Enterprise Growth Initiatives:

Strategic Directions and Options

Final Report

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EXECUTIVE SUMMARY

Sustainable growth of private enterprises is a requirement for increasing per capita income and consumption, creating jobs, and reducing poverty in developing and transition economies. For years, recognition of this fact has driven the U.S. Agency for International Development (USAID), the World Bank Group, and other donors to promote private enterprise development. Enterprise growth is a dynamic process that takes place within a competitive market environment. Not all individual enterprises survive, but those that do contribute greatly to the economic well-being of individuals and nations. Increasingly, enterprises operate in wider markets, with the global market setting the standards for performance. Increasingly, survival and success depend not only on factor inputs but also on innovation and technology.

Enterprise growth is shaped by three broad factors: demand for the products and services that firms produce; the quality of the business environment, which affects the incentives that firms face; and the competitive response of firms to market demand. Each of these factors offers entry points for enterprise growth initiatives. There are two broad schools of thought about programmatic approaches to enterprise development. The first concentrates on improving the business environment and incentive structure in the expectation that a competitive economy will emerge from the reform of policies, regulations, and institutions. The second approach focuses on stimulating the private sector response to existing market opportunities and barriers.

While proponents and critics have argued the merits of each approach, the true answer lies in addressing market imperfections in a manner consistent with the country context. In some settings, one or the other approach may be appropriate; in many settings a combination of both approaches will be best. Closed political systems, unstable or transitioning economies, and latent or overt conflict all pose challenges that require sophisticated, overarching programmatic responses. Increasingly, donor initiatives cut across sectors concerning both macro and micro issues and involve government, civil society, and the private sector. Decision makers and program designers need to understand fully the depth of market failures and fashion responses that address the root problem, not the surface effect. Market failures provide the most compelling argument for donor-financed enterprise growth initiatives that can help mobilize the private sector to revitalize the economy in partnership with government and civil society.

THE FRAMEWORK FOR ENTERPRISE GROWTH INITIATIVES

The important role that the private sector—which is the aggregate of productive enterprises—plays in reshaping underperforming economies is underscored by literature reviews and shown in program results. The salient observations consist of the following:

- The sustainable growth of private enterprises correlates quite directly with economic growth in virtually all countries. Private sector development provides the most important opportunity to raise the absolute income of the poor and generate productive employment.

- Developing sustainable private enterprises in a growing economy generally involves movements from agriculture to industry and services, from rural to urban areas, from smaller to larger firms, and from widespread informal sector activity to broad compliance with a reformed set of business laws and regulations.

- The business environment creates profit opportunities (incentives) that drive enterprise behavior. The private sector, particularly those segments that try to compete in broader regional, national, and global markets rather than relying on protection from competition, can play a critical role in reshaping the business environment to create incentives that foster a more open, competitive economy.

- A favorable business environment offers low transaction costs to help enterprises respond to market demand. Improving the business environment has broad impact on the private sector, including both local and foreign investors.

- A dynamic flow and churn of private enterprises accompanies economic growth. More important than the growth of individual enterprises—which are born, die, or grow—is the growth of the private sector as a whole. For greatest impact, enterprise growth programs should support this dynamic by concentrating as often as possible on the private sector as a whole and increasing its competitiveness. In circumstances where direct firm-level interventions are implemented, policy makers and practitioners should strive to improve the bottom-line performance of a sample of enterprises in order to learn about market failures and solutions, build credibility with public and private sector leaders, and demonstrate improved performance. However, focus primarily on a particular firm size (e.g., micro) may not achieve maximum impact within an industry cluster or a value chain. These positive externalities generated from direct firm-level interventions should lead to higher-impact initiatives that improve the business environment and industry or sector performance, generating broader benefits for the private sector and the overall economy.

- Informality in the economy has implications beyond the typical identification of "informal sector" with microenterprise. Improved competitiveness requires increased formality through more effective implementation and enforcement of policies, laws, and regulations. Achieving greater economic discipline or formality generally requires the participation of both public and private institutions.

Markets are generally the best mechanism for allocating a society's scarce resources to attain maximum social benefit. Intervention is justified when markets fail. Markets do not work in a vacuum, but are influenced by the legal, social, and cultural settings of particular countries. Governments can improve the workings of markets in several ways: by simplifying their rules and procedures and investing in public goods such as infrastructure and services so that transaction costs are reduced; by providing incentives for the private sector to invest in human capital or organize itself through business associations; and by providing important information (for example, on product safety or standards) that would not otherwise be available. When reform is needed but not undertaken (because the government is controlled by special interests, for example, or is in chaos), firms tend to operate informally. Donors can help by supporting governments to provide more effective services and by helping the private sector operate more formally. A second rationale for donor intervention arises from the need in some settings—in post-socialist economies, for instance, or when nontraditional products are brought to new markets—for firms to learn how to react effectively to major market changes that occur outside their country but affect prices and business practices inside the country (for example, the emergence of multinational grocery chains that dramatically alter supply chains and distribution channels for consumer products). Interventions to help individual producers or groups of producers learn how to upgrade production and market higher-value products should be temporary and should promote the development of sustainable markets.

STRATEGIC APPROACHES FOR ECONOMIC GROWTH INITIATIVES

Through enterprise growth initiatives, donors have the opportunity to help revitalize and reform market institutions. Given the complexity of both the problem of market failures and the solution of donor intervention, strategies for economic growth initiatives should entail the following elements:

1. **Multiple levels of engagement:** Enterprise growth initiatives should operate at national, sectoral, and enterprise levels to revitalize enterprise performance and build coalitions in the private sector to transform market institutions and improve the business environment. These interactions may operate simultaneously or sequentially, depending on the level of counterpart interest, commitment, and engagement. Direct firm-level assistance, in some circumstances, may initially be necessary and valuable to establish credibility with the private sector and to learn from market experience. Strategic management of such engagements should aim to achieve the highest impact for enterprise and economic growth, which is usually achieved by reforming the business environment and promoting growth in key sectors of the economy, including financial and business services.

2. **Rigorous market approaches:** Initiatives should focus on increasing market demand to increase profit opportunities in promising sectors. Enterprises with growth opportunities in local, regional, and international markets have a stake in improving the business environment. In addition, increased access to critical input markets, such as capital, business services, and land, improves the ability to compete. Higher productivity in the financial services and business services industries reduces transaction costs and supports innovation and higher value-added productivity.

3. **Simultaneous interventions:** Strategies should focus on leveraging improved private sector performance to support policy reform. Piloting new and sometimes controversial policy initiatives in the private sector will build support for reform in key public and private institutions.

4. **Strategic fit:** Strategies should respond to the environment, development phase, and political and economic variables within each country. Initiatives can operate in conflict, post-conflict recovery, and reconstruction phases, in transitional economies, and in developing market economies. In addition, initiatives should be adapted to the political and economic system and the ability to leverage domestic or foreign market demand.

Strategic management requires careful analysis and decisions to design and manage enterprise growth initiatives that respond to the opportunities and constraints for reform in each country setting. The objective is to maximize enterprise growth and economic growth by using a variety of program options, including direct firm-level assistance; industry cluster and value chain initiatives; programs to improve the financial, export, or services sectors; and policy and institutional reform programs. There are tradeoffs in risks and returns for each option or combination of options.

In environments where reform at the industry, sector, or national levels is too risky, direct firm assistance may be the best option. Direct firm assistance can lay the groundwork for higher-impact programs that benefit more enterprises.

In some environments, policy and institutional reform may be possible at a national level to improve the overall business environment for all enterprises. In other environments, some combination of direct firm-level assistance and industry, sector, and national programs may be most appropriate. The effective management of enterprise growth initiatives requires careful monitoring of results and evaluation of impact to guide continuous adjustments of enterprise programs in response to changes in the marketplace.

Fostering Private Enterprise Creation and Growth

In preparing this paper, we analyzed the collective experience of donor-funded initiatives aimed at fostering the creation and growth of private enterprise by reviewing 42 evaluations of projects funded by USAID, the World Bank Group, the U.K. Department for International Development (DFID), and the Inter-American Development Bank (IDB). We looked at projects that focused on three main areas: access to markets, access to capital, and access to business services. We then determined how each project improved productivity, augmented enterprise profitability, achieved sustainability, and maximized impact.

Our research on enterprise projects found that the evaluation system within USAID collapsed during organizational re-engineering initiated by the Executive Branch in the mid-1990s. It was difficult to find documentation on this topic at USAID. Information available from the World Bank and IDB was also quite limited. This was one indicator of the absence of capacity within donor organizations to learn from their experiences. We also found that staff in the head office had only a fragmentary knowledge of enterprise growth initiatives in the field. Without a comprehensive evaluation system, donor agencies are not in a position to support field missions and improve the performance of enterprise projects. An important conclusion is that donor agencies should invest in evaluation systems to capture lessons learned so they can strategically manage initiatives.

Our findings indicate that successful enterprise development projects generally share the following characteristics:

- They achieve the greatest impact by improving dynamic growth within strategic sectors, value chains, and industry clusters, rather than focusing primarily on firm size. (Projects that focus exclusively or primarily on firm size often fail to leverage and support dynamic growth.) This focus on improving the private sector supply response is complemented by efforts to improve the business environment. Thus, all enterprise growth projects should focus on improving both the business environment and the private sector supply response.

- They adhere to commercial principles and leverage market opportunities for growth. Effective donor interventions avoid subsidies that create dependency and distortions, and they introduce new incentives, such as new demand opportunities or innovative services, that become commercially sustainable.

- They are multifaceted, including components that address relevant market failures to fully leverage the project's impact. Policy components are particularly important to ensure enterprise projects improve the business environment to maximize impact on the greatest number of enterprises.

- They are of sufficient duration (generally 5 to 10 years) to establish brand identity, credibility, and strategic partnerships with key policy makers and private sector leaders.

- They typically make use of highly qualified local staff and source local service providers through open competitive procurement to achieve highest value services and support commercial relationships between local service providers and enterprises.

- They select counterpart organizations and local service providers in a transparent fashion to avoid political agendas and reinforce sound commercial practices and the principles of joint venture.

- They carefully factor in incentives to change enterprise behavior and performance and minimize or avoid subsidies that distort the behavior of enterprises, business associations, and public-private counterpart institutions.

- They build in learning and innovation processes to test and improve policy initiatives in the private sector, as well as services that eventually become commercially viable.

- They identify and support key champions in the public and private sectors to support, lead, and drive reform initiatives.

- They invest sufficient resources in research and development to learn about the churn effect and develop the appropriate economic incentives and legal framework—such as tax and bankruptcy laws—to support commercial services to encourage risk-taking and entrepreneurial behavior.

In analyzing donor inventions in improving access to markets, we draw many conclusions, including the following:

- High-impact projects use a rigorous approach with access to product markets providing new profit opportunities as incentives to improve enterprise performance.

- Direct firm-level assistance is more expensive than industry cluster or policy reform initiatives. Direct firm-level assistance is appropriate in high-risk environments such as conflict and post-conflict situations where government is ineffective, such as Kosovo and Zimbabwe, to minimize risks and develop private sector responses to food shortages, unemployment, and dysfunctional markets. In other situations, direct firm-level assistance is appropriate to develop credibility and trust with private and public sector leaders by generating bottom-line improvements and building momentum for higher-impact activities that improve industry and sector performance, as well as the business environment.

- Global benchmarking in competitive markets improves productivity in enterprises and industries with growth potential that must learn to compete against enterprises operating beyond their borders.

For improving access to capital, we found:

- Financial services in most emerging markets impede enterprise growth by failing to serve the needs of dynamic enterprises that need to borrow to sustain growth. Donor assistance should support applied research that examines greater innovation in financial services to support dynamic growth.

- Closing the financing gap—including investment requirements from $50,000 to $750,000 for growth enterprises that do not qualify for donor-sponsored microfinance programs or high-collateral commercial lending requirements—is an important way to accelerate enterprise growth and economic growth in developing and transition economies.

- Supporting profitable financial institutions and competitive financial services industries is more important than supporting lending programs to small and medium-sized enterprises. Enterprise projects should improve productivity in the financial services industry to generate innovative financial services to meet the needs of growth enterprises on a commercial basis.

- Perceptions of a financing gap often mask more fundamental problems at the firm level or in the legal and regulatory environment within which the financial sector operates. In many cases, these problems may need attention before, or as, the financing gap is closed.

