated by Table 2-4 and Chart 2-1 the structure of exports remains concentrated in primary goods, especially ores metals and fuels.

BOX 2-2: EXPORT PROMOTION MEASURES

Chile has aggressively pursued export-promoting incentives during the last three decades. The most important are the following:

- Free trade agreements with many Western Hemisphere countries, including the United States, Canada, Mexico, Central American countries, the European Union, Asian countries (China, South Korea and Singapore), and New Zealand.
- Elimination of all bans on specific exports and imports.
- Drawback and simplified tax rebates for export goods.
- Rebates of customs duties, and duty and value added tax waivers for imports used to produce export goods.
- Deferred payment of customs duties on imports of capital goods.
- CORFO lines of credit disbursed through commercial banks and funds administered by Pro Chile to finance promotional expenses of SME firms.
- Establishment of free trade zones.

These measures have resulted in significant increases of the number of exporting enterprises, products they manage to place, and the markets they are able to penetrate. In fact, in the late 1970s, only 200 enterprises exported, placing 200 products in 50 countries. A decade later, the number of exporting enterprises had grown exponentially to 3,666, which supplied 1400 products to 120 countries. The trend continued in the 1990s, and in 2006 the number of exporting firms had reached 6,880 businesses that placed 5,303 products to 184 countries.[9]

[9] Source: Pro Chile, "Hitos del Comercio Exterior: 30 Años."
[10] Chile's score on the International Monetary Fund's Trade Policy Restrictiveness Index, measuring tariff and non-tariff barriers to trade, is 1, the highest category obtainable.

TABLE 2-3: SELECTED EXTERNAL SECTOR INDICATORS

	1985	1990	1995	2000	2004
Index of Exports in Goods & Services (1985=100)	100	237.84	448.01	532.77	866.77
Trade/GDP (percent)	30.11	51.58	65.78	62.46	76.92
Trade Balance/GDP (Percent)	2.49	1.55	0.20	0.93	7.62

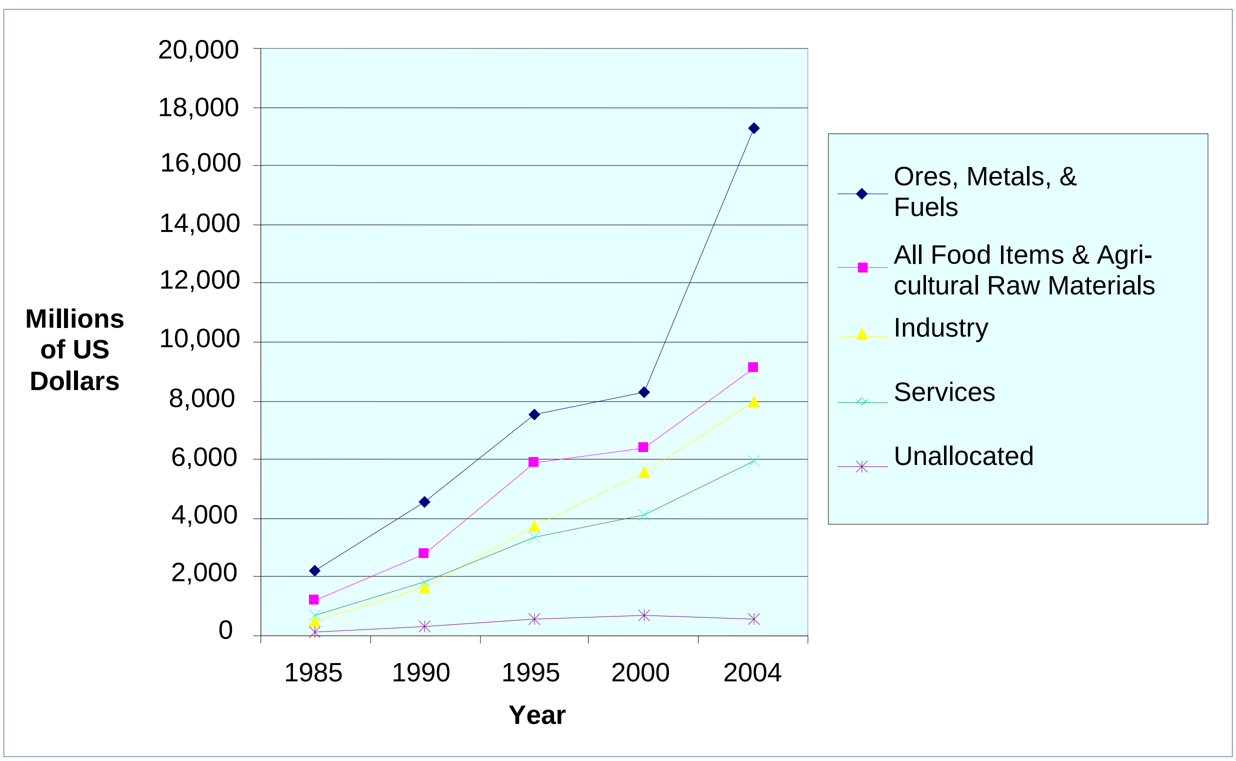
Source: UNCTAD Handbook of Statistics 2005, World Bank Development Indicators 2006 and Authors' Computations

TABLE 2-4: EXPORTS BY CATEGORY (MILLIONS OF DOLLARS)

	1985	%	1990	%	1995	%	2000	%	2004	%
Ores, Metals, & Fuels	2191.1	46.5	4569.1	40.8	7532.8	35.7	8313.5	33.1	17261.8	42.3
All Food Items & Agricultural Raw Materials	1200.2	25.5	2773.8	24.8	5911.7	28.0	6391.5	25.5	9110.9	22.3
Industry	507.8	10.8	1668.2	14.9	3740.6	17.7	5599.8	22.3	7961.1	19.5
Services	693.0	14.7	1848.0	16.5	3333.0	15.8	4083.0	16.3	5956.0	14.6
Unallocated	118.6	2.5	345.0	3.1	586.4	2.8	709.6	2.8	541.2	1.3
TOTAL	**4710.7**	**100.0**	**11204.1**	**100.0**	**21104.5**	**100.0**	**25097.4**	**100.0**	**40831.0**	**100.0**

Source: UNCTAD Handbook of Statistics 2005

CHART 2-1: EXPORTS BY CATEGORY (THOUSAND OF DOLLARS)



Source: UNCTAD Handbook of Statistics 2005

SECTION III

SME firms of Chile have shared in export growth. Their performance and the significance of their participation in export flows are explored below. First, basic data of SME contribution to sales, employment and productivity is presented.

Definition and Basic Data

Firms of all sizes in Chile are defined according to two criteria. One is the level of annual sales, adopted by the Ministry of Economy (MINECON), which uses data from the Internal Tax Service (SII). The other is the number of persons employed, adopted by the Ministry of Planning and Cooperation (MIDEPLAN), using data from the National Socio-economic Survey (CASEN). Four categories are recognized – micro enterprise, small enterprise, medium sized enterprise, and large enterprise. Table 3-1 provides the break down of this classification according to sales and number of employees.

TABLE 3-1: DEFINITION AND CLASSIFICATION OF FIRMS

	MINECON (annual sales in US dollars)	MIDEPLAN (staff)
Micro	0 – 58,000	1-9
Small	58,001 – 600,000	10-49
Medium	600,001 – 2,400,000	50-199
Large	2,400,001 and above	200 and more

Source: Dini & Stumpo, 2002, Chile Emprende; 2005, and Authors' Computations

Table 3-2 depicts the number of enterprises per category according to annual sales and its percentage distribution for the period 1994 – 2004. From Table 3-2 it can be inferred that the total number of enterprises grew considerably by 44% during the period. If anything, this indicator reflects the excellent performance of the economy during the period. Significantly, large enterprises registered the highest growth rate (90%), followed by medium sized enterprises (60%) and small enterprises (57%). The number of micro enterprises grew by 41%. In all, what the data suggests is that economic growth in Chile is led principally by large enterprises that have more capacity for sustained capital accumulation.

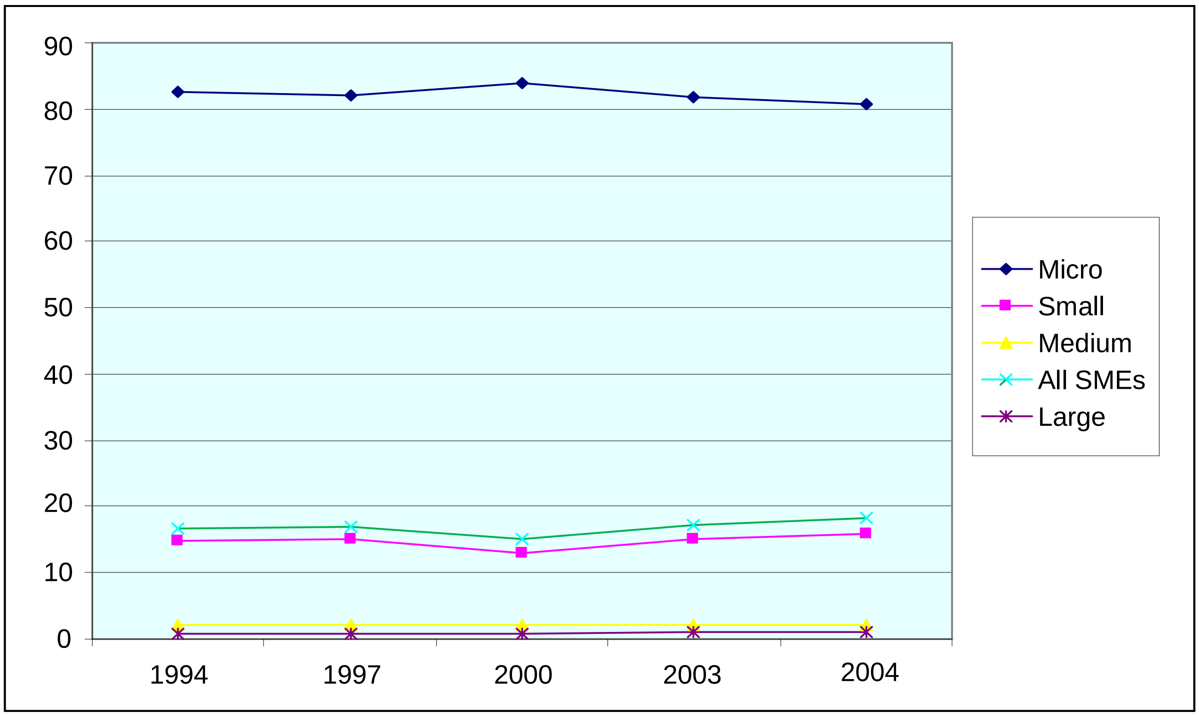
TABLE 3-2: NUMBER OF ENTERPRISES PER CATEGORY, 1994-2004

	1994		1997		2000		2003		2004	
		%		%		%		%		%
Micro	404,599	82.5	432,431	82.1	552,125	84.0	570,544	81.8	571,535	80.8
Small	71,984	14.7	78,805	15.0	85,873	13.1	105,524	15.1	112,731	15.9
Medium	9,649	2.0	10,870	2.1	13,098	2.0	14,577	2.1	15,748	2.2
All SMEs	81,633	16.7	89,675	17.0	98,971	15.1	120,101	17.2	128,479	18.2
Total	**490,286**	**100.0**	**526,920**	**100.0**	**657,062**	**100.0**	**697,513**	**100.0**	**707,634**	**100.0**

Source: Dini & Stumpo, 2002; Chile Emprende, 2005

Still, as evidenced by the tables, micro enterprises constitute the bulk of firms in Chile, representing, in 2004, 81% of the total. In that year, SME firms constituted 18% of total enterprises. Within this classification, small firms are by far the most numerous, representing almost 16% of total firms. Large enterprises barely surpass 1% of the total number of firms. This distribution of firms according to size generally approximates that found in the majority of Latin American countries.

CHART 3-1: NUMBER OF ENTERPRISES PER CATEGORY, PERCENTAGES, 1994-2004



Source: Dini & Stumpo, 2002; Chile Emprende, 2005

Thirty six percent of small and medium sized firms are in the commerce sector, 16 percent in services, 16 percent in transport and construction, 13 percent in industry and manufacturing, 12 percent in agriculture, and 6 percent in other sectors.

By sector small and medium firms represent 29 percent of the total number of firms (including micro firms) in industry and manufacturing, 24 percent of the firms in transport and construction, 23 percent of the number of firms in agriculture, 19 percent of the firms in services, 15 percent of the firms in commerce and 10 percent of the firms in other sectors.

Sales

Table 3.3 shows growth rates of annual sales according to firm size for the period 1994 – 2003. and Table 3.4 depicts the percentage distribution. Again, the data clearly illustrate that firms of all sizes increased their annual sales. But the percentage growth of sales of SME firms (49%) and of micro enterprises (40%) pales in comparison with that posted by large enterprises

(140%). Because of their more dynamic expansion, the participation of large enterprises on total sales in that period jumped sharply, from 69% to 78%, achieved largely at the expense of SME firms and micro enterprises, and reflecting their capacity for higher rates of productivity growth and capital accumulation.

TABLE 3-3: PERCENTAGE GROWTH OF ENTERPRISE SALES 1994 - 2003 (1994=100)

	1994	1997	2000	2003
Micro	100	110	110	140
Small	100	110	120	146
Medium	100	113	133	153
All SMEs	100	112	126	149
Large	100	127	172	240

Source: Dini & Stumpo, 2002; Chile Emprende; and Authors' Computations

TABLE 3-4: ENTERPRISE SALES 1994-2003, PERCENTAGE DISTRIBUTION

	1994	1997	2000	2003
Micro	4.86	4.40	3.41	3.39
Small	13.80	12.46	10.55	9.52
Medium	12.14	11.26	10.28	8.75
All SMEs	25.94	23.73	20.82	18.27
Large	69.20	71.88	75.76	78.34
Total	**100.00**	**100.00**	**100.00**	**100.00**

Source: Authors' Computations

Employment and Productivity

In 1996 the Ministry of Planning reported that large enterprises accounted for only 10% of total employment. The bulk of jobs were provided by micro enterprises (40%), followed by small enterprises (37%) and medium sized enterprises (13%). SME firms, therefore, contributed 50% of employment in the country. More recent data released by CORFO in the year 2000 varied insignificantly. Again, this relative contribution of SME firms to employment generation basically mirrors the situation in most Latin American countries.

As hinted above, the disparity of productivity levels between large and smaller enterprises is quite significant. Indicators of two ratios -- sales to number of enterprises, and sales to number of employees are depicted in Tables 3-5 and 3-6 respectively. All things being equal, the higher the ratios, the better the productivity performance. From Table 3-5 it is possible to conclude that the ratio of sales to number of enterprises during the period 1994 – 2003 in both the micro enterprise and SME sectors have been virtually stagnant, while that of large enterprises grew from 17.950 to 25.436 in the same period, that is, by 41%. This gap in productivity growth performance is also dramatized by the ratio sales to number of employees: during the period 1990 – 96, for large enterprises the ratio grew by 84%, while that posted by micro enterprises and SME firms was 22% and 36% respectively. Within the latter however, it is important to note that productivity growth was largely spearheaded by medium sized enterprises. These firms posted a growth rate of 151%, while that of small firms slightly declined.

TABLE 3-5: RATIO OF SALES TO NUMBER OF ENTERPRISES 1994 – 2003

	1994	1997	2000	2003
Micro	0.013	0.013	0.010	0.013
Small	0.202	0.203	0.203	0.201
Medium	1.323	1.330	1.300	1.339
All SMEs	0.334	0.340	0.349	0.339
Large	17.950	19.162	21.037	25.436
All Firms	**0.214**	**0.244**	**0.252**	**0.320**

Source: Authors' computations based on CORFO, in Dini & Stumpo, 2002, and Chile Emprende, 2005

TABLE 3.6: RATIO OF SALES TO NUMBER OF EMPLOYEES 1990-1996

	1990	1992	1994	1996
Micro	2.249	2.461	2.745	2.745
Small	8.807	9.122	9.206	8.630
Medium	8.606	9.355	21.353	21.661
All SMEs	8.746	9.191	12.548	12.052
Large	92.998	117.732	112.128	171.109
All Firms	**18.070**	**20.829**	**22.450**	**24.310**

Source: Authors' computations based on CORFO, in Dini & Stumpo, 2002, and Chile Emprende, 2005

SME Export Performance

The contribution of SME firms, in terms of the number of exporting units and export value, is determined by external and internal factors. The former includes the characteristics of the products they sell, the conditions in external markets, and the overall quality of the domestic business environment. Internal factors relate mainly to the managerial capacity of the firms. In this regard, there are important general weaknesses of Chile's SME enterprises that cannot be dismissed lightly. Worth highlighting are the following:

- Managerial skills needed to consolidate market shares and, more critically, to steer the firm along faster rates of growth of sales and profits are not easy to find in local markets. This problem is even more severe in case of family owned firms that are reluctant to hire technically qualified outsiders, even if their salaries can be afforded.
- A sizeable percentage of SME firms either do not know or do not access the SME-targeted support programs that are made available by CORFO and Pro Chile.
- The majority of SME firms lacks knowledge to appraise the potential opportunities of foreign markets and devotes little resources to access the necessary information.
- SME firms are at best inconsistent in allocating resources to introduce technological innovations in production processes and raise the skills of their workforce.

Consequently, total factor productivity tends to be sub-par, and the capacity to successfully engage in price-competition in domestic and foreign markets is diminished.

- Although it is more the exception than the rule, SME firms in Chile still must contend with domestic input suppliers that fail to meet high-quality standards and that do not fulfill pre-agreed delivery timelines.
- SME firms seldom pursue strategies aimed at ensuring overall quality assurance. This deficiency is expressed in aspects of business operations that are critical for a successful export drive, such as the capacity to meet international production standards, product packaging, cost-efficient marketing campaigns, and the timely delivery of products.
- Timely access to financial services and at reasonable cost is problematic for most SME firms. This important problem is addressed more thoroughly in the next section.

In Chile, SME firms export both directly, as individual firms, and indirectly, in associative arrangements. The challenges inherent in these two modalities are discussed below.

Direct Exports

Chile does offer examples of individual SME firms that have successfully penetrated foreign markets directly, especially in products where they enjoy strong comparative advantages (See Box 3-1).

But only a minority of SMEs grew and "graduated" into large exporting enterprises. In fact, there is no correlation between an increased number of SME firms and increases of "graduated", larger firms. On the other hand, according to Pro Chile, higher SME export activity, whether they originate in small and medium enterprises or in those that graduate, does not correlate with a drop in sales of the larger firms. What this suggests is that the majority of SME exporting firms and large enterprises do not directly compete in the same segments of foreign markets.

For the bulk of SME firms, the task of exporting directly and individually is becoming increasingly more difficult due to the following reasons:

BOX 3-1: A SUCCESSFUL SME EXPORTER AND THE VIEW FROM AN EXPORTER

Exporter

Viñas Montes was founded in 1987 by two partners with wine industry experience and two partners who shared a vision of making Chilean wines internationally known and recognized. In 1988 Viñas Montes exported 7,000 cases of wine; by 2006 it exported 600,000 cases to 75 countries on five continents. This former SME now ranks as the fifth largest wine exporter of the country.

What accounts for this success? First is the resilience of its owners and managers. The owners' vision of penetrating the high quality segment of the market directed them to develop the Montes Alpha Cabernet Sauvignon, reputed in the US market as being a high-quality wine.

Second, support from Pro Chile helped with product promotion. Pro Chile rented large spaces at international fairs, which facilitated making contacts with potential buyers. They helped with distributing product samples, getting discounts for trips and similar services. Since its inception, Viñas Montes has reimbursed Pro Chile for all expenditures made on its behalf. At present Viñas Montes no longer needs support from Pro Chile.

Source: Viñas Montes and Pandol websites and phone interviews with company's representatives.

First, it is of critical importance that the individual firm offers a *differentiated product* targeted in a precisely defined segment of foreign markets. The possibility of a differentiated product is materialized, first and above all, by existing conditions of comparative advantage. In this regard, individual SME firms in Chile potentially have ample profitable opportunities, for economic policy has been explicitly designed to facilitate the expansion of business activities that derive from the pursuit of this fundamental economic principle.

Within the domain of the firm however, it must be stated that crafting and establishing the bona fides of a differentiated product demands, at the very least, entrepreneurial ingenuity, risk-taking attitudes, time, patience, and a disposition to place more resources *first in the development of the product then in the funding of its commercialization.* Only a minority of SME firms, not only in Chile but also in most developing countries, can meet these conditions. When the product is not properly differentiated, the SME firm will be prey to a war of price competition from other producers that can turn out larger volumes of output, with the corresponding lower unit operating costs that SME firms will find it very difficult to match via reduced prices.[11]

BOX 3-2: A SUCCESSFUL SME EXPORTER AND THE VIEW FROM AN IMPORTER

Importer

Pandol Brothers', a California-based importer of fruits and vegetables, was one of the only two US importers of fruit and table grapes from Chile in the 1960s. Today, between 2.7 and 3.5 billion boxes of produce are imported from Chile annually from about a dozen Chilean exporters that include both large enterprises and SME firms. One of these enterprises is the subsidiary of Pandol in Chile, which owns several farms. Approximately 30% of Pandol's total imports from Chile are supplied by the company's owned farms. Pandol is therefore in a unique position, both as an importer and as in-country producer, to assess the strengths and weaknesses of the country's business environment. Pandol holds the view that the business environment facilitates private enterprise growth and is of much higher quality than those existing in other countries that produce and export the same products as Chile.