- Donor programs should support more innovative services for the dynamic growth of enterprises, including—in more sophisticated developing economies—mixed equity and debt instruments combined with consulting services that help newer, risk-taking enterprises grow. To achieve this, donor programs should support legal, regulatory, and institution-building steps required to develop more dynamic and competitive financial services industries.

- In some cases, direct firm-level assistance to establish a new or revitalized financial institution, such as the American Bank of Kosovo or the Agricultural Bank of Mongolia, can have a profound impact on upgrading competitive standards and the overall performance of the financial sector by providing innovative financial services to a wider range of enterprises.

For improving access to services, we learned the following:

- Building commercially viable business services, such as quality assurance and production improvement, accounting and audit, management consulting, Internet services, and market research, can increase productivity in all sectors, much like financial services. This process requires strict adherence to commercial principles and practices in working with local service providers and enterprises that purchase services in order to ensure high-value services that improve bottom-line performance.

- Effective demand—the willingness of enterprises to pay fees for business services—is crucial to the development of services that improve productivity and accelerate enterprise growth. In many cases, direct firm-level assistance and industry cluster upgrading services can create incentives for effective demand by ensuring higher productivity.

- Successful projects broker commercial relationships between local service providers and enterprises in a wide range of services that improve productivity, including quality standards, Web site design, market research, production realignment, and management or financial restructuring.

MAXIMIZING STRATEGIC IMPACT

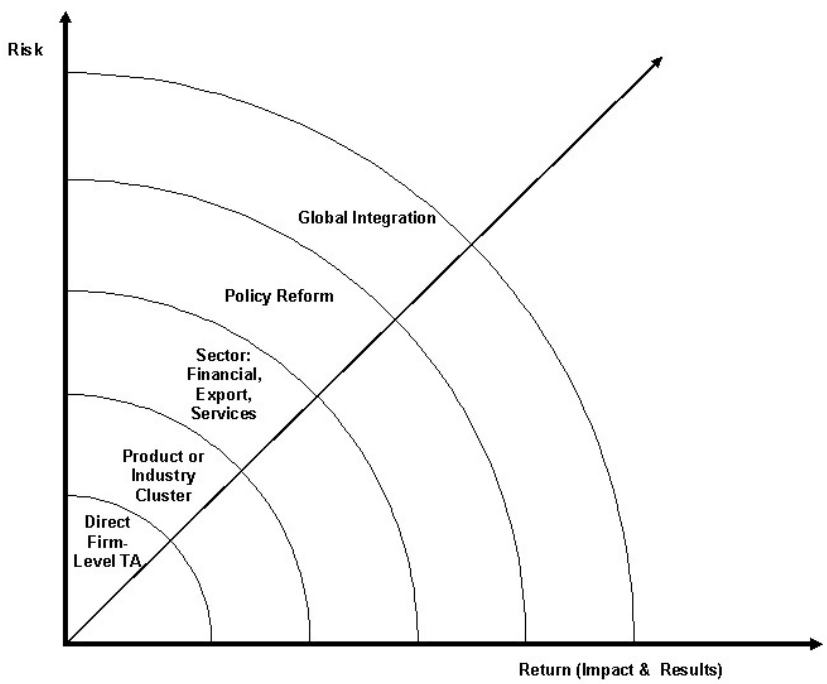
Evidence suggests that greater impact is achieved when larger numbers of enterprises are positively affected by enterprise growth initiatives. Three key considerations should shape enterprise growth strategies:

1. **The economic and political variables, and the development phases and conditions that require distinct strategies and approaches in different country environments.** Table E-1 at the end of this Executive Summary presents these issues and alternative intervention strategies.
2. **The important questions and issues that policy makers and practitioners should address to analyze political economy issues related to strategy.** Table E-2 at the end of this Executive Summary raises a series of questions that illustrate the complexity of

issues and actors that should be considered in the process of strategy formulation, including: entrenched political and economic interests that may pose serious constraints to enterprise growth projects; progressive leaders who are natural allies for change; market demand opportunities that create incentives for changing thinking and behavior; and considerations for improving productivity and innovation in key industries, such as financial and business services.

3. **The optimal program design to achieve impact.** Figure E-1 presents various intervention options that constitute program initiatives and the anticipated impact of each class of intervention, defined here as the combined effect of risks and returns on individual enterprises and their aggregate.

Figure E-1: Levels of Economic Growth Interventions



In the past, the interventions in Figure E-1 have been made sequentially, with adjustments and even reversion to lower risk and lower impact interventions to accommodate economic cycles and significant changes in the environment, such as war or recession. Increasingly, however, programs combine interventions to create greater opportunities for strategic impact. Although combinations of interventions can increase program complexity and risk, the distinct and often complementary characteristics of each intervention generate important benefits, as follows:

Direct Firm-Level Technical Assistance. The lowest potential impact measured in terms of increased economic growth is attained through direct firm-level technical assistance that targets a limited number of firms. Firm-level technical assistance, although more costly than other interventions, can be the right choice in high-risk environments, such as conflict and post-conflict situations, and for positioning higher-impact activities that require strong partnerships between the public and private sectors. Reform initiatives require champions, and donor projects can build the necessary trust and credibility by demonstrating bottom-line success at the enterprise level. Important positive externalities are achieved through firm-level assistance that can be leveraged in the next stages of enterprise growth initiatives. Positive externalities of direct firm-level activities include:

- **Learning and experimentation** about what works and does not work at the enterprise level in the marketplace can inform policy makers about reforms in taxes, regulations, and other levers to improve performance.

- **Establishing credibility and building relationships** with key private sector leaders who pay attention to improvements in bottom-line performance are crucial for the next stages of industry initiatives and policy reform. Reform requires champions who lead the change process based on new incentives.

- Piloting new reform initiatives or introducing new financial and business services or quality standards can create **demonstration effects** that proliferate in an industry and build momentum for reform.

These externalities are only valuable if donor agencies and project managers strategically leverage them for higher impact at the next stages of an initiative.

Industry Cluster Initiatives. Many enterprise growth initiatives focus on a specific industry, commodity, or product with growth potential. Increased productivity of nontraditional agribusiness exports, such as cut flowers or processed seed oils, or growth industries such as automotive manufacturing or information technology where there are anchor investors such as General Motors or Intel, presents opportunities for impact. By working within value chains that include small producers, transporters, large processors and exporters, labor groups, trade associations, related research and development institutions, and universities, higher productivity is achieved through improved integration of previously fragmented industries. Often, critical policy issues such as intellectual property rights of plant material, cold storage facilities and services, trade agreements, quality standards, and tax incentives require collective action within the industry cluster or value chain to improve performance. These initiatives work through cluster-based trade associations, public-private partnerships, and larger coalitions of interest groups to achieve greater impact when policies are harmonized to global standards to increase enterprise competitiveness at the national level.

Sector Initiatives. Improvements in strategic sectors of the economy, such as the financial sector or export-oriented sectors, can have far-reaching economic impact. The evaluations of financial initiatives indicate the importance of supporting more profitable, sustainable financial institutions within a more efficiently organized financial sector. This support requires important reform measures such as improved bank supervision and liberalization that encourages foreign investment and competition. Similarly, export and investment promotion requires changes in the policy environment as a prerequisite for improved performance of trade facilitation services, trade and investment promotion, and marketing activities.

Policy Reform. Policies that provide the private sector with new incentives to increase sustained value-added productivity have the greatest impact on enterprise growth. In an ideal world, government policies would automatically correct market failures. The right policies can provide the right incentives to change enterprise behavior to minimize rent seeking and maximize sustained value-added productivity.

Global Integration. Ultimately, effective integration into the global market will allow enterprises to achieve the greatest growth. This is not easily achieved for many countries without major shocks to major sectors of the economy that have been protected and cannot compete in an open market. The behind-the-border work to prepare enterprises, industries, and countries to understand competitive factors is crucial to reduce the risks and maximize the returns of global integration.

The challenge for enterprise growth initiatives is to achieve the highest impact at each stage and the most efficient overall performance over time.

THE IMPERATIVE FOR CHANGE

For donor organizations, contractors, and other stakeholders seeking to achieve real change and improve the lives of people in poor countries, the challenges are great. The private sector should play a leading role in transforming and revitalizing underperforming economies into competitive market economies. Transforming these poor economies should be motivated by the enlightened self-interest of public and private sector leaders, representative business organizations, and public-private partnerships.

The global market is a ruthless and efficient arbiter, rewarding enterprises that can compete and eliminating those firms that do not yet understand the requirements of market demand, market trends, and buyer requirements. Most enterprises that operate in unfavorable business environments have a disadvantage compared with enterprises in other countries that offer lower transaction costs and more favorable business environments.

Enterprise growth initiatives can play a major role in helping enterprises and the private sector take the lead in creating their future. Market economies cannot function or be competitive without a dynamic enterprise sector, and enterprise growth initiatives can assist private sector leaders and their government counterparts in revitalizing their economies and enhancing the welfare of their people. Ultimately, higher standards of living are in the interests of enterprise owners because markets function best when people have the incomes, consumption, and savings patterns associated with healthy, growing economies. Thus, it is in the interest of enterprise owners and private sector leaders to create positive change—and enterprise growth initiatives can be the catalytic force for that change and a positive force in support of economic growth.

Table E-1: Country Typologies, Development Phases, and Political and Economic Variables

Variables	Conflict	Post-Conflict Recovery & Reconstruction	Transitional Economies	Developing Market	Emerging Market
Open vs. Closed Political System	▪ Consider firm-level TA to limit risks and leverage markets for food security, job creation, and household incomes ▪ Complement humanitarian aid by leveraging markets for food production, input supplies, and logistical support ▪ Consider focus on industry cluster work in agribusiness and employment generating industries that support reconstruction and future growth ▪ Explore commercial solutions for health services and local community action	▪ If open, consider supporting national, regional, and industry levels of public-private dialogue to strengthen business environment and key industries ▪ If closed, consider supporting industry clusters at regional levels to encourage collective action	▪ If open, encourage public-private dialogue, focus on improving business environment to complement industry initiatives in growth areas ▪ If closed, consider focus on export-oriented industries and specific legal and regulatory reforms in those industries; focus on supporting services	▪ If open, consider work at all levels to improve business environment and test pilot reform initiatives through public-private partnerships ▪ If closed, explore support for export-oriented industries and enterprises that advocate reform where possible	▪ If closed, consider supporting bottom-up policy dialogue at industry and regional levels and cluster upgrading through associations ▪ If open, consider supporting national and regional dialogue and partnerships for specific industries
Open vs. Protected Economic System		▪ If open, explore support for export and large domestic demand industries ▪ If protectionist, consider supporting export-oriented industries	▪ If open, consider encouraging public-private dialogue and partnerships to support growth industries ▪ If protectionist, consider focus on export industries and large domestic industry	▪ If open, consider promoting foreign investment and export promotion in growth industries ▪ If protectionist, support export-oriented industries and enterprises	▪ If open, support FDI and trade promotion, and improved business environment ▪ If protectionist, support export industries and progressive leaders with specific policy reform initiatives
Small vs. Large Domestic Economy		▪ If small, consider focus on export industries and strengthening export associations ▪ If large, consider focus on export and large domestic industries, and improved business environment for investment	▪ If small, consider focus on export industries and regional integration through trade agreements advocated by industry ▪ If large, consider supporting anchor firms and foreign investors and cluster upgrading in large domestic industries	▪ If small, consider supporting improved business environment for FDI and export industries ▪ If large, consider supporting FDI in large domestic and export industries and national policy reform initiatives	▪ If small, consider strengthening public-private partnerships for improved business environment and export and investment promotion ▪ If large, consider focus on partnerships for improving business environment