Accordingly, the openness of the trade regime and regulations that expedite international trade transactions are major factors of success. Quality assurance has also been a decisive factor for the continuing relationship between Pandol Brothers' and Chilean exporters. Quality has been reflected not only in the produce itself, but also in the professionalism of the company's employees.

Source: Viñas Montes and Pandol websites and phone interviews with company's representatives.

Second, distribution channels are becoming increasingly more complex and sophisticated in consumer markets of the most advanced countries. Distribution firms, on one hand, follow closely consumer tastes for a multitude of both perishable and durable products that not in all cases enjoy the advantages of brand recognition. On the other hand, the supply of SME firms in search of reliable distribution channels has expanded considerably, as the number of firms vying to place their products in international markets has grown by leaps and bounds, from both developed and developing countries. Under these circumstances, it is difficult for an upstart SME firm willing to export to enlist the commitment of a distribution enterprise to advocate its particular product.

SME firms in Chile place an important percentage of their foreign sales in the United States

[11] Interestingly, a survey of successful SME exporters in Chile indicates that almost half of them cannot offset any type of disadvantage they face in foreign markets via lower prices. (See Moori-Koenig 2004). If anything, this is evidence that they operate in highly competitive markets. Under these circumstances, the need to differentiate a product that must be placed in well targeted market niches becomes more urgent.

and countries of the European Union. Fortunately, flagship products, such as wine, fruits and seafood have solidly established themselves in these highly competitive markets. A much stiffer challenge awaits those SME firms that are intent on marketing other products that can be potentially profitable.

Third, importers, especially those of developed countries, increasingly prize quality assurance of products they buy. As noted, quality assurance relates not only to the demand of certified standards of production, but also to the fulfillment of obligations that are mutually agreed by each part at the moment of the transaction, such as the timely delivery of the product at price and quantities that have been clearly specified beforehand. In many Latin American countries, SME firms face difficulties to meet international quality standards, in part because the public programs needed to fill these gaps are either weak or non-existing.

Fortunately, in this respect, Chile is making steady progress, as evidenced by the support programs of CORFO. Still, the majority of SME firms have yet to take advantage of the benefits conferred by these programs.

Fourth, the success of an exporting SME firm is intimately tied to a *sustained* effort aimed at penetrating foreign markets. This effort must be enshrined in the design of a realistic business plan and supported by financial resources that must be allocated to fund the marketing strategy. Timeframe is a key issue. An effort that is not underlined by a long-term commitment of financial resources is probably doomed to failure. The Latin American experience in countries such as Colombia, Brazil, Mexico and Chile proper is littered with SME firms that *occasionally* export; firms that can be very agile in taking advantage of market opportunities that suddenly emerge, but that abandon the export drive once such opportunities vanish. Typically, these firms show export sales in a discontinuing fashion - one year they export, the following three or four they do not, then they export again, then they stop doing it, and so on. Their strategy is basically reactive and in time, as world markets become increasingly more competitive, their presence in export markets is bound to disappear.

On the other hand, individual SME firms that follow a more proactive approach will typically establish a division staffed with capable professionals who will be permanently tasked with the responsibility of placing foreign sales. But this requires financial resources that are always scarce, and more so in the case of SME firms. A budget then is needed to fund basic promotional activities, such as business trips, participation in foreign trade fairs, development of a state-of-the-art website and the like. Many an individual SME in Chile has managed to meet these prerequisites, but the majority of them have not.

Fifth and finally, an individual SME firm must ponder the threats from foreign firms that can turn out goods that can be priced significantly lower because they are produced in large volumes. If anything, the emergence in the last decade of China and, to a lesser extent, India, as formidable world competitors in the production of a large number of consumer goods, dramatizes this threat.

Associative Arrangements for Exports

If world economic trends make it more difficult for individual SME firms to successfully place their products in foreign markets, the alternative is for them to enter into productive – vertical and horizontal – associative arrangements.

In general, vertical associations have the greater promise when the legal and regulatory framework of business activities is transparent and applicable to all, that is, when it is not captured by a handful of powerful large firms that, in cahoots with government officials, secure for themselves special privileges, all of which perpetuates, in this process, trends of economic exclusion. In addition, vertical associations materialize more easily when the managerial, technological, human resource and capital endowment gaps between the well-established, larger concerns and the SME firms is not that significant. In countries that face this unfortunate reality, it is very difficult for SME firms to meet the quality standards that the larger firms require. Typically, these countries would primarily offer what is most abundant and cheap – unskilled labor – but this attracts a pattern of foreign investments that generate limited economic value added. In this context, large firms in need to buy an array of non-labor inputs look elsewhere to find reliable suppliers, and the possibility of integrating numerous small producers into productive value chains remains a distant dream.

BOX 4-1: HORIZONTAL ASSOCIATIONS

In **horizontal associations**, like-minded producers of approximately equal size pool efforts and resources to place their products in foreign markets. An advantage of this relationship is that it reduces the potential for exploitative patterns in commercial transactions. Other important benefits include: (a) arrangements do not preclude SME firms from developing and advertising their own brands; (b) it facilitates obtaining hefty discounts on large volume of purchases and obtain other favorable terms from their suppliers; and (c) pooling of resources to fund lower the cost of conducting the common tasks in exporting and acquiring technical assistance to raise quality standards and productivity levels.

Horizontal associations facilitate a larger volume of exports, lowering of production costs, and dissemination of valuable market information and new technologies within the membership. The arrangements penetrate new markets and consolidate existing ones. Yet, they are not easy to implement, as coordination among members may be problematic and time consuming.

Source: Ramírez (2005)

Fortunately, and as revealed in the next section, Chile features a legal and regulatory framework that is considered of high quality. And the country is not cursed by yawning gaps in the divide between large and small firms. Not surprisingly then, vertical associations have become more common in the last two decades, most notably in business activities where the country enjoys strong comparative advantages – agriculture, fisheries

BOX 4-2: VERTICAL ASSOCIATIONS

In **vertical associations,** SME firms link themselves dynamically with a larger business concern, and become *indirect* exporters. The products may be either final goods or intermediate inputs. The larger firm could be an experienced producer or a trader who is knowledgeable of trends and conditions in foreign markets. Market analysis, identification and design of products, definition of brands, and direct relationships with foreign buyers are tasks normally provided by the large firm. SME firms are relieved from these responsibilities, an important conservation of financial resources for SMEs.

Vertical associations carry risks that engender potential costs for SME firms. One is the high concentration of sales to a single, large client that can breed overdependence in key aspects of business operations, such as finance and production. In this context, the bargaining power of SME firms, as credit recipients, and as sellers of goods and services, is likely to be diminished. Another risk is that SME firms may not be able to develop and promote their own brands, an important restriction that can blunt future plans to directly penetrate foreign markets.

Source: Ramírez (2005)

and metals.

On the other hand, the establishment in Chile of horizontal associations has its challenges. Actual experience points to the presence of the following problems:

- Members display too strong of individualistic tendencies and leaders may be too rigid and too imposing.
- Differences in objectives, priority markets, and action plans are sometimes too difficult to bridge at the beginning, or may surface later on.
- Members can reveal poor disposition for teamwork and lack of commitment to cooperate with the manager.
- Lack of access to financial services is an obstacle to finance working capital and planned investments.
- Many associations report difficulties in finding good managers or in retaining those proven to be capable.

Overall Significance of SME Exports

As Table 3-7 illustrates, in 2000 less than 1% of the total number of firms exported. The relative decline, as compared with 1997, mainly mirrors the adverse shock from the severe Asian financial and economic crisis. The group of large enterprises had the highest proportional representation, with almost a third of businesses within this category that place sales in foreign markets. Within the SME sector, the gap between small and medium enterprises is wide – less than 2% in the former and above 10% in the latter. Total SME exports include a wide variety of agricultural products, manufactured goods, commerce, services and even transport and construction equipment. In 2005, 48% of exports of small enterprises were destined to the Mercosur market, 39% to the United States, and 13% to the European Community. The preferred market of medium enterprises was also Mercosur (52%), but they placed proportionally higher sales in the European Union (22%) and Asian countries (12%) than in the United States (9%).[12]

TABLE 3-7: PERCENTAGE OF EXPORTING FIRMS, BY SIZE

	1997	2000
Micro	0.14	0.09
Small	2.00	1.78
Medium	12.00	10.59
All SMEs	3.21	2.94
Large	38.10	31.80
All Firms	**1.01**	**0.81**

Source: Authors' computations and Comité de Fomento de la MyPE, 2003; CORFO, in Dini & Stumpo, 2002; Chile Emprende, 2005

[12] **Source:** CIpyme (undated)

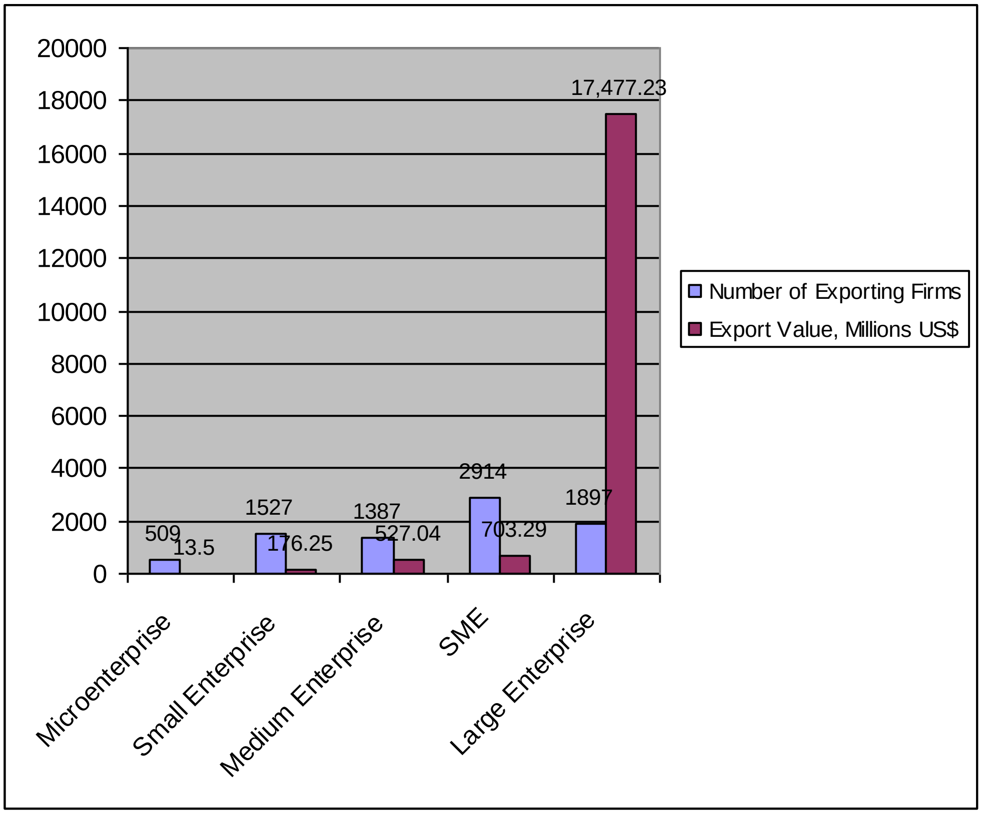
Table 3-8 shows data of number of exporting enterprises and dollar value for the years 1997 and 2000. Both indicators do not vary significantly from one year to the other. In 2000, SME firms accounted for almost 55% of the total numbers of enterprises that exported. On average, they exported $240 thousand per firm. The contribution of large enterprises was 36% and that of micro enterprises was 9%. In terms of dollar value however, the bulk is contributed by large enterprises (96%), with each exporting on average around $8 million. Therefore, while the absolute number of SME exporting firms and their total dollar value seems to be slightly ascending, the relative value contribution of SME firms on total exports appears to be very low and even declining.