Table E-2: Strategy Considerations for Enterprise Growth Initiatives

Strategic Issues	National	Industry/Sector	Enterprise
		Project Design and Implementation	
What are the objectives and measurements of enterprise growth initiatives?	**Objectives:** ▪ Increased GDP per capita ▪ Reduced poverty ▪ Increased jobs	**Objectives:** ▪ Profit leading to value-added growth ▪ Increased contribution to GDP by industry, commodity, or product ▪ Increased innovation	**Objectives:** ▪ Increased sales and market share ▪ Increased profitability ▪ Increased employment ▪ Increased innovation
	Measurement Indicators and Tools: ▪ Time series data measuring increased total employment and GDP per capita over time ▪ Attribution of policy reforms based on surveys of key stakeholder institutions (e.g., associations, universities, labor, NGOs)	**Measurement Indicators and Tools:** ▪ Expansion in trade opportunities through trade agreements, reduced tariff barriers, regulatory reform, harmonization with global standards ▪ Time series data for each industry or commodity measuring changes in exports, market share, investments, and employment ▪ Surveys of industry group and sample enterprises for attribution and relevance of donor-financed initiatives ▪ Assess inputs (services brokered, fees collected, commercial sustainability, # firms served, etc.) ▪ Assess outputs (improved productivity, sales, jobs created, etc.) ▪ Assess public-private partnerships for R&D, industry upgrading, investment in infrastructure and social capital.	**Measurement Indicators and Tools:** ▪ Surveys of client-assisted enterprises, with control group of unassisted enterprises, for improved profitability, sales, productivity improvement, and employment ▪ Assess attribution of donor-assisted activities and demonstration effect through surveys ▪ Assess inputs (services provided, fees collected, transactions brokered, etc.) ▪ Assess outputs (sales, profits, exports, jobs created, etc.) ▪ Assess R&D and technology acquisition
What are the incentives for reforming and revitalizing market institutions to achieve improved enterprise productivity, innovation, and performance?	**Issues:** ▪ Who are the winners and losers under the current economic regime? ▪ Who will be the winners and losers in efforts to liberalize the economy and increase competition? ▪ What are the power levers of reformers and obstructionists?	**Issues:** ▪ Which industries are export oriented, which are subsidized and import-substitution oriented? ▪ Which business leaders and organizations are progressive and market-oriented? ▪ Identify products and services that can compete in global markets ▪ Which industries are export-oriented, and utilize global technology, standards, and practices?	**Issues:** ▪ What services will strengthen lead investors and anchor firms in growth industries? ▪ What demand-led criteria and incentives will assist firms to self-select for risk-taking initiatives? ▪ Which firms provide greatest leverage to increase productivity?
	Tools: ▪ Stakeholder analysis, market segmentation ▪ Investor roadmaps, investment climate assessments ▪ Assess competitiveness rankings ▪ Segment stakeholders by progressive government and business leaders ▪ Identify reform initiatives and resources to expand market access	**Tools:** ▪ Assess time series trade data ▪ Assess competitive benchmarking within the industry and with competing countries ▪ Survey industry expert opinion ▪ Assess value chains through subsector analysis, baseline surveys	**Tools:** ▪ Conduct enterprise audits and product testing to identify restructuring opportunities in selected firms ▪ Offer match-making grants for firms willing to innovate and take calculated risks ▪ Introduce high value services to improve firm bottom-line performance

Strategic Issues	National	Industry/Sector	Enterprise
How can enterprise growth initiatives be mutually reinforcing and maximize impact at multiple levels?	**Issues:** ▪ Which policy reforms support industry-level and firm-level interventions? ▪ Which public leaders/agencies can effectively partner with private entities to provide more efficient and effective services? ▪ Which reforms improve global harmonization (e.g., telecom, IPR)	**Issues:** ▪ Which industry groups support liberalization and advocate reform? ▪ Which industry issues develop broad-based support for growth? ▪ Which cluster services will upgrade a large segment of firms in selected industries? ▪ What pilot activities will provide data and results in support of policy reforms?	**Issues:** ▪ Which firm-level interventions achieve the greatest results and demonstrate new behavior in response to new incentives? ▪ How will assisting lead firms improve suppliers and smaller firms?
	Tools: ▪ Test pilot initiatives for proposed reforms at industry and firm levels to demonstrate results and galvanize support for reform ▪ Design public-private partnerships for the right activities (e.g., research and development)	**Tools:** ▪ Identify policy, institutional, and services requirements of enterprises in growth industries ▪ Support progressive leadership groups to upgrade enterprise performance in growth areas ▪ Measure results, disseminate results, and expand benefits	**Tools:** ▪ Analysis of value chain and subsector ▪ Design services to improve bottom-line performance of emerging risk-taking enterprises and lead firms with broadest impact ▪ Measure results, disseminate results, and assess demonstration effect and replicable commercial solutions
Improving Access to Capital			
Do financial services improve enterprise productivity in response to new demand opportunities?	**Issues:** ▪ Does the necessary supporting legal framework exist for competitive financial services (e.g., rule of law, effective enforcement, collateral registry, credit bureaus, etc.)? ▪ What laws and institutions could be improved to support financial intermediation? ▪ Is there sufficient competition in the financial sector? ▪ How does productivity of financial services compare to other industries? ▪ Are interest rates subsidized? ▪ Do state banks crowd out competition?	**Issues:** ▪ How effectively do lead financial services firms perform compared to global standards? ▪ Are credit services primarily collateral-based or cash flow-oriented? ▪ Do bankers understand market dynamics of key growth industries? ▪ Does the industry have a reform agenda for the financial services sector? ▪ Are there debt and equity instruments available? ▪ What services will upgrade financial sector performance (e.g., training, credit guarantees, etc.)?	**Issues:** ▪ Do firms finance growth with external sources of financing? ▪ Do firms see banks as strategic partners to expand operations and grow? ▪ Do financial services focus on improving enterprise performance (e.g., cash flow lending)? ▪ Is there a range of financial services to assist enterprises in various growth stages (e.g., micro to risk-taking firms, working capital and trade finance to asset financing)? ▪ Do firms prepare financial statements and business plans for external financing and investment?
	Tools: ▪ Assess critical constraints and areas for improvement ▪ Develop dialogue with government and financial sector leaders for reform ▪ Conduct cost-benefit analysis of current and new financial policies and regulations	**Tools:** ▪ Conduct industry-specific gap analysis compared to global industry standards ▪ Analyze demand-led services opportunities to upgrade financial institutions ▪ Develop reform agenda with representative industry group, including foreign and local banks	**Tools:** ▪ Identify and work with innovating financial services firms ▪ Broker commercial linkages between growth enterprises and financial service providers ▪ Use incentives strategically to encourage innovation in financial services and deal flow of bankable enterprises

Strategic Issues	National	Industry/Sector	Enterprise
What is the capacity of the financial services industry to deliver value-adding services?	**Issues:** ▪ Is there sufficient competition to support innovation and higher productivity among financial service providers? ▪ Do foreign banks operate? ▪ What incentives will encourage the government to attract foreign banks and investors (e.g., Hong Kong Shanghai Bank, Citibank, etc.)? ▪ Do state banks provide effective services? ▪ Is there access to long-term funds?	**Issues:** ▪ Is there an active association to identify and address financial sector issues? ▪ What industry solutions will upgrade productivity (e.g., credit skills, management information systems, and credit bureaus)? ▪ Can upgrading services be provided through a bankers association, bank training institute, or other intermediary? ▪ Are there correspondent bank programs to build capacity?	**Issues:** ▪ What is the performance of lead financial services firms? ▪ Are there opportunities to upgrade productivity and innovation of 1 or 2 lead financial services institutions? ▪ Do banks understand how to structure enterprise financing for lowest cost of capital? ▪ Do financial institutions have credit analysis skills?
	Tools: ▪ Analyze constraints and productivity among state and private banks ▪ Conduct cost-benefit analysis of efficiency of financial sector ▪ Assess need for new financial innovations (e.g., risk sharing, insurance, guarantees)	**Tools:** ▪ Assess opportunities to upgrade financial services for growth industries (e.g., agricultural credit, export insurance, etc.) ▪ Pilot and test financial innovations (e.g., risk sharing, insurance, guarantees) ▪ Support advocacy for financial sector reform	**Tools:** ▪ Invest in, manage, or provide assistance to upgrade selected financial institution(s) (e.g., American Bank of Kosovo) ▪ Turnaround and privatize state banks (Ag Bank of Mongolia)
What are incentives for introducing innovative financial services to improve enterprise productivity, innovation, and performance?	**Issues:** ▪ What reforms will increase competition? ▪ What measures will encourage financial sector deepening? ▪ What incentives will encourage commercial banks to go down market, and microfinance institutions to go up market?	**Issues:** ▪ Can financial institutions cooperate to share costs for improving their performance? ▪ Are there risk-sharing schemes through credit guarantees, credit bureaus, and training programs? ▪ Do banks understand risk management and how to minimize non-performing loans?	**Issues:** ▪ Is there a deal flow of bankable enterprises? ▪ Are there growth enterprises in export and key industries that require financial services? ▪ Do firms understand cross-product marketing to grow enterprises into larger clients?
	Tools: ▪ Assess bank regulations and oversight to improve incentives for productive credit and equity ▪ Work with government and financial sector to limit the scope and control of state banks ▪ Encourage new investors in the sector	**Tools:** ▪ Assess industry performance against other countries ▪ Assess cost-benefit of adopting risk-sharing schemes; pilot promising schemes ▪ Identify and introduce new technologies and industry innovations	**Tools:** ▪ Provide assistance to introduce innovative financial services for growth enterprises ▪ Develop a deal flow of bankable firms ▪ Work with innovative financial service providers to offer debt, equity, and consulting services

Strategic Issues	National	Industry/Sector	Enterprise
	Improving Access To Markets		
Where is there increased demand that provides profit opportunities (incentives) for private sector initiative?	**Issues:** ▪ What are key policies and constraints to enterprise growth in the business environment? ▪ Is the economy harmonized and integrated into global markets? ▪ Assess the key macro and microeconomic factors in Table 1 ▪ Assess legal and regulatory procedures governing enterprises; lack of trade opportunities; bottlenecks in trade services; inefficiencies in infrastructure, human capital ▪ Assess trade policies, tariff and non-tariff issues creating distortions and preventing open competition	**Issues:** ▪ Which industries, commodities, products have higher value growth potential? ▪ Which commodities can be branded and upgraded? ▪ Which products/services can meet buyer requirements or global industry standards? ▪ Do trade data indicate trends for certain industries? ▪ What are traditional skills and capabilities to leverage? (e.g., traditional sword making in Pakistan converted into second leading producer of surgical instruments)	**Issues:** ▪ Which enterprises already export and can expand capacity? ▪ What are the global investors and anchor firms in key value chains and industries? ▪ Do enterprises have existing capacity to respond to buyer requirements? ▪ Identify entrepreneurs who are risk-takers, innovators, and investors in capital, labor, and technology ▪ Are these firms willing to invest?
	Tools: ▪ Cost-benefit analysis of existing laws and regulations compared to new ones. ▪ Tax modeling of increased growth generating greater tax revenues	**Tools:** ▪ Interviews with industry experts, buyers, and investors ▪ Industry trade data trends and leading competing nations ▪ Benchmarking industry best practices worldwide	**Tools:** ▪ Sample surveys of enterprises ▪ Baseline surveys of promising enterprises in growth industries, ▪ Demand-driven self-selecting criteria to identify risk-taking firms and innovative initiatives ▪ Product sample testing with buyers
What are the critical “access” issues?	**Issues:** ▪ Which government agencies and business organizations or leaders support liberalization and export-oriented industries? ▪ What is the impact of losers and winners? ▪ Is there asymmetrical power between government and business or between monopolies and private businesses? ▪ Does government open the way for private sector initiative or crowd it out? ▪ Are there opportunities for public-private action to address constraints?	**Issues:** ▪ Are there monopolies or collusion that prevent more competition? ▪ What restricts foreign investors and world-class businesses? ▪ Is there effective trade promotion and upgrading services? ▪ Is there cooperation among enterprises through associations and public-private partnerships to attend trade fairs, conduct market research, upgrade services? ▪ Do associations address customer’s customer issues or only political interests?	**Issues:** ▪ Do firms understand buyer requirements, competitive factors, and distribution channels? ▪ Which firms are risk-takers and manage bottlenecks effectively? ▪ Do firms speak the right business language? ▪ Do firms manage growth opportunities effectively? ▪ Do they use global technology, management practices, and marketing tactics?
	Tools: ▪ Stakeholder analysis of winners and losers ▪ Growth model to expand winners circle ▪ Public-private roundtables to discuss business constraints and opportunities	**Tools:** ▪ Investor roadmaps, investment climate assessments, subsector analysis ▪ Business surveys ▪ Industry expert opinion ▪ Assess technology applications	**Tools:** ▪ Analyze product flows through distribution channels and value-added chains ▪ Conduct enterprise audits ▪ Conduct business surveys

Strategic Issues	National	Industry/Sector	Enterprise
What are incentives for changing productivity, innovation, and performance?	**Issues:** ▪ Do key government leaders understand and accept the role of private firms and competition? ▪ What are key competing countries that provide alternative examples? ▪ Is there cooperation between government, universities, think tanks, and private sector for research and development, and work force planning?	**Issues:** ▪ Do anchor firms meet global industry productivity levels? ▪ Is there vertical and horizontal cooperation within value chains and across industries? ▪ Does industry understand its global competition, trends, threats, and opportunities? ▪ What is the level of awareness within the industry?	**Issues:** ▪ Is the entrepreneur willing to invest at least 50% in a new initiative? ▪ Would he/she invest without cost sharing? ▪ Do entrepreneurs understand investment to improve performance?
	Tools: ▪ Analyze competitiveness rankings against competing countries ▪ Conduct SWOT analysis with business and government leaders ▪ Visit trade exhibitions, innovation centers, etc.	**Tools:** ▪ Analyze global market trends with key industry leaders; develop growth strategy ▪ Assess standards and benchmarking within industry and compared to global standards ▪ Identify and introduce new technologies and industry innovations	**Tools:** ▪ Productivity assessments at firms ▪ Benchmarking against anchor firms or lead investors ▪ Linking sales opportunities to restructuring costs within high growth firms
Improving Access To Services			
What services can improve enterprise productivity in response to new demand opportunities?	**Issues:** ▪ What registration and regulatory requirements could be improved through more efficient services (e.g., company registration)? ▪ Which services could be provided most effectively and efficiently by government and private service providers under agreement with government (e.g., visa services, port services, etc.)? ▪ Is there sufficient competition in key services areas that affect enterprise productivity (e.g., telecoms, extension services, banking, etc.)	**Issues:** ▪ What services do exporting and lead firms currently use? ▪ Which services will upgrade productivity of lead firms and other firms in the value chain? ▪ What services could be provided by global investors and anchor firms in high-growth value chains and industries? ▪ What industry standards can be implemented through new services (e.g., product quality, ISO, etc.)? ▪ What services will increase value-added productivity? ▪ What services can be brokered and provided through collective action (e.g., associations and other brokers)? ▪ Does the industry have a reform agenda to improve strategic services (e.g., cold storage and logistics at ports)?	**Issues:** ▪ Is there a tradition of using business services? ▪ What services will improve market access for specific firms (e.g., ISO, technology applications, etc.)? ▪ What specific buyer requirements can be addressed through improved productivity (e.g., just-in-time production)? ▪ Will restructuring enterprises through business services improve productivity to meet buyer requirements? ▪ Which firms have growth opportunities and are risk-takers and investors? ▪ Will new services result in improved bottom-line performance?
	Tools: ▪ Cost-benefit analysis of existing services, and laws and regulations compared to possible new ones ▪ Pilot innovative services to test effective demand, efficiency and performance at the enterprise level and revenue generation for government agencies	**Tools:** ▪ Conduct industry-specific gap analysis compared to global industry standards ▪ Analyze demand-led services opportunities ▪ Assess existing demand and supply of services sector	**Tools:** ▪ Identify and work with selected firms that share costs, invest, and have growth opportunities ▪ Broker commercial linkages between growth enterprises and service providers ▪ Use subsidies strategically to create incentives for commercially viable value-adding services

Strategic Issues	National	Industry/Sector	Enterprise
What is the capacity of the services industry to deliver value-adding services?	**Issues:** ▪ Are there research and development capabilities that could support more effective commercial services (e.g. agricultural research to support private services)? ▪ Are there tax incentives for firms to invest in training, technology, and innovation with supporting services? ▪ Is there sufficient competition in key areas of the services industry? ▪ What incentives will attract anchor investors in strategic services industries (e.g., Microsoft, Hong Kong Shanghai Bank, etc.)?	**Issues:** ▪ Is there a tradition of commercially-viable value-adding business consulting services? ▪ Do anchor firms provide, or could they provide, value-adding services to smaller firms (e.g., supplier credit, training, technology)? ▪ Are there cost-sharing and piloting opportunities with anchor firms? ▪ Do associations focus on new market opportunities and services to upgrade to market requirements? ▪ How can productivity be improved within the services industry?	**Issues:** ▪ Do firms buy services for fee? ▪ Are services available within the supply chain? ▪ If not, are there specific services that can upgrade productivity and bottom-line performance? ▪ Which services can be delivered through local firms or require new capacity from foreign sources? ▪ What technical and training services can be combined with new technology acquisition?
	Tools: ▪ Analyze constraints in key industries and explore new public-private services models ▪ Conduct cost-benefit analysis of various services models ▪ Assess and test grant fund mechanism for outsourcing strategic services	**Tools:** ▪ Analyze pricing and value-added characteristics of cluster services ▪ Pilot cluster services for fees to upgrade services in group of firms ▪ Improve capacity of service providers by twinning with foreign experts	**Tools:** ▪ Analyze firm productivity to analyze improvement areas ▪ Introduce strategic services through cost-sharing schemes ▪ Build capacity of local providers ▪ Assess bottom-line improvements to restructuring within high-growth firms
What are incentives for introducing commercial services to improve productivity, innovation, and performance?	**Issues:** ▪ What incentives will attract global services firms (e.g., tax, accounting, quality assurance, banking, transport, logistics)? ▪ Can government outsource services to global firms (e.g., visa, procurement, etc.)? ▪ What role can government procurement play in supporting a more competitive services industry?	**Issues:** ▪ Do services improve productivity, thereby justifying fees? ▪ Can services be provided to a cluster of firms? ▪ Is cost sharing among multiple firms viable for introducing new strategic services? ▪ What is the effective demand for such services?	**Issues:** ▪ Are firms willing to pay for value-adding services? ▪ Will cost sharing reduce risk and introduce services that increase productivity? ▪ Will subsidies support commercial transactions or crowd them out? ▪ Do anchor firms or lead investors provide services or need for services?
	Tools: ▪ Assess outsourcing models in other countries ▪ Assess tax and other incentives in other countries	**Tools:** ▪ Analyze global market trends with key industry leaders; develop growth strategy ▪ Assess standards and benchmarking within industry and compared to global standards ▪ Identify and introduce new technologies and industry innovations	**Tools:** ▪ Offer cost-sharing grants to pilot strategic services ▪ Link new business to services that upgrade performance

CHAPTER ONE
INTRODUCTION

Sustainable growth of private enterprises is a requirement for increasing per capita income and consumption, creating jobs, and reducing poverty in developing and transition economies. Recognition of this fact drives efforts of the U.S. Agency for International Development (USAID), the World Bank Group, and other donors to promote private enterprise development.

Within the donor community, USAID is perceived as having special interest and expertise in the private sector. It tries to support investment, risk-taking, and entrepreneurship by private businesses and seeks to define better ways to do this. In the past, like other donors, USAID concentrated on efforts to improve the business environment, but it sometimes found the private sector response to reforms disappointing. It also experimented with other approaches, including micro and small enterprise development, microfinance, technology transfer, business services, export promotion, and competitiveness. Some activities had a large impact, others a modest impact, and some had no impact at all; in many cases, the impact is unknown because systematic evaluation was not undertaken. Because finding the right combination of interventions to accelerate private enterprise growth in developing and transition countries has proven difficult, USAID commissioned this study to improve its understanding of enterprise growth and find more effective ways to stimulate the sustainable growth of private enterprises of all sizes.

This report responds to three questions posed by USAID. First, what are the key factors that contribute to the sustainable growth of private enterprises? Second, when and under what conditions does enterprise growth translate into economic growth? Third (and most important), what has been the collective experience of donor-funded initiatives intended to catalyze or facilitate private enterprise creation and growth in developing and transitional economies—what has worked, what has not, and in what circumstances?

In this report, we have added an important fourth question: "What's new?" We are said to be living in an era of accelerated globalization, in which many businesses and national economies are becoming integrated, owing to cross-border capital flows, advances in technology, and a series of monetary unions and trade agreements. The bipolar world of the Cold War, with its centrally directed and market economies, has given way to a more unified world, which displays stronger interest in market-based systems and democracy. Yet a few communist governments and guided economies remain, and other countries have far to go before their transitions to capitalism and democracy are complete. Moreover, local conflicts abound, stimulated by access to weapons of high portability and low cost and by the economic self-interest of factions. What does such a world imply for improved practice by donors and practitioners?

In the United States, furthermore, increased political interest in foreign assistance—both among countries with positive economic and political performance and in countries in transition, conflict, or post-conflict—has rendered foreign assistance very dynamic. As higher funding levels have brought select programs under close scrutiny, new approaches to foreign aid have emerged. The recently established Millennium Challenge Account (MCA), for example, will significantly alter modalities and foci of assistance.

ENTERPRISE GROWTH: AN INTEGRAL ELEMENT OF DYNAMIC GROWTH

For decades, USAID and other donors have supported enterprise growth, both for its favorable impact on the income and employment levels of targeted populations and as an engine of economic development. This study reflects on the collective experience of donors, particularly in the past decade, in order to identify key characteristics of these initiatives and to determine strategic options for future ones. The best initiatives leverage the dynamic and innovative aspects of enterprises, and their aggregate, the private sector.

Enterprise growth initiatives have evolved along a continuum of greater sophistication and complexity, matching the growing understanding of the dynamics of the private sector, particularly in the face of the changing world economy. Since the mid-1990s, initiatives have rarely concentrated on a single facet of enterprise growth or set of actors. Increasingly, initiatives cut across sectors, address macro- and micro-level issues, and involve government and private sector groups. Even initiatives focused on a given topic, such as microfinance, entailed issues in supervision, regulation, and interface with the commercial banking sector. Firm size became less of a factor in program design as the importance of inter-firm linkages became apparent for increasing productivity and value, accelerating use of capital and technology, and bridging market size or fragmentation.

Globalization has also placed higher requirements on program interventions, including a stronger premium for commercial orientation. Interventions should seek to emulate private sector transactions and avoid, to the degree possible, subsidies and other incentives that shift entrepreneurs away from strong market-based responses. That said, no one set of incentives—along with concomitant opportunities and risks—is appropriate in all country settings, in light of variable political climates and economic structures. Market-based incentives do not work well when the national political economy is closed and protected.

The different country contexts are the starting points for enterprise interventions and highlight the importance of differentiated strategies. Donors have favored partial or comprehensive policy reform, designed to help government strengthen market forces, as well as private sector support, designed to augment private sector responses to market opportunities and barriers. Increasingly, USAID and other donors are adopting various combinations of the two general approaches to address market imperfections, from both angles.

Because all country settings or starting points for enterprise growth initiatives are different, measuring impact is complex, particularly when cross-country comparisons are desired. Evidence shows that enterprise growth and growth in gross domestic product (GDP) are mutually supporting. With positive increases in GDP—particularly GDP per capita—enterprises grow in number, size, and type. In mid-to-high income economies, many enterprises have gone through a process of transformation, moving from rural to urban sectors, from informal to formal status, and from micro to large in size. In the process, they have accounted for growing levels of employment, productivity, and profitability. Evidence also suggests that in low-income or stagnant economies, enterprise formation and growth help lessen poverty and address quality of life for the poor. Despite these positive attributions, enterprise growth or even overall economic growth will not necessarily lessen disparities in income distribution in a country, regardless of income level.

Donor approaches to enterprise growth are shaped by concerns over how to best trigger overall economic growth and whether special measures are needed for assisting the poor. This difference in orientation results in subtly different programmatic approaches by donor, as well as healthy debate about the most effective means for transforming poor economies. Because each donor also demonstrates different aptitudes for supporting economic development by virtue of its mandates, loan or grant instruments, and costs of implementation, it is unlikely that there will be complete convergence of opinion. Owing to its use of contracts and grants, USAID can be creative in working through the various levels of the private sector (supply) response.

REPORT CONTENTS

This report provides theoretical and practical insights on enterprise growth initiatives and possible future directions to accommodate the needs and interests of both seasoned practitioners and those new to the field. Chapter One serves as an introduction. Chapter Two describes the factors affecting sustainable enterprise growth, including the importance of the political economy for enterprise health and growth. Such dynamics have been critical in shaping donor initiatives to date. On the basis of a literature review, Chapter Three investigates further the concept of enterprise growth. Examining the relationship between economic and enterprise growth, the chapter argues that economic growth reduces poverty and suggests that changes in per capita GDP are an effective gauge for measuring the impact of enterprise growth initiatives. As donors hold different positions on the importance of general and "pro-poor" growth patterns, Chapter Four shows how donor attitudes have influenced approaches to enterprise initiatives. Generally speaking, donor responses have opted for policy reform or private-sector development, or a combination of the two, as the means for sponsoring enterprise growth. Distilling the results of 42 evaluations of enterprise growth initiatives, Chapters Five and Six offer a series of perspectives, guiding principles, and best practices for future initiatives.