TABLE 3-8: NUMBER OF EXPORTING FIRMS AND EXPORT AMOUNT, 1997 AND 2000

	1997				2000			
	Exporting Firms		Exports, $		Exporting Firms		Exports, $	
	Number	% of all Firms	Millions US$	% of all Firms	Number	% of all Firms	Millions US$	% of all Firms
Micro	597	11.2	17	0.1	509	9.6	13.5	0.1
Small	1575	29.7	181	1.1	1527	28.7	176.35	01.0
Medium	1304	24.6	505.0	3.0	1387	26.1	527.0	2.9
All SMEs	2879	54.2	686	4.1	2914	54.8	703.3	3.9
Large	1834	34.5	15,942.	95.8	1897	35.7	17,477.2	96.1
Total	**5310**	**100.0**	**16,645**	**100.0**	**5320**	**100**	**18,194.0**	**100.0**

Source: Comité de Fomento de la MyPE, 2003

CHART 3-2: NUMBER OF EXPORTING FIRMS AND VALUE OF EXPORTS PER CATEGORY, MILLIONS US$, 2000



Data of 2004 seems to corroborate this situation and general trend. In this year, it is fair to state, total value of SME exports jumped significantly to $1,259 million, an increase of 79% from 2000.[13] But this amount constituted 3.1% of the total value of exports, significantly lower than the 3.87% registered in 2000.[14]

In light of these recent data, is it then safe to conclude that, while SME firms are increasing their export dollar values, their relative contribution to total export is insignificant and with a tendency to decline? Unfortunately, the answer is not that simple due to the following two reasons. First, official statistics only report direct exports from *individual* firms. In doing so, it does not capture the value generated by associative arrangements. Put simply, the official data does not reflect the value of *indirect* exports from SME firms that are articulated in clusters and value chains.[15] In fisheries, the salmon industry provides a good illustration of a successful cluster. Established in 1978, the cluster groups 150 firms that employ 29 thousand people and generate other 12 thousand indirect jobs. Almost 97% of total output is destined for export, which grew twofold between 1996 and 2000, from $480 million to $970 million.[16] As regards value chains, it is important to emphasize that in Chile, both agriculture and mining, sectors that are engines of

[13] The break down of this value is as follows: small enterprise exports amounted to $288 million, representing just 0.7% of total exports, and those from medium enterprises totaled $$972 million, equivalent to 2.4% of total exports.
[14] CIpyme (undated)
[15] A rigorous analysis of these relationships and how they contribute to Chile's economic growth, employment and export flows escape the scope of this study.
[16] Pietrobelli (2004).

growth, feature numerous small producers that are vertically integrated with large traders through the sale of final goods, intermediate inputs, and services.[17]

A second reason lies in the fact that the defining range of dollar values for annual sales seems to be way too low. In Chile, as indicated in Table 3-1, a small enterprise is defined as one posting annual sales between $58 thousand and $600 thousand, while the range that defines a medium enterprise is between $600 thousand and $2.4 million. By way of comparison, one can consider the definition parameters of Argentina. Admittedly, the economy of this country is larger than Chile's, but the differences between what constitutes an SME firm and what does not should not be that large. For example, in retail trade, services and agriculture -- all three sectors that in Chile, it is pertinent to underline, concentrate large numbers of SME firms -- an Argentine small enterprise is defined as a firm with annual sales of $10.8 million (retail trade), $3.2 million (services) and $1.8 million (agriculture). In case of medium enterprises, the definition is annual sales of $86 million (retail trade), $21.6 million (services) and $10.8 million (agriculture). Because of these large differences in SME definitions that cannot be possibly justified on grounds of economy size, a comparison of performance between the SME sectors of Chile and Argentina is analytically suspect and likely to result in irrelevant findings. Furthermore, this conundrum is as valid when comparing Chile with countries whose economies are far smaller. In this regard, the cases of El Salvador and the Dominican Republic are also very illustrative. Accordingly, El Salvador and the Dominican Republic define small enterprises as business units with annual sales of $684 thousand and $1.2 million respectively, values that top the ceiling of what is small firm in Chile. Likewise, the annual sales definition of medium enterprises in these two countries is twice as high as Chile's -- $4.6 million (El Salvador) and $5 million (Dominican Republic).

What these examples suggest is that in Chile there may be numerous firms that are defined as large, but which in other countries they would be considered as either small or medium –sized. Italy and Spain, which are direct competitors of Chile in wine, would show a more significant SME contribution to total exports than Chile's probably because their SME sectors are more dynamically integrated into world markets, *but also because SME firms are defined with higher value of annual sales.* The implication, therefore, is that both the actual number of SME firms that export and the relatively low percentage contribution of SME firms to total exports that is reported by the official statistics may be understated and, consequently, deceiving.[18]

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[17]Neither interviews with public officials and private sector representatives, nor examination of available data could shed light on an approximate number of SME firms that export their products *indirectly*. But it is quite revealing the fact that CORFO reports that 46% of the SME firms that access its support programs state that they either export directly or sell their products to traders. Significantly, the statistic does not include the services and inputs that the traders buy from SME firms.

[18] It is highly relevant to point out, indeed, that Moori-Koenig et al (2004) who analyze the best practices of successful exporting SME firms chose to raise the sales ceiling of medium sized enterprises to $7.5 million, more than three times the officially sanctioned cut-off between medium and large enterprises. This arbitrary, albeit useful manipulation of the data, allowed the researchers to work with a larger sample of firms and thus obtain findings that facilitated more interesting insights on SME export performance.

SECTION IV

Notwithstanding the likelihood that data on SME export values may well be understated, it is still possible that actual contribution from the sector to overall country exports may be significantly below potential. Therefore, it is pertinent to ask two questions. First, is the business environment more conducive to foster or smother a more vigorous SME engagement in foreign markets? And second, how effective is the government overall policy approach to secure a better articulation of SME firms with international markets?

SME Exports and the Business Environment

Representatives of both large enterprise and SME business associations state that the overall business environment plays an instrumental role and does impact export performance. For ease of exposition, the discussion of how the business environment has fostered or retarded SME export expansion is divided into its two basic components – the macro economic and regulatory impacts.

Macro Economy Impact

As stated previously, the foundation of rapid economic growth and good export performance in Chile has been the design and efficient implementation of a sound macro economic policy.

It is certainly interesting to note, first of all, how the perceptions of SME owners and managers on aspects of the macro economic situation clearly mirror their strong preference to operate in domestic as opposed to international markets. For example, a survey of SME firms conducted in 2002 reveals that opinions on the macro economic context typically reflect the concerns of firms that cater their sales primarily to the domestic market. As such, inward-oriented SME firms, which by far constitute the great majority of the sector, consider that a high rate of unemployment, taxes that restrict domestic consumption, and low wages, are important obstacles that prevent a faster expansion of sales.[19] They overwhelmingly worry more about drastic declines in domestic demand and express concern about depreciating trends in the *peso* for the negative impact this has on the domestic price of foreign inputs they must buy to produce goods and services.[20]

According to SME representatives, the key components of the macro economic policy that relate directly to the ability of their firms to compete internationally are: (a) the exchange rate and tax incentives; (b) free trade agreements; (c) improvement in the economic infrastructure; and (d) ease of access to financial markets. Each of these is briefly discussed below.

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[19] Bravo et al (2002)

[20] These conditions, it is worth emphasizing would be generally favorably to SME firms that orient their sales primarily to export markets. A depreciating peso and a high rate of unemployment, for example, would tend to lower real wages even further, with the consequence of cheapening production costs. Likewise, restrictions on domestic consumption lead to the release of resources that can be utilized for a larger volume of exports.

In the country at large, the widespread consensus among public officials, development practitioners and private businesses is that the government commitment to keep a ***competitive real exchange rate*** was definitively a most fundamental factor accounting for overall excellent export performance. Private businessmen, critically, found this commitment *credible* and, consequently, made decisions that materialized long-term investment plans. Because of large capital inflows, keeping a high exchange rate was not always easy. But it is safe to state that during the period 1984 – 2003 the exchange rate was a great incentive for export expansion for firms of all size. Representatives of SME associations certainly share this opinion. In their view, the exchange rate policy was the catalyst for the emergence of numerous small and medium sized exporting firms which otherwise would have stayed confined in local markets.[21]

Tax incentives that played a decisive role to bolster all exports, including those of SME firms are: (a) reimbursement of customs duties applied to imports of raw materials and intermediate inputs that are used in the production of an exported good; (b) anticipated reimbursement of the value added tax; and (c) a reimbursement *(reintegro simplificado*) of 3% of all taxes on inputs purchased by exporting firms.

The path to good export performance was also opened by the numerous free ***trade agreements*** that the government negotiated. With an open trade regime, SME firms could access a wider variety of imported inputs at competitive, cheaper prices, all of which helped reduce production costs. To be sure, free trade agreements carry the promise of immense benefits for firms that aggressively compete in domestic and foreign markets, but painful costs for those that fail to adjust. Among the latter were numerous SME firms that, in the main, did not operate in the economic sectors blessed by comparative advantage. On the other hand, outward-oriented SME firms generally did not oppose the opening of the economy, while many decisively embraced it.