HOW WE WORKED

This report was drafted over 10 weeks and subsequently revised by a team from Development Alternatives, Inc. (DAI): Donald Snodgrass (Team Leader); James Packard Winkler (Deputy Team Leader); Charles Johnson (Organizational Development Specialist); Marina Krivoshlykova (Research Assistant); and Andrew Iappini (Project Associate). Charles Johnson was primarily responsible for determining the internal organizational implications for USAID of the team's findings; his findings have been reported separately to USAID.

We began by addressing significant conceptual, definitional, and practical issues. What exactly is a private enterprise? How should private enterprise growth be measured? What is meant by sustainability? How should we prioritize and assess the myriad factors that influence the sustainable growth of private enterprise? Which of those influential factors should be regarded as "key"?

We then turned to issues of impact. How should economic growth be defined for purposes of this study? How can the relationship between enterprise growth and economic growth be traced, conceptualized, defined, and implemented? Given the many factors that influence enterprise growth, how broadly should donor-funded initiatives to promote private enterprise growth be defined?

The strict time and budget constraints of our study did not permit us to conduct primary research or carry out our own program evaluations. Instead, we relied on a survey of previous research findings, expert opinion, and donor experience as encapsulated in the memories of practitioners and in formal program evaluations. Specifically, we:

- Consulted a large and far-reaching collection of books, articles, and reports on private enterprise development (see bibliography, Annex A);

- Discussed enterprise growth with experts, including academics, aid agency officials, officials of nongovernmental organizations (NGOs) active in enterprise promotion, and consultants—business consultants as well as consultants who work primarily for USAID and other donors (see list of interviews, Annex B);

- Assembled and analyzed economic data on enterprise development and economic growth, including information compiled by organizations that attempt to measure aspects of the business climate;

- Reviewed 42 evaluations of enterprise interventions carried out by USAID, the World Bank, the Inter-American Development Bank (IDB), and the U.K. Department for International Development (DFID) (see list of project reviews, Annex C); and

- Participated in a roundtable discussion of the draft report and enterprise development programs, held in Washington, D.C., on October 2, 2003. The roundtable brought together a group of experts, including representatives of USAID and three other donor agencies (see Annex D), and yielded insights now incorporated into the final report.

ACKNOWLEDGMENTS

On behalf of the DAI team, we wish to express our sincere thanks to Emmy Simmons and Steve Hadley and their staff in the Bureau of Economic Growth, Agriculture, and Trade, especially to Brad Wallach and Kristin Randall, who ably guided our work. We also thank those who agreed to be interviewed for this study and those who participated in the roundtable. While we have worked hard to incorporate their insights into this paper, we note the complexity of the task. The effort to understand the dynamics of enterprise growth, their implications for economic development, and the ways in which donors can most effectively encourage private enterprises in developing countries to fulfill their potential as engines of development is ongoing. Following acceptance of this report in its final form, more specific efforts to assist USAID missions in programming enterprise development activities are planned.

CHAPTER TWO
GROWTH OF SUSTAINABLE PRIVATE ENTERPRISES

Private enterprises—the productive units and wealth creators in market economies—are profit-seeking firms that trade or produce goods and services for sale to consumers and other producers. In search of profits, they respond to demand opportunities in local or foreign markets through trade or by combining capital, labor, technology, and other critical inputs. Well-functioning markets result in strong enterprise growth, efficient resource allocation, and the maximization of profits and social well-being. Market failures and underperforming economies create conditions that require governments and donors to intervene to make markets more efficient and encourage enterprise growth.

ENTERPRISES

Private enterprises are found in all sectors and may be of any size. At the micro end of the spectrum, they have fewer than 10 employees and—according to the World Bank's definition—assets and sales of $10,000 or less. Microenterprises, and the somewhat larger small enterprises with 10 to 50 employees, have traditionally been the focus of enterprise development programs, either directly through business support initiatives or indirectly as recipients of loans from microfinance programs. In the middle of the size spectrum, enterprises have between 50 and 300 employees and total assets and sales of $3 million to $15 million. As significant risk takers—and often the partners of technology programs—mid-sized enterprises (which are not numerous in most developing and transition economies) tend to be high-value producers with strong growth potential. Their financing needs often fall into the gap between microfinance programs and banking institutions. Their managers are particularly adept at understanding issues of competitiveness and risk. At the high end of the spectrum are large enterprises whose work forces exceed 300 employees and whose assets and sales exceed $15 million. While these entities tend to be outside the sphere of traditional donor assistance programs, they can play important roles in cluster and competitiveness programs that work with dynamic combinations of enterprises and non-profit organizations, typically along value chains.

The private sector is the aggregate of all enterprises. The "churn effect" of a dynamic private sector means that as the private sector grows, many individual enterprises also grow and new ones are formed, but some enterprises shrink while others go out of business. Donor programs have concentrated on both individual enterprises and their aggregate. The programs have often measured enterprise or aggregate growth in various ways—for example, by number of enterprises, employment, gross production or sales, or net value added (gross production minus purchased inputs).

Factors Affecting Enterprise Growth

Enterprises in the private sector are collectively conditioned by three sets of factors.

- **Demand:** The size of the overall domestic market—which comprises private and public consumption and investment—is a key factor for enterprise growth. Small domestic markets mean that expanding private sectors need to turn to regional and global markets for continued growth. In assessing market size, consideration should be given to the projected future growth rate of domestic demand; the shape of national income distribution (which influences consumer demand); and the industrial structure of the national economy (which influences demand for producer goods and services). In addition, the quality of the transportation and communication infrastructure can influence the breadth of domestic markets. Increasing sales in export markets can be an important means of escape from the limitations created by small and stagnant internal markets, but developing country exporters may face difficulties resulting from tariffs, quantitative restrictions, and other barriers to trade.

- **Business environment:** The country setting or overall environment in which enterprises operate may be favorable or unfavorable to enterprise creation and growth. A favorable or enabling environment for enterprises provides economic and political stability, offers low costs for business transactions, and allows for efficient business operations that lead to greater amounts of innovation and creativity. A conjoining of several forces, the business environment is composed of macro policies—such as monetary, fiscal, trade, and exchange rate policy—and more micro-level regulations such as land and business registration, labor codes, tax administration, and banking regulations. A key characteristic of the business environment is that it lies outside the direct control of enterprises; government can shape the environment through reform and a dynamic process of policy dialogue. Countries that pursue liberal political and economic models tend to fare better with their business environment. But it is possible for countries to display a positive macroeconomic profile and be weak at the microeconomic or regulatory level, as is now the case in many Latin American countries.

- **Private sector supply response:** Supply response refers to the ability of private enterprises to meet demand for goods and services, and it is strengthened when enterprises can access appropriate financial and business services. Supply response is increasingly regarded as a function not only of enterprise-level efficiency and a solid understanding of customer needs and requirements; it is also tied to the strength of the networks to which enterprises are connected. These networks can include clusters of enterprises producing identical or similar products, as well as value chain relationships with external suppliers, processing agents, marketing firms, think tanks, government entities, and others. In the present era of globalization, these networks are not limited to domestic business relationships but increasingly stretch around the world. Michael Porter has made significant contributions in underscoring the importance of industry clusters and cluster rivalry and cooperation for advancing competitive advantage. Business networks expedite the flow of information, reduce transaction costs, and serve as the basis for policy dialogue on key reform issues.

In Figure 1, the dynamic growth patterns are conditioned by market efficiencies and by the market failures that justify interventions.

Figure 1: Growth and Development of Sustainable Private Enterprises

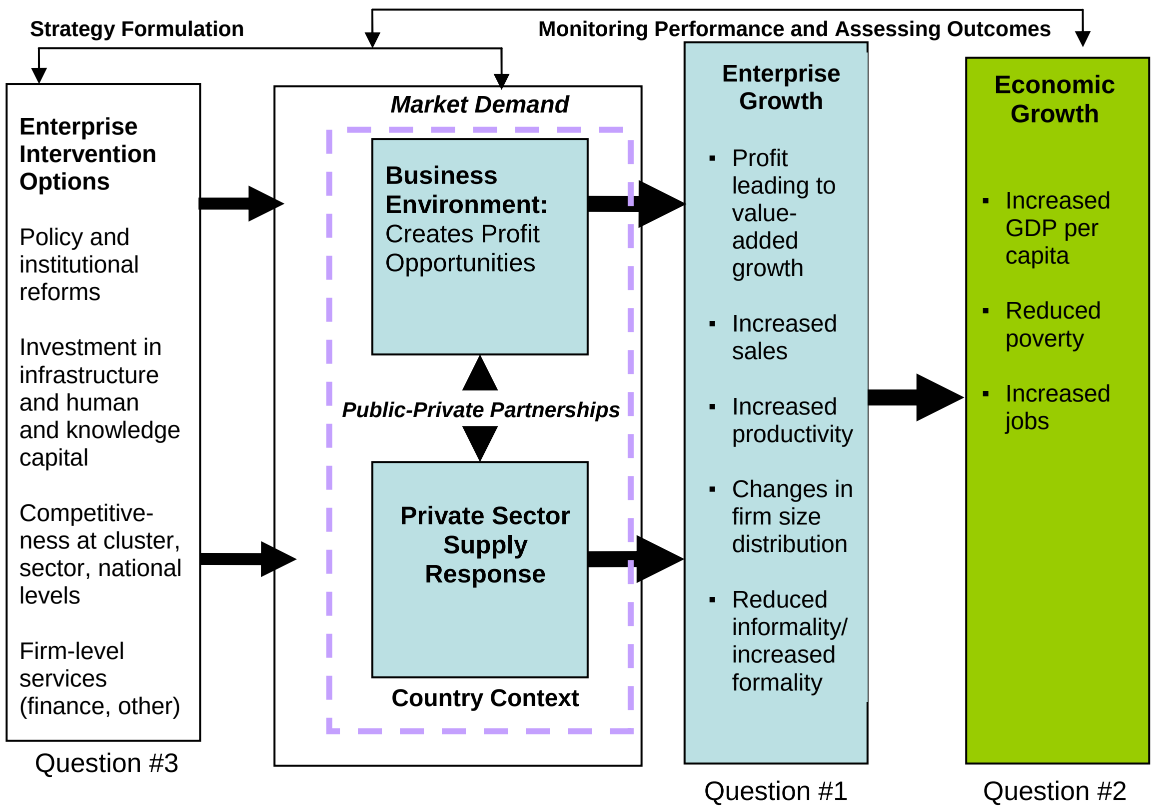


Figure 1 also puts into market perspective the Enterprise Study Methodology Framework:

Question 1: What are key factors that contribute to the sustainable growth of private enterprises?

Question 2: When and under what conditions does enterprise growth translate into economic growth?

Questions 3: What has been the collective experience of donor-funded initiatives intended to catalyze/facilitate private enterprise creation and growth in developing and transitional economies? (What has worked? What hasn't? In what circumstances?)

A KEY CONSTRAINT TO ENTERPRISE GROWTH: MARKET FAILURE

Markets are generally understood to be the best mechanism for allocating society's scarce resources for the greatest possible social benefit. Markets efficiently allocate thousands of different products among consumers and thousands of productive inputs among producers. They are flexible and adapt quickly to changing conditions, providing incentives for growth, innovation, and structural change. Reliance on markets encourages private economic activity and the dispersion of economic power (Perkins et al. 2001). Despite these powerful virtues of the market system, economists have noted several circumstances in which markets fail:

- When too little output is produced and sold at too high a price because of a monopoly, an oligopoly, or a small, protected market;
- When there is too little investment, by the public or private sector, in infrastructure and public goods that provide broad social benefits but smaller returns to the investor;
- Lack of appropriate regulation or taxation of activities that generate external diseconomies (for example, pollution);
- Lack of appropriate management of common resources, including natural resources;
- Markets unable to accommodate the changes in economic structure needed for economic development (a classic example is of an industry in its infancy which, in theory, can develop and become sustainable if it is given temporary tariff protection or an initial subsidy); and
- Inadequate information available to people involved in the market, whether laborer, producer, consumer, or other.