Interestingly, free trade agreements were negotiated *bilaterally* with developed and developing countries alike. It must be underlined that the conduction of bilateral trade negotiations requires, above all, the presence of superbly trained trade negotiators that are technically assisted by a cadre of highly skilled professionals, most notably economists and lawyers. It also requires flawless coordination among state ministries and agencies and, most important, effective dialogue between the government and representatives of the private sector. Fortunately, these critical conditions were present in Chile.

Time has demonstrated that engaging in bilateral trade negotiations was a strategic decision that proved to be correct. Bilateral trade agreements meant breaking away from the Andean block and joining the largest South American economies – Brazil and Argentina – as an associate member, not as free trade partner, which enabled the country to keep a lower and uniform external tariff and some duties to protect its agricultural sector. The benefit of this decision is that it spared the country from the costs of politically tainted, protracted negotiations with the developed countries. As a consequence, Chilean goods, including those produced by SME firms, freely enter most of the countries with large consumer markets – United States, Canada, Mexico, the European Union, Thailand, China.

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[21] In the last three years, unfortunately, the peso has greatly appreciated due to the commodity boom in world markets. SME firms see that their competitive position is rapidly being eroded. What is worrisome is that there are signs of capital investments in sectors where the country enjoys strong comparative advantages, such as agriculture, that are being postponed or canceled. At the same time, there are aggressive producers who try to find ways to raise total factor productivity so as to reduce operating costs and, in this way, keep their competitive edge.

Following the economic crisis of 1982, and accompanying the sound conduct of macroeconomic policy, an ambitious program of modernization and expansion of the ***economic infrastructure*** was launched. A principal vehicle to finance and implement the numerous projects has been public-private partnerships. This vehicle has proven to be effective and gives another evidence of the presence in public administration of technically skilled civil servants who can ably enlist the participation of the private sector for the public good. Economic infrastructure projects have included construction of new, good-quality highways and roads that connect small towns located in rich agricultural areas with secondary cities and major urban centers. Another important feature of the modernization of the economic infrastructure was the renovation of airport terminals and seaports. A virtuous cycle was therefore put in motion, by which the export boom triggered the undertaking of public investments to modernize ports, thus leading to significant reduction of transport costs which, in turn, helped firms of all sizes gain competitive advantages in foreign markets. Remarkably, and notwithstanding the economic slowdown induced by the Asian crisis of the second half of the 1990s, public investments in economic infrastructure were kept at high levels and continue apace to this day. The results are certainly positive: Chile also features a modern communications network and is the Latin American country with the highest internet use per 1000 inhabitants. In this decade, investments have been undertaken to ensure that small producers in distant towns are wired not just to the internet but to land and mobile telephones as well. By all accounts, the task has yet to be completed, but it is undeniable that significant progress has been achieved.

In all, the business sector, including representatives of SME firms, are of the opinion that successive governments have "done their job" with respect to the expansion and modernization of the economic infrastructure, and that this has been an important factor for the competitiveness of their firms.

Unfortunately, the picture is not as rosy with respect to ***access to financial services***. To be sure, Chile is the Latin American country with the best indicators of efficiency and depth of financial markets.[22] However, and mirroring the overall situation in all Latin American countries, the great majority of SME firms do not have adequate access to financial services. A bit of history is helpful here: in the aftermath of the banking collapse of the early 1980s, Chile adopted far reaching measures to secure a better vigilance of the banking system. These measures, in combination with more relaxed requirements on the entry of foreign banks and, most critically, with the presence of vigorous economic growth, underlined the sustained expansion of financial services. The consequence was the commercial bank penetration of market segments that had never been previously served. The explosion of consumer credit and the emergence of micro enterprise finance provide useful illustrations of this dynamic commercial bank activity in the last fifteen years. Why this revolution has not extended to the SME segment is certainly puzzling. For it must be emphasized that micro enterprise credit, for all practical purposes, is executed on the basis of unsecured lending. Therefore, it is indeed not devoid of irony why SME lending, which on theory should be less risky than micro enterprise credit, has not been blessed by the "revolution" that the latter has endured not only in Chile but in most Latin American countries as well. The discomforting reality is that to this day, SME lending remains the missing middle.

In Chile, only 17% of the universe of SME firms can obtain credit from commercial banks.[23] These include those that exhibit the largest values of assets and the longest time of activity in

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[22] In the period 2000 - 04 the average ratio of total credit to gross domestic product was 0.59 and the number of bank branches and automatic teller machines were 33.4 per 100 thousand inhabitants. During the period 1996 – 2003, the average bank administrative costs, expressed as percentage of total assets, were 4. (Rojas-Suárez 2005)
[23] Errázuriz (2006).

the market, as well as the SME firms that successfully export. In general, these firms face fewer restrictions to access commercial bank credit than the ones who do not export. In this SME export group, it is not uncommon to find enterprises that finance activities from three commercial banks – two local and one foreign. Occasional exporters operate only with one local bank and almost invariably have no access to international sources of credit. Not surprisingly, the value of total exports from firms financed with commercial bank credit obtained from more two or more sources is significantly higher than that that is either not financed by bank credit or financed just by one source.[24]

For the larger majority of SME firms, options to finance working capital needs or investment projects are basically confined to self-finance – either from retained earnings or from the owners' net worth – and supplier credit. Supplier credit is plentiful in Chile but it is normally more expensive than terms offered by commercial banks. Some firms obtain credit from informal lenders, including friends and relatives. But these sources make little dent in alleviating acute problems of liquidity.

The majority of SME firms face liquidity constraints because they are perceived by commercial banks as being higher risks. The principal reasons that explain this perception are the following:

- Basic financial information, such as balance sheets, income and loss statements and cash flow schedules are not reliable because they are not always transparent and commonly are informally prepared. Banks, therefore, make visits to the client to verify and obtain additional information, all of which, in the end, raises the cost of lending.
- During the Asian crisis of the late 1990s, many SME firms with bank loans fell behind on their repayment reschedules. As a result banks reclassified them as borrowers of lower quality and, therefore, more risky.
- Sources of income are not diversified. As much as 50% of SME firms sell only to one or two clients.
- Banks perceive that a large number of SME firms do not always meet legal and regulatory requirements, such as tax obligations, payment of license fees, health and safety standards and the like. Corrective measures undertaken by authorities mean liabilities that SME firms must assume, with its corresponding negative impact on profits that diminish the capacity to pay back loans.
- Most SME firms cannot offer corporate collateral. Most of them offer personal guaranties of owners that are not always valuated accurately and/or executed rapidly at reasonably cost.

The government attitude to this problem underlines more direct, active involvement than detachment. For example, CORFO makes available to SME firms long term, non-guaranteed, unsubsidized lines of credit through commercial banks and other non-bank financial intermediaries to finance input purchases and commercialization expenses of exporters. In so doing, CORFO acts as a typical second story lending institution that is not involved in the examination and approval of SME projects that request financing. Such authorization is the responsibility of the financial intermediary, which evaluates the project and negotiates directly with the borrower the credit terms.[25] Another policy tool is the role of Banco Estado whose

[24] Bravo et al. (2004). According to this study, export values of "successful" SME exporting firms are as ten times higher than those of occasional exporters.
[25] In the times that preceded the implementation of pro-market reforms, CORFO operated as a retail lender. Neither project/borrower evaluation nor loan collection procedures were a strong suit nor, consequently, large losses were incurred.

principal objective is to provide financial services to low income and socially disadvantaged clients. Banco Estado is, if not the only one, definitively one of the handful of state-owned banks in Latin America that has a clear vision, adheres by prudential norms and supervision requirements that are applied to all commercial banks, and is competently staffed and efficiently run. In 2000, Banco Estado had the largest SME coverage of any bank in the country, with 304 branches, 173 of which were the only bank to service the area.

To remedy the problem of collateral, the government offers to financial intermediaries the *Fondo de Garantía para Pequeños Empresarios* (FOGAPE). At present, fifteen financial entities use this instrument, a five-fold increase since 1998. In that year, the value of guaranteed credits was less than $10 million, while in 2004 such value surpassed $450 million.[26] Remarkably, this fast expansion of the program has been underlined by its adequate, transparent administration. At the same time however, the usefulness of the program has limitations. For example, it does not play an instrumental role in fostering long-term credit. Above all, the program does not provide incentives for commercial banks to move away from traditional collateral-based lending.

Government measures clearly have been insufficient. The problem is that if a large number of SME firms remain marginalized, financial market segmentation will be reinforced and, with this, arresting further significant reductions in bank spreads. The ultimate consequence of this problem would be to ratify a country- cost of capital that may be relatively high in comparison with that prevailing in countries in similar stage of economic development. And it goes beyond saying that a relatively high cost of capital penalizes the competitive position of SME firms and, therefore, their capacity to penetrate foreign markets more vigorously.

If the provision of financial services to SME firms is to expand massively and rapidly, it is imperative that both the public sector and the private commercial banks do their job. Within the former lies the responsibility of discerning if current bank prudential norms and regulatory requirements are conducive to spur more competition in the supply side of the credit market. In this regard, there are two factors that can be arguably cited as obstacles that prevent keener bank competition: a usury law that mandates ceilings on interest rates, and minimal bank capital requirements that may be way too high.[27] And with respect to the commercial banks, it is important that they move decisively to discard collateral-based lending in favor of credit technologies that can determine the capacity and willingness to pay of prospective clients, and measure with accuracy the probabilities of loan default.

Regulatory Impact

Legal and regulatory frameworks largely shape the relationship between governments and the private sector. The relationship can breed trust, indifference and in some cases despair. A relationship that is based on trust enhances the disposition of the private sector to carry on with

[26] Llisterri et al (2006).

[27] As demonstrated by the micro finance revolution, the elimination of interest rate ceilings can be a major determinant of a major expansion of micro enterprise lending. Presumably, the same principle would apply to SME credit. Yet, it is not a *sine qua non* condition. Colombia, a country where interest rate controls persist, commercial bank loans to SME firms are growing rapidly. Also, it can be persuasively argued that ceilings has the potential benefit of forcing banks to reduce costs and, therefore, to become more efficient. This scenario precisely unfolded in Chile's micro lending market.

Lowering capital requirements, on the other hand, would expand the number of licensed financial intermediaries. Whether such measure is advisable in a country with fresh memories of a catastrophic bank collapse and that has taken steps to exert due vigilance of the safety of the system, is an open question.

business decisions and investment plans that ultimately contribute to economic growth. This is possible because the private sector is reasonably confident that policy makers will make judicious decisions in the economy, including those that "do nothing." Indifference, on the other hand, emerges when the private sector recognizes that policy makers exhibit either lack of knowledge of the factors that drive business activity, or unpredictability in policy-making decisions. In this context, government and the private sector would "go their own way," each operating in their respective spheres with relative degree of autonomy, and without the benefit of engaging in effective policy dialogue. No sustained process of economic growth is possible under these circumstances that, unfortunately, are prevalent in many developing countries. Finally, despair depicts a private sector "on the ropes." It is a situation characteristic of countries wherein political or bureaucratic elites have captured the regulatory framework to appropriate and amass economic wealth.

Neither indifference nor despair colors the regulatory framework in Chile. Trust, that intangible, priceless cultural asset, is becoming, slowly but surely, the defining characteristic of the relationship between government authorities and representatives of the private sector. Therefore, as indicated previously, Chile definitively approximates the conditions that characterize a "good" regulatory framework.[28] The following attributes are highlighted:

- *Transparency*. Since the demise of the military government in the late 1980s, laws and regulations are increasingly designed in close consultation with key stakeholders in the private sector, including business associations that represent SME firms.

- *Accountability.* Efforts are directed to hold regulators accountable to the public and their representatives in the legislature. Although the degrees of excellence existing in the most developed countries are still not within grasp, regulators are monitored more effectively than in the past. Consequently, in Chile the margins of regulators for making arbitrary decisions have been reduced significantly.

- *Targeting and Proportionality.* Good regulatory frameworks focus on areas of policy intervention that are well identified, with the consequence of diminishing the chances that the intervention will not generate unwelcome effects in other areas of business activity. Moreover, the policy intervention should be proportional to the problem that has been identified.

  In Chile, the policy instruments that are made available to support SME firms provide a useful illustration of a targeted intervention. The instruments, as many a SME manager would argue, are probably still insufficient to significantly reduce the disparities between large and small firms. In fact, in programs designed to foster enterprise training, large firms apparently have captured the bulk of the public subsidies.[29] But what is important to underline is the conservative economic approach that guides a public intervention. Because the memories of unbridled state activism are probably still fresh, Chilean authorities prefer to err on the side of caution. Therefore, pro-SME interventions, such as the aforementioned CORFO programs that make available long term financing, would not be undertaken if they were suspect of causing market distortions.

- *Consistency.* Laws and regulations that are often changed signal uncertainty or lack of direction in the design of economic policy. This is not a feature of Chile's political

[28] Cook et al (2003) provides a good discussion of good regulatory principles and practices.
[29] Berry (2002)

economy, as laws and regulations have become increasingly more predictable since the mid 1980s. Uncertainty on the direction of economic policy, therefore, has been reduced. In this context, investment plans then can be more confidently planned and implemented.

Furthermore, there is the issue of *efficiency*. A good regulatory framework is one which does not over regulate and engender high transactions costs for private businesses, that is, one that is not saddled by numerous, complex and unclear procedural requirements that negatively affect the normal conduction of business operations. Generally, the existence of high transactions costs underline the inability and/or unwillingness of SME firms to formalize operations, and/or incur in capital outlays that are necessary to compete more successfully in domestic and international markets. When transactions costs are high, overall informality and waste of valuable economic resources prevail.

In Chile, as some representatives of SME associations point out, there seems to be, more than over regulation, a zeal for *over vigilance*, mainly expressed in too numerous visits by inspectors of state agencies – health, environment, agriculture, tax inspectorate and the like. And, as revealed below, owners and managers do point to the existence of some regulatory procedures that are either too costly to implement or take too long to process, with the corresponding negative impact on business operations. The overall consensus however is that the government authorities in Chile are committed to making the regulatory framework more efficient, and to the increasing satisfaction of the private sector. As of this writing, for example, the government is exploring ways to simplify, streamline and harmonize health and safety regulations, and to establish a one-stop window facility that would centralize information on all the regulations and procedures that firms of all size are required to comply. It is therefore not surprising that Chile is becoming less and less burdened by the problems associated with economic informality, the curse of most of the countries of the region.

Finally, it is worth pointing out that a "good" regulatory framework is worthless if laws and regulations cannot be properly implemented and enforced. The key element of the administration of the regulatory framework is the quality of the public bureaucracy. Chile excels in this regard, especially in comparison with countries of the region. Admittedly, the provision of public services is not flawless. For example, approval procedures are sometimes subject to unfounded delays, and practices of acquiescing to informal requests to speed them up have not been totally eradicated. As episodes of petty corruption in state agencies are, at most, very rare, such informal practices seem to be more the exception than the norm. Underlining the drive towards high bureaucratic standards is the presence of a well educated technocratic class trained in top universities in the United States and Europe. In addition, mid-level civil servants, in general, are not perceived as low-social status individuals. They possess adequate skills, and because they benefit from regular training programs and draw competitive salaries, are normally motivated to perform their functions effectively. The decisions of state agencies, on the other hand, are not always free from political interference, but efforts are made to balance them with the application of more objective criteria. Managers of SME firms, in general, concur with this opinion.[30]

A "good" regulatory framework however, is far from perfect and, as noted above, SME firms voice concern on particular deficiencies that directly or indirectly affect negatively their capacity to compete in domestic and foreign markets. The most important are highlighted below.

[30] According to Bravo et al, only a small minority of SME firms believes that the operations of some state agencies are tainted by influence peddling and that political interference may be sapping the effectiveness of the agencies.

- *Local governments* tend to enact numerous regulations affecting business start-ups and operations that are unnecessarily complex, unclear, time-consuming and costly to fulfill. The consequence has been unrealized sales expansion and missed opportunities to create more jobs and access new markets.[31] Furthermore, this obstacle has probably contributed to retard the goal of instigating a process of a more even economic development between rich and poorer regions, and to aggravate the concentration of economic power in the large firms. These units, as a general rule, can more easily comply with costly regulations than SME firms because they are not hampered by budget constraints and, consequently, are far more likely not to incur in risks of non compliance and the penalties associated with it.

- *Labor legislation* is considered to be too restrictive and source of rigidities in the labor market. In most SME firms, labor can constitute as much as 60% of total operation costs. The principal problem that SME firms cite is not related to wage and non-wage labor costs,[32] but to administrative restrictions associated with hiring and firing. Costs of firing are considered to be too high, equivalent to one year of wages.[33] The legislation, therefore, may deprive SME managers of the necessary flexibility to find and hire human resources with more nimble and better skills to perform complex tasks, while creating disincentives for the undertaking of in-house, regular training programs aimed at increasing the productivity of the work force. Nonetheless, this negative impact is partially compensated with low wage costs.

- *Environmental regulations* probably constitute a stiffer challenge in light of the trade agreements signed with developed countries. As a general rule, these countries demand compliance with strict environmental standards. Non-compliance can lead to denial of product certifications and, ultimately, to loss of foreign market shares and new business opportunities. The problem is that compliance can entail the introduction of costly investments that many an SME firm could not undertake, at least in the short term.

These problems cannot be considered as unimportant. Yet, it is not unreasonable to generally conclude that the regulatory framework in Chile does not present serious obstacles that block a more vigorous penetration of SME firms in foreign markets. In fact, Chile has made great strides to eliminate unnecessary requirements and streamline and simplify the regulations and procedures that apply to international trade transactions. SME firms certainly share this impression. Almost all goods are not subject to export/import bans or are subject to special licenses. As depicted by Table 3-9, the number of required documents needed to export or import goods and services is few. The process is not hampered by tedious, time-consuming authorizations that must be approved by civil servants. And last but not least, it is worth mentioning that customs provides transparent and agile services, at cost that is considered to be reasonable.

[31] As of this writing, the government is taking measures aimed at streamlining and harmonizing the regulations of local governments.
[32] Surprisingly, Chile exhibits non-wage labor costs that are among the lowest in the world. (World Bank Doing Business Reports)

[33] World Bank Doing Business Reports

TABLE 3-9: TRADE PROCEDURES INDICATORS

Indicator	Export Procedures (Number)	Time for Export (Days)	Cost to Export (US$ per container)	Import Procedures (Number)	Time for Import (Days)	Cost to Import (US$ per container)
Chile	7	20	510	9	24	510
Latin America	7.3	22.2	1067.5	9.5	27.9	1225.5
OECD	4.8	10.5	811.0	5.9	12.2	882.6

Source: World Bank Doing Business Report 2007

SME Policy Approach

If the business environment is fundamentally "friendly," that is, free of severe obstacles that restrict the operating capacity of SME firms, it is then pertinent to ask what options are available for a country like Chile that is intent in securing a more dynamic articulation of these enterprises with international markets. If anything, the increasing globalization of the world economy reduces the space within which governments can act with autonomy. In this context, the menu of policy instruments that can effectively make a difference is more limited, and the adequate design and efficient implementation of the interventions become real, tough challenges. Generally, in developing countries the challenges are more daunting because the economic landscapes are riddled with market imperfections and failures that smother the growth potential of SME firms. Admittedly, and because of the impressive institutional development witnessed in the last decades, in Chile this problem is not as significant as it is in the rest of Latin America. But the challenge is no less real and no less difficult. For it must be underlined, once again, that the country's SME firms operate in one of the most open economies of the world. The drastic liberalization of the trade regime was indeed painful, as it led to the elimination by foreign competitors of so many firms, SME enterprises included, and especially those in the manufacturing sector. Gone in this survival-of-the-fittest process were the institutional memories of owners, managers and workers, from which so many useful lessons on how best can firms adapt to marked shifts in demand patterns in domestic and international market could have been drawn. Largely, this opportunity was missed in Chile. Consequently, many firms had to start from scratch, thus making unavoidable the absorption of high costs of learning.

Principles of Support Programs

Public interventions in support to SME firms rest on the assumption, first of all, that Chile's product, factor and financial markets do suffer from imperfections. For example, a large number of SME managers and workers still have no access to high-quality education. As a result, the productive capacity of human capital in SME firms is severely handicapped, and their developmental potential is consequently stunted. Another market imperfection relates to the problem of information asymmetry. One important asymmetry takes place in credit markets. As mentioned before, commercial banks lack technologies to accurately assess the capacity and willingness to pay back loans on part of SME firms. The consequence is the unintended discrimination of a mass of potentially sound customers. Finally, public interventions could also be justified, in principle, by the existence of undue market concentration. Admittedly, in Chile it is hard to ascertain the existence of large private monopolies or oligopolies earning huge economic rents.[34] At the same time however, it is undeniable that large enterprises in Chile, because of economies of scale, and easier access to financial services, do have the capacity to outmatch, both in price and quality, SME firms in domestic markets.

Second, and notwithstanding the presence of market imperfections, the government relies on market mechanisms for the delivery of technical assistance programs. Put simply, the support programs are anchored not on a traditional top down approach, where the state agencies played central stage as direct providers of support services, but on subsidies made available to SME firms that are intent on using them. With no interference from the state agency, the beneficiaries are free to select private providers. Therefore, the subsidies are demand-driven.[35]

Third, it is important to note that private-public dialogue features prominently in the overall design and execution of economic policy. The government regularly consults with private business associations about how particular elements of macro and micro economic policies impact the business environment. The process normally starts with the establishment of inter-ministerial or inter-agency working groups that are commissioned to analyze technically problems associated with a particular regulatory norm and, based on the findings, propose a menu of regulatory solutions. That which is most cost-effective and which minimizes risks of regulatory arbitrage is selected and presented for discussion to business associations, academic experts, regional development agencies and, most significantly, a public – private committee that is explicitly established to assess the costs and benefits of a proposed regulatory modification. If this is enacted, the committee also monitors its implementation.