In all these cases, unrestricted markets fail to produce a socially desirable outcome. Intervention is required.

Markets do not work in a vacuum. They are influenced by the legal, social, and cultural setting in each country, as well as by government attitudes toward the market economy.

Governments are responsible for providing a business environment in which private firms not only are generally free to produce what they choose but also are encouraged to produce goods with large external benefits and discouraged from producing goods with high external costs. Governments can improve the workings of markets in several ways: by simplifying their rules and procedures; by investing in public goods such as infrastructure and services so that transaction costs are reduced; by providing incentives for the private sector to invest in human capital or organize itself through business associations to provide valuable marketing or upgrading services; and by providing important information (on product safety or standards, for example) that would not otherwise be available. When reform is needed but not undertaken (because the government is controlled by special interests, for instance, or is in chaos), firms tend to operate informally. If reform is not forthcoming, the situation can be termed a government failure and tied to market failure.

Donor interventions are appropriate when markets fail. When government responses are inadequate, donors may advocate needed reforms, target informal economic activity, or try to help firms succeed by temporarily providing services that a well-functioning government would provide if one existed. Donors can opt to strengthen the private sector supply response directly when production and marketing information is not instantly or freely available to all. In the era of globalization, with fragmentation of local markets, donors can help the private sector learn how to work more effectively at different market levels. In many post-socialist and low-income settings, donors can assist with entry into new markets, such as nontraditional exports. In countries where recent events have interrupted the flow of foreign direct investment, donors can concentrate on firms with high growth potential.

Under the right conditions—such as an open or transitioning political system—the private sector can play an important role in spurring important changes in the business environment, as well as in the way business is conducted. Public-private partnerships serve as the interface between business and government regarding needed changes in the overall business environment. Through formal and informal arrangements, these partnerships allow government and the private sector to work in tandem to restructure the business environment. In the process, the partnerships respond to constraints to enterprise and economic growth.

THE ROLE OF POLITICAL ECONOMY IN ENTERPRISE GROWTH

It is difficult to overstate the impact of political and economic systems on enterprise growth. Enterprise growth initiatives often operate in the most difficult country settings. Examples include:

- Helping small farmers in Zimbabwe grow subsistence and cash crops for local and regional markets in the midst of political upheaval;

- Dealing with a populist Minister of Economy and Industry who wants to save traditional labor-intensive industries, such as footwear or textiles, that are dying and cannot compete in global markets;

- Improving the competitive performance of small businesses in the Palestinian Territories during the Intifada to sell information technology services and consumer and industrial products to Israel, the Gulf, Europe, and the United States;

- Addressing conflicts raised by an industry association dominated by the personal and business interests of its board members while the membership is disenfranchised and disconnected from market realities;

- Supporting private sector institutions and businesses in Ukraine burdened by regulations that encourage corruption and create high transaction costs and tax disincentives that make it almost impossible to compete against foreign products in their own market, let alone global markets; and

- Promoting competition in a country where the minister's brother and other political allies control the telecommunications monopoly, licenses are issued to clan or party loyalists, or a minority tribe controls government and restricts resources to a rival tribe.

At first glance, the challenges appear overwhelming. But change is made possible by the notion that properly crafted incentives—with a strong commercial or market-based orientation—can alter behavior, inform policy makers, galvanize collective action, support enterprise growth, and generate increased competition among enterprises. Getting the business environment right and catalyzing private sector action are critical, mutually reinforcing elements of the change process for enterprise growth.

Incentives driven by purely political or vested interests tend to suppress dynamic growth. The degree of political openness to economic reform largely determines the ability of the private sector to influence decision makers about the business environment. On occasion, changing vested interests is sometimes easier during instability, as in places such as Kosovo and the Palestinian Territories, in contrast to countries such as Ukraine and Egypt, where established political and economic institutions have created perverse incentives and reinforced unproductive behavior.

Enterprise growth initiatives operate in a variety of country settings, which influence the possibilities for enterprise growth and the rationale behind program interventions:

- **Conflict situations:** Business is disrupted by fighting and related instability, at least in parts of the country (certain areas may be relatively unaffected, as in southern Sri Lanka over the past decade). Government may have ceased to function effectively. Investment slows drastically, and capital stock is run down. Large formal firms either close down or operate at low levels, but some informal activities thrive, especially those that seek to make money out of war and instability. Unemployment, inflation, and human suffering rise; per capita income falls. Under these conditions, enterprise initiatives can leverage private sector activities in pockets of relative peace or stability for increased food and basic production.

- **Post-conflict recovery and reconstruction:** Monetary and fiscal stabilization are followed by efforts to restore damaged and neglected infrastructure. Donors and returning expatriates play important roles. Government remains weak. Reforms that normally would be blocked by ruling elites may be possible in this transitional period. Efforts to restart development may motivate favorable terms for foreign investors if there are natural resources to be developed. Per capita income gradually recovers its pre-conflict level. Under these conditions, enterprise initiatives can bolster fragile peace and accelerate recovery by expanding livelihood options and deepening private sector activities while laying the foundation for reform.

- **Transitional economies:** In socialist economies, large enterprises were state-owned (and were typically larger than comparable firms in developed market economies), while smaller firms were private and usually informal. The emerging post-socialist structure of enterprise in these countries depends heavily on how privatization takes place. Privatization can either promote the emergence of small and medium-sized enterprises (SMEs) or create a structure dominated by a few wealthy new capitalists. The latter structure is often supported by repressive, closed systems of government. We have seen that while some transitional economies are growing and have surpassed the highest per capita income level achieved under socialism, others either are mired at a lower income level or are growing slowly and remain poorer than they were. A tremendous amount of learning is involved in countries where private business was long suppressed. Enterprise interventions can cover the full array of interventions, from direct firm-level assistance to cluster or sector support and strategic policy reform.

- **Developing market economies:** "Developing" often is a misnomer for many low- and middle-income economies that have not, in fact, grown in recent years. The stagnant and slow-growing countries in this group have large micro and small business sectors and pervasive informality. They may still have significant public ownership of firms, and they typically attract little foreign investment. Much of their industry is focused on import substitution, and their exports still consist mainly of lightly processed commodities for which they receive low prices. Few of their firms have forged linkages to global markets. Rent seeking by groups allied to undemocratic regimes impedes the growth of competitive private enterprise. Among market economies that are truly developing, by contrast, things are beginning to happen: the business environment is improving, investment is rising, and enterprises are growing and linking themselves with other firms for increased sales to national, regional, and world markets. This is the group with perhaps the greatest potential for private enterprise development, and again, enterprise initiatives can cover the full array of interventions, from direct firm-level assistance to cluster or sector support and strategic policy reform.

- **Emerging market economies:** This group includes a small number of rapidly growing middle-income economies. (Certain other economies at this income level, such as Argentina, have long stagnated and should not be regarded as emerging market economies, although they are sometimes referred to in this way.) True emerging market economies such as Malaysia have fast-growing domestic demand and improving business environments, high levels of foreign direct investment, burgeoning industrial (and sometimes also service) exports, and rapid growth in the number and average scale of private firms. Per capita income is rising rapidly in these countries, poverty is declining, and employment is shifting to higher-paid occupations. In short, these countries show all the characteristics enterprise development initiatives strive to produce. Enterprise initiatives need to be highly strategic, addressing market failures without interfering in functioning areas.

Clearly, political systems and conditions influence enterprise growth and possibilities for growth-enhancing interventions. While some developing and transition countries are politically stable, others are either suffering from internal conflict or recovering from recent conflict. Civil wars and other conflicts severely disrupt economies, usually causing income per capita to fall. The post-conflict situation requires that a sequence of actions be undertaken: macroeconomic stabilization; reconstruction of damaged physical, human, and institutional infrastructure; and efforts to bring about recovery and resumed economic growth (Snodgrass, forthcoming). Occasionally, an unexpected benefit arises when conflict facilitates constructive policy reform by weakening or displacing formerly powerful vested interests.

Equally important is whether the political system is open or closed. An open system permits business and other interests to participate in the policy-making process, as may be necessary to enact reforms that will improve the business environment. In a closed system, reform is likely to be more difficult and is only feasible with consent from the top, since non-elites are shut out of the policy-making process. The key caveat is that countries like China and Vietnam sometimes display strong economic growth despite their closed political systems and deeply flawed business environments.

The next chapter investigates further the concept of enterprise growth by tracing theory and practice in enterprise development. Subsequent chapters examine donor attitudes and preferred programming modalities for enterprise growth.

CHAPTER THREE
ENTERPRISE GROWTH AND ECONOMIC GROWTH

There is strong evidence that enterprise growth translates into economic growth. In fact, the relative importance of the private sector has increased globally since 1980, in the wake of extensive privatization in many parts of the world, the transition from socialist to market economies in much of Europe and Central Asia, and the passing of boom times in petroleum-producing countries. By virtue of the dominant statistical position of the private sector in practically all economies at 80 to 90 percent of GDP, enterprise growth is needed for sustained increases in GDP to take place. When the fraction of the population that works remains constant, moreover, increases in GDP per capita require identical increases in output per worker (labor productivity).

Not everyone accepts that concentration on economic growth will provide adequate reduction in poverty. Donors debate whether and how measures to promote economic growth need to be supplemented by special initiatives that concentrate specifically on alleviating poverty, creating jobs, or otherwise improving the quality of life of the poor. Making economic growth "pro-poor"—for example, by emphasizing rural development and large-scale job creation—is important for poverty reduction, especially in larger countries with substantial low-income populations. That said, however, studies indicate that the average income of the poor rises as rapidly as that of the non-poor when GDP per capita increases. Economic growth will alleviate absolute poverty in most cases, although some growth patterns are more pro-poor than others. Growth tied to the creation of more productive employment helps compensate for the weakness of social safety nets.

A REVIEW OF THE LITERATURE

The most important ideas about enterprise development and its relationship to economic growth are attributable to pioneering economists such as Adam Smith and Joseph Schumpeter. Smith (1776) traced productivity growth to the division of labor (increasing specialization), which he said was limited by the extent of the market. Economic development, he suggested, involves the gradual widening of markets from local to regional, national, and global dimensions. As this process unfolds, productivity rises, and goods and services are produced more efficiently. All of this, Smith famously asserted, is motivated by the quest for profit.

Schumpeter (1934) added an explanation for business cycles to Smith's theory of economic growth. The ups and downs experienced in free enterprise economies, he said, are caused by the periodic introduction of new products and new technologies by some firms and the consequent loss of competitive advantage by others. For Schumpeter, economic fluctuations are part of an uneven, discontinuous process of economic growth. Schumpeter memorably characterized the process of capitalist development as "creative destruction." In his vision, economies advance in fits and starts as new enterprises are formed, and some enterprises grow while others shrink or even are forced to close.

Empirical evidence suggests that economic growth is accompanied by systematic and fairly predictable patterns of structural change. The long-term decline of agriculture—in terms of share of value added and employment—that accompanies long-term growth in GDP per capita was thoroughly established by Colin Clark (1957), Simon Kuznets (1966; 1971), Hollis Chenery and Moshe Syrquin (1986), and others. Correspondingly, the share of industry in GDP and total employment has been shown to increase. Clark claimed that a further phase of economic development would see a rise in the relative importance of the service sector. Kuznets rebutted this claim on the basis of experience through the 1960s, but the recent expansion of the service sector in many developing and developed countries makes it appear that Clark's prediction is coming true after all.

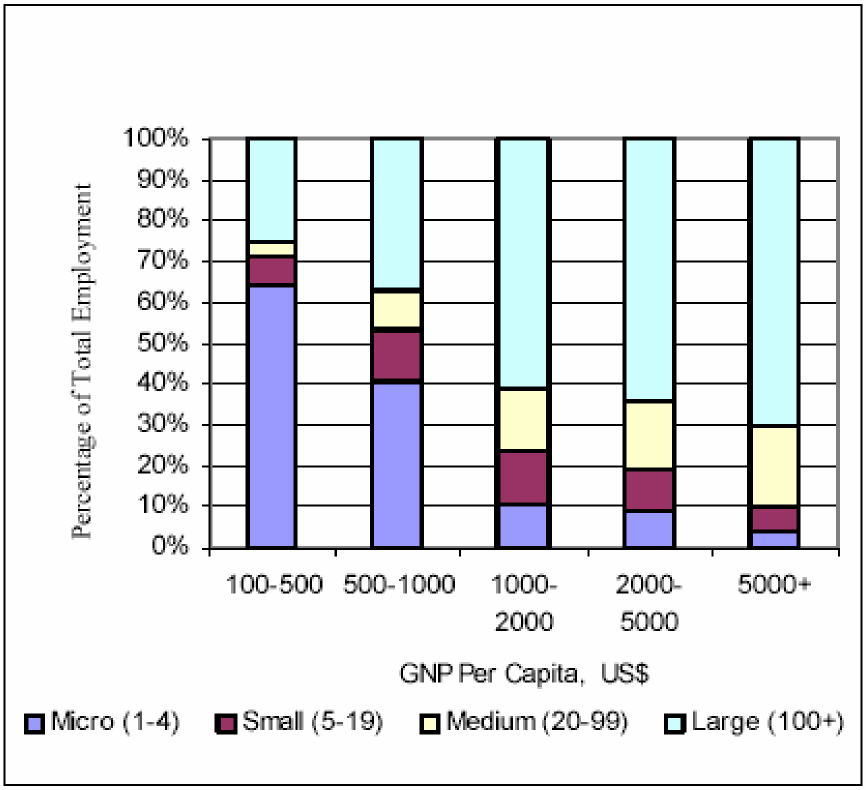
Equally firm is the proposition that economic growth involves a shift of economic activity from rural to urban areas. Agriculture, of course, is strongly associated with rural areas, while industrial and service activities take place in both urban and rural areas, but primarily in cities and towns.

Another important generalization is that economic growth involves the gradual broadening of markets at the local, regional, national, and global levels. This process of market integration forces firms to compete in wider markets as time goes by. This competition increases efficiency. Besides increasing the division of labor, as Adam Smith noted so long ago, the widening of markets also increases opportunities to realize economies of scale, invest capital, and adopt more productive technologies. In the process, some firms gain while others are hurt—for example, those that previously enjoyed "natural protection" in local markets as a result of high transportation costs.

Less certain but highly likely are two more important types of structural shift: systematic changes in the size distribution of enterprises and in the degree of legal formality with which enterprises are constituted. Donald Snodgrass and Tyler Biggs (1996) followed up on earlier studies such as that by Dennis Anderson (1982) and used data from national censuses and surveys of manufacturing to define the size distribution of enterprises in the manufacturing sector at different levels of GDP per capita (see Figure 2). Simply put, average firm size increases as GDP per capita rises. A large part of this rise is accounted for by sharp declines in the importance of microenterprises, although SMEs also become less important. At low levels of economic development, micro and small enterprises are the dominant mode of production, often accounting for at least 90 percent of manufacturing enterprises and 75 percent or more of manufacturing employment.

In countries that experience economic growth, microenterprises and, to a lesser degree, SMEs face growing competition from larger firms as falling transportation costs, rising income, and deregulation cut into the "natural protection" of local markets. Later, as unskilled labor starts to become scarce, microenterprises and SMEs lose another source of competitive advantage: their ability to pay wages lower than those of their larger competitors. Their profits also may be squeezed by falling prices for their products as larger competitors adopt capital-intensive technologies imported from abroad. In most developed countries, the share of microenterprises

Figure 2: Distribution of Manufacturing Employment by Enterprise Size



Source: Snodgrass and Biggs (1996).

and SMEs in total manufacturing employment has fallen to roughly 25 percent. A few developed countries—notably Japan and, to a lesser extent, Italy—have maintained a significantly larger share (40 to 50 percent) of manufacturing employment in microenterprises and SMEs.

These changes in the distribution of employment among manufacturing enterprises of different sizes are accompanied by changes in productivity differentials among enterprise size groups. In low-income countries, wages and output per worker in SMEs (10-49 employees) are only 40 percent of the level achieved in very large firms (500+ employees). In high-income countries, however, although very large firms continue to have higher labor productivity and to pay higher wages, the differential has narrowed significantly, with wages and labor productivity in SMEs averaging 65 to 70 percent of the level achieved in very large firms.

Changes in the relative importance of large and small enterprises and in their pay and productivity levels are attributable to the economies of scale and scope that some firms are able to acquire. Historically, these advantages have permitted large manufacturing firms to out-compete smaller firms, either driving them out of business or forcing them to make radical adjustments that ultimately lead them to approach large-firm productivity levels without the benefit of economies of scale and scope. To do so, they adopt "niche" strategies that permit them to benefit from their greater flexibility, unique human talents, and shorter turnaround times. Their capital intensity and technology levels become similar to those of large firms. As a result of this competitive process, SMEs in developed countries bear little resemblance to SMEs (let alone to microenterprises) in low- or middle-income countries.

We have been discussing the changes in enterprise size structure that accompany economic growth in the manufacturing sector. To our knowledge, the presence of similar patterns in the agricultural and service sectors has not been established systematically, but the likelihood that they are present in those sectors as well is suggested by the emergence of large commercial farms in many developed countries, the replacement of "mom and pop" grocery stores by supermarkets, and the current trend for conventional supermarkets and shopping malls to give way to "big box" stores such as Wal-Mart, where such changes are permitted by existing laws and regulations.

The Informal Sector

The term "informal sector" was coined in the early 1970s by an International Labour Office mission to Kenya (ILO 1972). Informal enterprises are unregistered or otherwise not officially recognized and may evade certain taxes, minimum wage regulations, and other official requirements. Hernando de Soto (1989) has said that informal enterprises "carry out legal activities in illegal ways." There is a large overlap between enterprise scale and informality. The great majority of microenterprises and SMEs can be characterized as informal (for example, bus companies in Lima, Peru, cited by de Soto). Most large enterprises are in the formal sector, but some countries also have large informal enterprises. We believe that economic development involves a gradual shift from informal to formal production, as long as laws and regulations undergo reform to make compliance easier and enforcement more consistent.

Informal economic activity dominates low-income economies and remains important in middle-income countries that create high barriers to formalization. Socialist economies that banned or discouraged most private economic activity had extensive informal economies, which tended to persist into the period of post-socialist transition. Even developed market economies have considerable informal economic activity, especially in periods of economic adversity. During the current recession in the United States, for example, self-employment has increased, sometimes formally (registered sole proprietorships) and sometimes informally (part-time activities to generate extra cash).

There are two sharply competing views of the role of the informal sector in developing countries. One perspective sees participants in the informal sector as having been forced to work there by a shortage of "decent" jobs in the formal sector. The other stresses the entrepreneurial character of the informal sector and argues that many of its participants choose to work there. Gary Fields (1990) tried to reconcile these competing views by suggesting that the typical informal sector has two "tiers": a relatively well-off entrepreneurial group and a poorer mass of the involuntarily informal. According to a recent review,

> A variety of evidence . . . supports the view that informal entrepreneurship can be a viable, even a desirable, alternative to formal sector work. The majority of the sector should probably be

> viewed as a collection of small businesses with all the usual accompanying characteristics: high failure rates and a high variance of incomes, but also an opportunity for independence and an outlet for entrepreneurial energies. (Maloney 2003)

Micro and Small Enterprises

In the United States and other developed countries, SMEs play important roles as sources of employment growth and innovation (Caves 1998; United States 2001; Audretsch 2002). Firm growth rates typically diminish as firm size grows. There is considerable new entry in most industries and substantial mobility of incumbent firms among size groups. From 1990 to 1995, smaller firms experienced faster employment growth than larger firms and generated more patents on a per-employee basis. This level of innovation may be in part attributable to the shift in public policy from anti-trust, regulation, and public ownership to one favoring enterprise start-ups, job creation, spillovers, and technological change (Audretsch 2002).

Developing sustainable private enterprises in a growing economy generally involves moving from agriculture to industry and services, from rural to urban, from small to larger firms, and from widespread informal sector activity to broad compliance with a reformed set of business laws and regulations. But what happens if the economy is poor and does not grow?

In low-income and low-growth economies, micro and small enterprises (MSEs) serve as important sources of livelihood for large numbers of people. These enterprises, which are often closely integrated with the household economies of the poor and employ several household members, help low-income families absorb shocks and preserve the quality of their lives. One example of this is the city of Ahmedabad, India, once known as the “Manchester of India” because of its concentration of textile mills. During the 1980s and 1990s, restrictions imposed by the Indian government caused most of these mills to close, eliminating tens of thousands of mill jobs. (This occurred despite government regulations forbidding the closing of factories and firing of workers.) Displaced mill workers and their wives turned in large numbers to the informal sector for their subsistence, entering occupations such as vegetable selling, garment making, and cigarette rolling. In such circumstances, appropriate government policy, at a minimum, avoids discrimination against the informal sector (such as banning vegetable selling in the city center to reduce congestion) and at best finds ways to assist people who are struggling for a livelihood through informal sector activities, for example by developing appropriate microfinance systems.

Carl Liedholm and Donald Mead (1999) analyzed the dynamics of MSEs in six small African countries and the Dominican Republic. This sample includes four low-income countries (Kenya, Lesotho, Malawi, and Zimbabwe), two lower middle-income countries (Swaziland and the Dominican Republic), and one upper middle-income country (Botswana). Four of the seven countries in the sample (Kenya, Malawi, Swaziland, and Zimbabwe) experienced little or no growth in GDP per capita in the 1990s, while two (Botswana and Lesotho) experienced moderate growth and one (the Dominican Republic) grew rapidly. Their sample is thus reasonably representative of developing countries in the 1990s and is not marked either by high incomes or by rapid economic growth.

Liedholm and Mead emphasize that MSEs are the dominant mode of production and provider of employment in developing countries. Their importance is much greater than indicated by official statistics, which omit many MSEs, especially tiny "one-person enterprises." As expected, one-person firms are least evident in the Dominican Republic, the richest and fastest-growing country in the sample. Most MSEs were found in rural areas—the Dominican Republic had the largest share of urban firms (46 percent). Although trade was the most important form of economic activity, MSEs also were significant participants in some branches of manufacturing (apparel, food and beverages, and wood products). Most firms were owned and operated by women. Productivity (defined as return to the proprietor per hour worked) was much higher in enterprises with two to five employees than in one-person enterprises, but larger microenterprises and SMEs were not clearly more productive than microenterprises with two to five employees.

Liedholm and Mead focus on small-firm dynamics in these low-growth settings. They summarize their findings as follows:

> There is much churning in the universe of MSEs. Many new enterprises are started each year, but many others also cease operation. While new start rates vary by sector and location as well as over time, there is an underlying positive net stream of new businesses feeding the universe of MSEs. . . . Among those enterprises that survive, most do not grow in terms of employment. Of all new enterprises starting out at the very small end of the MSE size range, only about a quarter subsequently added to their work force. . . . Among the remaining quarter that do expand their work force after start-up, most grow only in small amounts, adding only a few additional workers. The process of graduation whereby enterprises start out very small and subsequently move into the upper end of the small enterprise size range is a transition managed by only about 1 percent of those that start out very small. . . . Over the long haul, most MSE jobs come into existence through new starts; about three quarters of all existing job openings in MSEs originally came into being in this way, with the remainder resulting from expansion of existing enterprises. (p. 103)

Besides giving large numbers of people opportunities to earn a living, preserve the quality of their lives, and guard themselves against economic shocks, micro, small, and medium-sized enterprises in low-income countries may also make important contributions to production, employment, flexibility, and dynamism and thus play an active part in the process of economic growth. One important hypothesis, which has received increasing attention lately, is that helping small firms in developing and transition countries to link up, either singly or in groups, with product markets where they can achieve higher value added, can help them emulate some of the achievements of their rich-country counterparts.

Firm Relationships and Competitive Advantage

Research by Michael Porter, Gary Gereffi, Hubert Schmitz, Raphael Kaplinsky, and others has highlighted the importance of relationships among enterprises as major determinants of enterprise growth and development. Products sold in global markets or in domestic markets distant from the place of production pass through "value chains" in which unit values rise steadily as goods are transformed and eventually delivered to their final users. To sell in distant markets, firms must link into these value chains. To raise their productivity and profits, they must often "move up" the value chain by making outputs that are increasingly finished and sophisticated. For example, small-scale producers of horticultural products (fruits and flowers) in Kenya must upgrade their products and link up with large-scale marketing organizations to gain access to the European market, which offers better prices for their products but imposes demanding quality and delivery standards.