It is then far from an exaggeration to postulate that Chile has managed to establish institutional mechanisms that facilitate the undertaking of fluid, constructive private-dialogue that, in the end, would result in win-win outcomes. A good illustration of constructive private-public dialogue is provided by recent efforts to increase volumes of SME exports to countries with which Chile has signed free trade agreements. In 2004, a private-public committee was set up to address this issue. Initial deliberations led to decisions pointing to the advisability of embracing a comprehensive approach. Therefore, four sub-committees were established that convene at least twice a year to discuss and evaluate the following tasks:

- An analysis of customs procedures in Chile in order to ensure that qualities and prices of imports that compete domestically with SME products are appropriately assessed. In addition, customs would provide guidelines to ensure that SME exports comply with trade legislation of the importing country.

- A review of the CORFO programs aimed at improving quality assurance of SME firms and their competitiveness.

- Identification of non-tariff barriers to export in trading partner countries and provision of technical assistance to SME exports on how to overcome these barriers.

- A review of all government-sponsored export promotion activities and how they can be better tailored to the characteristics of SME exporting firms.

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[34] In case that they exist, it is plausibly to argue that the government does have the capability to regulate their investment and pricing decisions.

[35] Berry (2002)

The impact of the work of this committee has yet to be assessed. Still, the example serves to underline the importance of SME firms and their capacity to export in the government agenda. If anything, the government, aware of criticism invoked by SME representatives that is more "wired" to the concerns of the large enterprises that are so adequately represented by SOFOFA, seems to be increasingly paying more heed to the demands voiced by SME firms. To wit, it has established early this year six new private-public committees that will address problems in the following areas: (a) market access and competitiveness; (b) support programs; (c) access to financial services; (d) enterprise growth; (e) labor legislation; and (f) SME associations. This initiative, it is important to point out, should not be interpreted as an implicit acknowledgement that the regulatory framework contains norms that *explicitly* favor large enterprise and which, in the process, discriminate against or penalize the operations of SME firms. Instead, it is more correct to postulate that the government has recognized that some regulatory norms do not factor in market imperfections that negatively affect the operations of SME firms and, consequently, are not facilitators of faster sector growth.

The Role of SME Associations

A key determinant of a successful private-public dialogue is the presence of SME associations that can effectively engage policy makers to ensure the removal of policy, legal and regulatory elements that retard enterprise development. In Chile, fortunately, there is no shortage of supply of good SME associations, especially those that represent SME exporting firms. They have good leaders, possess good infrastructure facilities, are staffed by competent individuals and, in the main, are financially self-sustaining. Significantly, some of the SME associations, most notably those that represent successful exporters, have close ties with universities and research centers. The relationship with the academic community enables SME firms to access information on markets and to technological innovations that can be applied to enhance the quality of their products.

At the same time however, it is recognized that SME associations are fundamentally dispersed and, consequently, constrained by lack of effective bargaining power. This problem, more than an alleged failure to produce technical representations to policy makers, seems to be the most limiting constraint. In addition, their degree of actual representation seems to be very low – no more than 5% of all SME firms. Understandably, the government, in general, adopts a cautious approach when discussing policy issues with the sector. For in circumstances wherein the advocates of the private sector -- no matter how well intended they are or how tightly they embrace policies for the common good -- exhibit low degrees of representation, there are risks that cannot be ignored. The most important of these is that private sector representatives can give in to the temptation of advocating programs that would maximize their rents and not the benefits for the sector at large. For this reason, the government has wisely decided to incorporate into its support programs initiatives aimed at strengthening SME associations.

Support Programs

An interesting feature of public interventions in Chile in support of the SME firms is the role of the private sector. In fact, the government goes out of its way to delegate the execution of support programs to qualified private enterprises that are formally registered as providers of business services. A key principle of program implementation is the partial financing of projects by the SME firms that benefit from them. In the main, the programs are a mixture of interventions that support both individual SME efforts to export directly and indirectly through associative arrangements.

Aside the financial support provided by Banco Estado, the public support programs are centralized in Pro Chile and, especially, CORFO. The mission of Pro Chile is to facilitate SME access to foreign markets. This agency also manages financial programs, such as the *Fondo de Promoción de Exportaciones* (FPE), which funds analysis of market prospects; the *Fondo de Promoción de Exportaciones Agrícolas* (FPEA), which supports export diversification and associative arrangements in the agricultural sector; and the *Programa de Internacionalización de las PYME* (INTERPYME), which is focused in introducing SME firms into export activities.

CORFO plays a far more prominent role. Aside the financial role it plays as a second story lending institution, the agency is focused on raising productivity levels of SME firms, fostering the economic development of regions, and mitigating the impact of market imperfections on SME firms. The overall objective of CORFO's programs is to raise levels of quality assurance of SME firms which, indirectly, enhances their capacity to compete more successfully in domestic and international markets.

CORFO supports the expansion of associative arrangements for export through two programs – the *Programa de Proveedores (PDP)* and the *Proyectos Asociativos de Fomento (PROFO*). In the PDP, the agency kicks in 50% of the costs to be incurred by a large firm intent in transferring technical and managerial know-how to prospective SME suppliers. Clearly, this represents a subsidy to a business concern that, *strictu sensu*, does not need it. But CORFO strongly believes that that these costs are more than outweighed by the important benefits the program generates. Originally launched in the early 1990s, the program was slated to expire in 2002, but it was extended because of demands from both large enterprises and SME firms alike. Large enterprises are enthusiastic users of the program and have become *de facto* vehicles for the concession to SME firms of world-recognized certifications of quality standards that are demanded by large and prestigious foreign buyers. It is hardly surprising therefore that since the beginning of this decade the number of SME beneficiaries has increased five fold, from two to ten thousand.

And why not: tangible benefits for SME firms have evolved from their participation in PDP programs. The programs make possible easier access to supplier credit, facilitate the adoption of more efficient and modern techniques of production as well as processes aimed at improving quality assurance, make firm sales more predictable, reduce uncertainties tied to the collection of sales, and so on. In fact, CORFO believes that yields are high, and thus allocates 30% of its budget to the program.

The PROFO, on the other hand, sponsors the development of horizontal associations. The program was launched in 1992 and it is estimated that by the end of that decade the number of participating SME firms had reached almost ten thousand, of which more than a fourth had been in the program for more than three years. An evaluation conducted in 1997 by the Department of Economics of the Universidad de Chile measured the impact of the program by comparing the performance of participating firms with those of firms of the same sector that chose not to do it. The principal findings were the following:[36]

[36] Berry (2002)

- Because of PROFO, participating firms developed strategic and marketing plans, and introduced innovations that led to automation, better production planning, and improvement in procedures for overall quality control.

- Participating firms devoted more resources to the technical training of managers and skilled workers.

- PROFO improved the access to market information and engendered new business opportunities for participating firms.

- Participating firms had better access to other support programs, including the PDP, which are available to the benefit of SME firms.

- Of high relevance is the fact that participating firms registered a 13% increase in job creation, which is significantly higher than that of firms of the same sector that did not participate. On the other hand, there was not much difference between participating and non-participating firms as regards salary and productivity increases.

It has been noted that horizontal associative arrangements in the Chilean setting are not devoid of weaknesses and limitations. The aforementioned evaluation concludes that PROFO does not contribute significantly to improving SME access to more technically qualified human resources and plays no role in securing better credit terms for working capital needs. Neither does it provide the mechanisms to facilitate more capital investments. Of late, an important concern is that a typical PROFO takes much too long to materialize. This problem can be attributed, in part, to the fact that potential members have little experience with ventures grounded on teamwork principles and have yet to overcome obstacles derived from lack of trust. Among small producers that are isolated and operate in remote rural areas, lack of trust can be deeply rooted. The engagement and educational role of some SME associations suggests that this obstacle should be overcome with the passing of time.

Another problem lies in the fact that the management of the association is a complex task. An outside manager is appointed by the association to supervise the implementation of the project and to minimize risks of failure, including the desertion of members before the project is completed. Unfortunately, it is not easy to find the "right" manager. In fact, a high turnover of managers has been reported. The principal complaint voiced by participating SME firms is that while managers can be technically very capable, not all can relate culturally to their needs and aspirations. Proper and effective communication is therefore not effortless with the consequence that valuable time and resources are lost.

Other support programs offered by CORFO that are worth highlighting are *Chile Emprende* and the *Servicio de Cooperación Técnica* (SERCOTEC). The former is directly implemented by private-public committees -- composed of ministries, regional governments, and representatives of SME firms -- that are established in all the regions of the country with the purpose of identifying and fostering business opportunities for micro and SME firms. SERCOTEC, on the other hand, is more engaged with the design of projects, also supported by private-public committees. Critically, the program provides technical assistance for the institutional strengthening of SME associations, and seeks to raise the technical capacities of local governments.

Effectiveness of the SME Policy Support Programs

The support programs are managed in a transparent and efficient manner. In general, they provide valuable technical assistance to the SME firms that manage to access them. More important, they help to build social capital in the form of the private-public committees set up to address the principal problems of the sector.

At the same time, the overall policy implementation is not devoid of important shortcomings. The most important are the following.

First, outreach is limited. Successful SME exporting firms have access and do make use of the programs, but the majority of the SME firms still do not. The problem, basically, is not explained by inadequate communicational campaigns of the state agencies. In fact, information on the scope of programs and on specific projects that are tendered to the public is disseminated widely in the local media and via internet. It is then more plausible to argue that lack of access to the support programs is more related to the inadequate capacity of potential SME beneficiaries to understand and/or comply with program guidelines and eligibility requirements.

Second, the existence of a large number of SME firms that do not have access to the support programs suggests that the demand-driven approach that the government so zealously follows has its own limits. Chile then faces the challenge of improving the design and delivery of programs without violating the principles of a demand-driven approach. The problem, in principle, can be gradually remedied with increased improvements in information dissemination and access. As hinted above, government agencies regularly update and enhance the quality of their websites. At the same time increased connectivity in areas away from the main urban centers hold the promise of better access in the near future. Still, improved information flows alone will not be enough. More effective public-private programs, for example in the form of government incentives to support the development of SME business associations, are needed to enhance the institutional capabilities of the most disadvantaged SME firms that cannot meet the requirements of the support programs..

Third, there is room for improvement as regards policy coordination. To be sure, CORFO plays the most important role, but ministries develop programs of their own whose administration is sometimes delegated to other state agencies. Pro Chile's administration of development funds of the Ministry of Agriculture is a case in point. There is indeed the risk of duplication of efforts and, consequently, the waste of public resources.

Finally, lack of effective coordination is also manifested by the difficulties of matching finance programs with the appropriate technical assistance to SME firms. As a country that is awash in foreign currency reserves and with sizeable fiscal surpluses, there is no dearth of funds to finance economic development projects. But, as evidenced by the experience of PROFO, the effectiveness of projects can be impaired when capable providers of technical assistance of business services are not easily found in the local market. As in so many developing countries, the industry of technical assistance providers of business services is still incipient.

SECTION V

High economic growth and good export performance have distinguished Chile for the last twenty years. An overall “friendly” business environment underpins the expansion of private enterprises and the consequence has been a steady rise of jobs and incomes. To be sure, the economy is not free of market failures and imperfections, but these do not give way to massive informality. Since the divide between the formal and informal sector, by Latin American standards, is not as severe, poverty and problems associated with income inequality are not impossible to resolve. A pre-condition to successfully addressing these problems, of course, is good, sound of management of the economy. Chile has largely excelled in this regard. Local experts believe that if in the next ten years the economy keeps humming at the current pace, the export base becomes more diversified, and access to domestic and international markets by micro, small and medium enterprises is improved, Chile will have joined the club of developed countries.

This report sheds light in how the business environment has impacted the export performance of SME firms. The question is if the Chilean experience offers useful lessons that can be programmatically applied in other settings. The answer, in principle, is yes, with the caveat that Chile’s political economy exhibits particular features and attributes that, unfortunately, may be in short supply in a large number of developing countries. It is worth highlighting some of these.

- Abject poverty of a sizeable part of the population and yawning gaps between rich and poor have not been a historical constant. In fact, since early last century, a vigorous middle class emerged and is now considered to be the backbone of society. With the presence of a strong, engaged middle class, good economic and democratic governance becomes a distinct possibility.

- A long tradition of respect for the rule of law underlines public expectation for the *transparent* design of economic policies and regulatory norms. In this context, explicit policies that sanction socioeconomic exclusion become more difficult to justify.

- The state apparatus functions well. It undergoes a permanent process of modernization. Key state agencies enjoy a significant degree of managerial, technical and financial autonomy. Public administration adheres by high professional standards and offers a clear and attractive career path. High officials exhibit technical competence and civil servants are mostly paid adequately. Petty corruption does not permeate the delivery of public services.

- Grand corruption, in the form of state capture by powerful bureaucrats, acting or not in cahoots with powerful economic elites, has significantly diminished since the demise of the military dictatorship in 1989. It seems to be more the exception than the norm. If and when occurs, it is not condoned and measures are introduced to make anti-corruption firewalls more secure.

- In all, the *public bureaucracy is not an impediment to the introduction of reforms in the business environment*. To the contrary, it is an active partner of private enterprise. Constructive dialogue makes possible the enactment of regulatory norms that facilitate, rather than smother, the process of wealth creation by private firms.

- Chile features an entrepreneurial class that is aggressive, forward-looking and suffused with the dynamic challenges of modernity. In these times of globalization, it is this new breed of entrepreneurship that has placed a country with a remote geographical location, indeed far from the richest markets of the world, in the doorsteps of self-sustained economic development.

While these features may set Chile apart from many, if not the majority of developing countries, its experience with business environment reforms and export performance still offers valuable lessons for technical assistance programs intent on fostering a more dynamic participation of SME firms in international markets. The most important are the following:

First, macro economic fundamentals matter. This means not only sound conduct of fiscal, monetary and exchange rate policies. Open trade regimes are also important and, critically, a good quality of the economic infrastructure as well.

SME firms willing to export will never prosper in an economic milieu characterized by high inflation and poorly developed transportation networks, utilities and communication systems. Countries that exhibit these problems engender high operating costs for private enterprises. Under these circumstances, placing development assistance resources say, in projects aimed at enhancing the competitiveness of SME firms, is likely to yield low net benefits. Whatever improvements, if any, that such projects may generate, may ultimately rest upon more on the existence of relatively low real wages. It is advisable then to find other interventions that should yield higher returns.

Second, the administrative and institutional qualities of state agencies matter. A country can pass efficient and business friendly regulatory norms. But they will come to naught if it does not possess the capacity to enforce them, or if authorities give in to pressures from rent-seeking individuals and/or enterprises intent to capture the norms to maximize their own private benefits.

Export gains in Chile including those generated by SME exporting firms would have never materialized if the measures to eliminate non-tariff trade barriers and unnecessary restrictions had not been accompanied by highly efficient customs procedures. And while it is highly plausible that the larger business concerns within the group of SME firms may be the major beneficiaries of subsidies dispensed by the support programs of CORFO, there is no evidence that undue collusion with civil servants is the source of it. In fact, the current policy strategy sanctions procedures and shapes practices that are far different from those that prevailed in times when the state agencies were direct providers of support services.

A main lesson is that upgrading administrative capacities of state agencies is not a sufficient condition to get the job done. What is also necessary is that the *institutional framework* wherein they operate also be modified. In the realm of the macro economy, a good example is the change that led to autonomy for the Central Bank and for the state agency in charge of bank supervision. As far as the support policies to the SME sector is concerned, Chile, for better or worse, but with the exception of Banco Estado, decided to discard the direct provision of the programs by state agencies. Nowadays, the execution of the programs, indeed, carries the imprint of heavy private sector participation. This new approach is far from flawless, but is not at all overly tainted by cronyism and waste of scarce public resources.

Admittedly, upgrading administrative capacities of state agencies is a costly undertaking. Also, reforms in the institutional framework can be risky when proposed changes face the opposition of private and public groups with vested interests in the status quo. For these reasons, donor interventions must be carefully targeted. For example, upgrading the managerial and technical skills of a small cadre of *empowered* professionals nestled say, in a trade ministry or a public development agency, is likely to yield high benefits if project design incorporates activities that can propel, by way of *benign metastasis,* a thorough process of institutional reform.

Third, policy dialogue that enhances social and economic *inclusion* matters. For the last fifteen years, since democracy was restored, Chile has privileged a participatory approach to reform. The cornerstone of this approach is a permanent process of public-private dialogue that is evidently constructive and productive. Through the establishment of ad-hoc private-public committees commissioned to analyze issues that directly and indirectly impact the profitability of the SME sector, and to propose regulatory norms and public programs to address them, Chile has *de facto* instituted mechanisms for consult and resolution of policy disputes that the private sector finds very valuable.

To be effective, public-private dialogue requires the engagement of financially independent, competently staffed, well-run private sector organizations that are representative of their constituents. In Chile the large majority of SME firms have yet to find or set up venues that can properly represent them. The government is aware of this problem and has instituted programs to strengthen SME associations. This indeed is a measure that can have a far-reaching, positive impact. Donors then can feel reasonably confident that well targeted projects that strengthen the institutional capacity of SME organizations can have a positive impact, especially if these are to be managed by competent, energetic leaders.

It is important to emphasize that the Chilean model of public-private dialogue cannot be easily replicated in countries where the relationship between the public sector and the private sector is fundamentally antagonistic. Neither is it likely to yield good results when the goals and interests of large enterprises and SME firms diverge dramatically. In these settings trust is most likely in short supply, and the endowment of *relational* capital is therefore poor. Under these circumstances, stand-alone interventions that seek to strengthen SME associations so as to empower them in their advocacy role, may be fruitless. The impact is likely to be limited if the sector and other key stakeholders remain at loggerheads.

For this very reason, it is more advisable to accompany projects of SME institutional strengthening with activities aimed at breaking the logjam of communication among the stakeholders. In this regard, and following an appreciative inquiry-based approach to stakeholder analysis, projects can fund the organization and conduction of say, SME competitiveness workshops, with the participation of a small group of influential stakeholders hailing from different layers of society and who do not seemingly share the same interests. The objective of the exercise would be to identify mutual interests, and to plant the seeds for the establishment of a relationship of communication and mutual collaboration.

Fourth, finance matters. The Chilean experience vividly demonstrates that far-reaching reforms in the business environment will have a limited impact on SME exports when firms do not have adequate access to financial services. In fact, permanent and sporadic SME exporting firms believe that the finance problem represents a more severe obstacle than the more typical restrictions of licensing, labor legislation and environmental requirements. Unsurprisingly, the majority of SME firms also share this view.

Therefore, projects that help expand the provision of financial services to SME firms are bound to yield high benefits. A successful project of this type would have two basic components. The first is to provide assistance to the state agency in charge of bank supervision in order to introduce bank norms that facilitate, not obstruct, credit delivery to SME firms. The second component is the direct provision of technical assistance to commercial banks interested in lending to the sector.

Fifth, the overall managerial capacities of SME firms matter. Many SME firms in Chile are outmatched by competitors in domestic and international markets, not so much because of "glitches" in the regulatory framework or difficulties in accessing commercial bank loans at reasonable terms as by the reluctance or inability of owners to introduce modern management techniques.

The future of SME exports then is also tied to the ability of the firms to access reliable and high-quality services that will directly translate into concrete improvements of their managerial skills. One vehicle to obtain this is via stronger linkages or partnering with larger firms. In this regard, Chile has lessons to offer by virtue of the long years of implementation of CORFO's PDP. Unfortunately, the outreach of the program is still limited. Another vehicle lies in the development of a market for business services. In Chile at this moment, the conclusion is that the market is still undeveloped.

Donor projects can help develop the market especially when they contemplate activities that (a) sensitize SME firms on the benefits that can be derived from demanding these services and, most importantly, to the advisability that the services be delivered for a fee; (b) prod local providers of business services, which may include individual consultants, consultancy firms and even associations, go through a process of formal registration; and (c) provide extensive training to selected formally registered local providers on the particular background and needs of SME firms, and on tools that can facilitate delivery and improve quality of their services.

Sixth and finally, associative arrangements for exports matter. Chile is increasingly devoting more public resources to foster clusters and value chains. This is a explicit recognition that, in these times of keener competition in global markets, the associative arrangements are vehicles that can link small producers with the international economy. Projects that foster the development of these arrangements, therefore, are likely to yield high results.

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1. Public Agencies

Corporación de Fomento de la Producción (CORFO)
Pro Chile
Servicio de Cooperación Técnica (SERCOTEC)
Ministerio de Economía
Banco Estado

2. Private Sector

Wines of Chile
Asexma Chile AG
Asociación de Exportadores de Chile (ASOEX)
Sociedad de Fomento Fabril (SOFOFA)
Asociación de Viñas de Chile
FEDEFRUTA
Viña Montes
Pandol Brothers

3. International Development Agencies

Inter American Development Bank
Comisión Económica para América Latina (CEPAL)

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