Porter's research into business history in the United States and other developed countries, as well as studies of late-industrializing countries such as Taiwan and South Korea, shows that to accomplish this end, firms often grouped themselves into clusters in which they could complement one another in various ways. Although firms did compete with one another, achieving national competitiveness also involved important elements of inter-firm cooperation, especially at stages where strong economies of scale were present. Clustering was especially important for SMEs, which could not realize economies of scale on their own and often lacked the information and technical competence needed to compete at higher levels of the value chain.

Porter's research has focused attention on the fact that enterprise growth depends not only on what goes on within the firm, or on what the government does to shape the business environment and influence the level of demand, but also on relationships among private firms. Recognizing this fact, USAID has promoted cluster-based competitiveness initiatives in developing countries since 1998 (The Mitchell Group 2003). These and similar efforts by other donors, and by developing country governments and business groups, seek to replicate some of the business successes achieved by wealthier countries in earlier times.

According to the principle of comparative advantage, first enunciated by David Ricardo in 1817, all countries can gain by producing those items that they can produce most efficiently, based on their resource endowments (supplies of land, natural resources, capital, and labor), and trading with other nations to obtain items that they wish to consume but can produce less efficiently. This principle applies regardless of how well or how poorly endowed with resources a country is, but it does imply that countries with richer resource endowments will enjoy higher levels of income and consumption than countries with poorer resource endowments.

While the principle of comparative advantage has great practical significance, in many cases countries' economic growth have failed to correspond with their resource endowments. For example, several oil-rich countries—Nigeria is a prominent example—have squandered the proceeds from their petroleum exports and failed to use those earnings as a basis for sustainable economic growth. In fact, a comparative study of many countries (Sachs and Warner 1995) found that, other things being equal, natural resource wealth was a curse for development more often than it was a blessing. There are also examples of countries that have developed successfully with severely limited resource endowments. When Singapore was expelled from the Malaysian Federation in 1965, the consensus among economists at the time was that Singapore was not economically viable because of its small size and lack of natural resources. Yet Singapore found inventive ways to grow—fundamentally, by breaking out of its dependence on the Southeast Asian regional economy and linking up in various ways with the global economy—and within 25 years had joined the ranks of the developed countries.

Michael Porter and other business scholars emphasize the importance of competitive advantage and downplay the significance of comparative advantage. They suggest that success in economic development depends on what nations do to enhance their competitiveness in international markets and is not preordained by the resources that they do or do not possess. There is much to be said for this view, as the case of Singapore shows, yet the principle of comparative advantage remains valid and significant and should not be dismissed.

COUNTRY SETTINGS AND ENTERPRISE GROWTH

Where has enterprise growth occurred and where has it not occurred? We live in a world in which a few countries are experiencing rapid economic growth, many others are growing slowly if at all, and international disparities in living standards are widening. Because the private sector dominates almost all economies, these differences in economic growth rates among countries reflect differences in the performance of private enterprises.

The World Bank's World Development Indicators database lists 97 developing economies with populations of 1 million or more in 2002 and 29 transition countries. Fifty developing countries are classified as low-income economies, 29 as lower middle-income economies, and 18 as upper middle-income economies.

In the period between 1990 and 2002, more than half of the low-income countries (29 out of 50, including 24 in sub-Saharan Africa) were unable to raise their level of GDP per capita. Thirteen experienced slow growth in the 1 to 3 percent per annum range. Only 8 low-income countries achieved better than 3 percent average annual growth in GDP per capita. Four were in Asia (Bangladesh, India, Laos, and Vietnam), but it is interesting to note that 4 sub-Saharan countries (Eritrea, Mozambique, Sudan, and Uganda) registered similar achievements despite the generally poor performance of countries in that region.

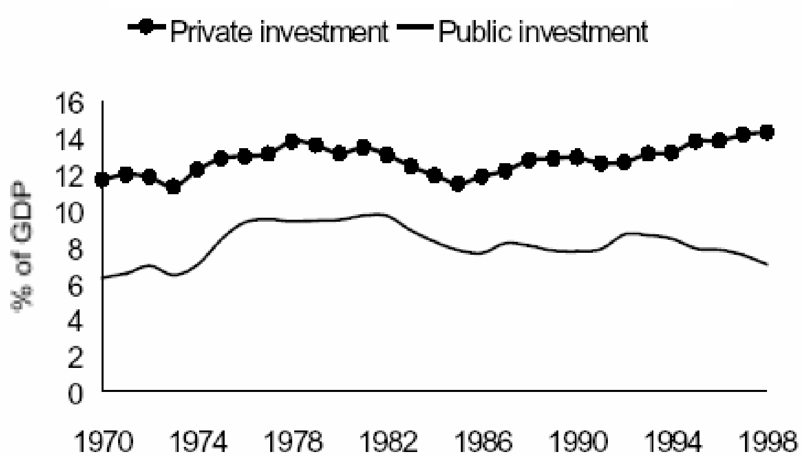
Middle-income countries generally grew faster than low-income countries, in many cases sustaining the growth that had raised them out of the low-income category in earlier periods. Some oil-based, middle-income economies stagnated (Algeria, Gabon, Iraq, Oman, Saudi Arabia, and Venezuela), as did countries with severe political problems such as Colombia, Cuba, and South Africa . Nine middle-income countries raised GDP per capita by more than 3 percent a year between 1990 and 2002, including the growth leader among all developing countries, China, at 8.6 percent per year on average.

Transition economies should be viewed somewhat differently. Most of them experienced declines in living standards, in some cases drastic, after the Soviet Union broke up. In most countries, these declines bottomed out around 1993. Since then, the growth experiences of transition economies have varied. Ten countries have recorded little or no growth in GDP per capita since 1993. Eight others have raised their income levels since 1993 but have not yet recovered their 1990 income levels. Nine others, the most successful of the transition countries, exceeded their 1990 income levels by 2002. The fastest-growing transition countries since 1993 (in ascending order) are Hungary, Georgia, Lithuania, the Slovak Republic, Poland, Croatia, Estonia, Latvia, and Albania.

By definition, the private sector is the entire economy minus the public sector. The public and private sectors can be measured either through their shares in production or through their shares in final expenditure (consumption and investment). We do not have comprehensive data on the production side, but we do know that during the 1980s and 1990s substantial privatization took place in developing, developed, and transitional countries. Incomplete data collected by the World Bank suggest that the importance of public sector enterprises (as a share of GDP, gross domestic investment, credit outstanding, and total employment) declined in most of the countries for which data are available between the 1980s and 1990s. As a result of these declines, private enterprise, already a dominant economic force in developing countries, became even more important nearly everywhere.

Data on the expenditure side of the national accounts are more complete, but comprehensive information on the division of gross investment between the private and public sectors is not available. The International Finance Corporation has, however, compiled data for 50 developing countries that show private investment rising to about 13 percent of GDP by 1996, while public investment fell to about 6 percent (Figure 3). Private investment was clearly more important than public investment in the late 1990s in all developing regions except sub-Saharan Africa. Government consumption expenditure, meanwhile, is a relatively small and in many cases declining share of GDP. In low-income countries, for example, government consumption averaged only 13 percent of GDP in 1990 and fell to 12 percent by 2002. In lower-middle income countries, the share was similar but may have risen slightly (from 12 to 13 percent) over the same period. Historically, government was much larger in socialist and oil-based economies, but both groups of countries have seen declines in the relative importance of government consumption (to about 16 percent on average and to 14 percent in the most successful transition economies). Even in Saudi Arabia, government consumption fell from 31 percent of GDP in 1990 to 27 percent in 2002. In Albania, it dropped from 19 percent to 13 percent and in Poland from 19 percent to a mere 4 percent.

Figure 3: Trends in Private and Public Investment (percent of GDP)



Source: Bouton and Sumlinski 2000: 21

The data just presented clearly indicate that the private sector—consisting of many different kinds of private enterprises—makes up by far the largest share of all the world's economies. If we define private enterprise growth as the growth of aggregate value added in the private sector and the private sector represents 80 to 90 percent of GDP, it is clear mathematically that the two growth rates cannot differ by much and that there is a direct relationship between the growth of private enterprise and the growth of GDP. Even government consumption, the remaining 10 to 20 percent of GDP, depends indirectly on the government revenue generated by private sector economic activity.

GDP AS AN INDICATOR OF ECONOMIC GROWTH

This near-identity of enterprise growth with national economic growth uses value added as the metric of enterprise growth and aggregate GDP as the metric of economic growth. If we instead use GDP per capita (as we should) as our measure of economic growth, then the relationship that becomes important is that between labor productivity (output per worker) and GDP per capita. If the population that works remains constant, then raising GDP per capita at a given rate requires that labor productivity rise at the same rate. If the employed share of the population rises, then labor productivity can grow a bit more slowly than GDP per capita. Conversely, if the employed population falls, then labor productivity must rise a bit more rapidly than GDP per capita.
A different argument for the close relationship between enterprise growth and economic growth derives from modern theories of economic growth, including Robert Solow's "neo-classical" theory (Gregory Mankiw 1992; David Romer 1996) and the "exogenous growth" theory of David Romer and others. According to these theories, the long-term growth rate of an economy depends solely on technical progress—its ability to extract increasing amounts of production from given endowments of labor, capital, and land and natural resources. The productivity of labor (as well as that of other resources) must rise if GDP per capita is to go up.

An overwhelming share of the world's research and development activity takes place in a few high-income countries. To benefit from the high end of technological development, low- and middle-income countries must participate in international trade and investment, which serve as mechanisms for the diffusion of sophisticated technology. Simultaneously, they must develop a capacity to adapt imported technology to local conditions, since much imported technology is more appropriate to the factor proportions of developed countries.

Although governments frequently intervene in technology acquisition and adaptation, upgrading national technological capability is primarily the task of the private sector. Research shows that, dollar for dollar, private investment contributes more to economic growth than public investment (Bouton and Sumlinski 2000). Entrepreneurs, motivated by opportunities for profit, will seek out ways to improve their production technology.

Over the years, critics have raised frequent objections on welfare grounds to using GDP per capita as a measure of economic growth. As we saw earlier, growth in private sector value added does not guarantee that any individual enterprise will grow or even survive. Growth in the number of enterprises can be either a good sign or a bad one, depending on what is happening to labor productivity. The same could be said for growth in total employment. It is a good thing if productivity is rising, but it reflects only shared poverty if productivity is stagnant or declining.

Employment generation is often emphasized because it provides an important mechanism for sharing the benefits of economic growth (making growth "pro-poor"), particularly in societies where other methods of income redistribution or social support for the poor are weak or nonexistent. Although income inequality appears to be growing in many countries and in the world as a whole, several studies indicate that income distribution has no clear relationship—either positive or negative—to the rate of economic growth. On average, in other words, the incomes of the poor grow about as fast as the incomes of the non-poor. Growth thus tends to reduce absolute poverty, although efforts to accelerate the creation of productive employment and other steps to make growth pro-poor can enhance its poverty-reducing effects.

This chapter—tracing the theory and practice of enterprise development as depicted by researchers and analysts—has explained the theoretical grounding that contributes to the variety of donor perspectives with respect to enterprise growth. The next chapter explores how donor attitudes have been translated into programs.

CHAPTER FOUR
DONOR APPROACHES

The debate over the effectiveness of enterprise growth within the framework of economic growth, employment generation, and poverty reduction programs is perhaps best illustrated by the different programmatic approaches favored by donors. USAID—as well as, increasingly, DFID—stands out for expressing confidence in the attendant positive effects of economic growth led by a vibrant private sector. The World Bank stresses market solutions to poverty reduction but does not rely as heavily on direct involvement with the private sector. The International Labour Organization focuses directly on employment creation.

These donor tendencies are further reinforced by the classification of enterprise growth interventions into two broad categories (see Table 1). The first category concentrates on improving the business environment for enterprises, including competition policy and social policies that directly address work force dynamics and social safety nets. The associated wide range of interventions includes efforts to improve macroeconomic stability through monetary and fiscal policy, as well as initiatives to improve the microeconomic environment through a wide range of options—from privatization to trade policies and efforts to upgrade the social and physical infrastructure. The second category focuses directly on the private sector—or supply—response to market, political, and economic conditions. Interventions in this category are equally numerous and range from strengthening public-private partnerships to improving access to markets and services. Crosscutting activities consist of market linkages, business services, and investment and export promotion.

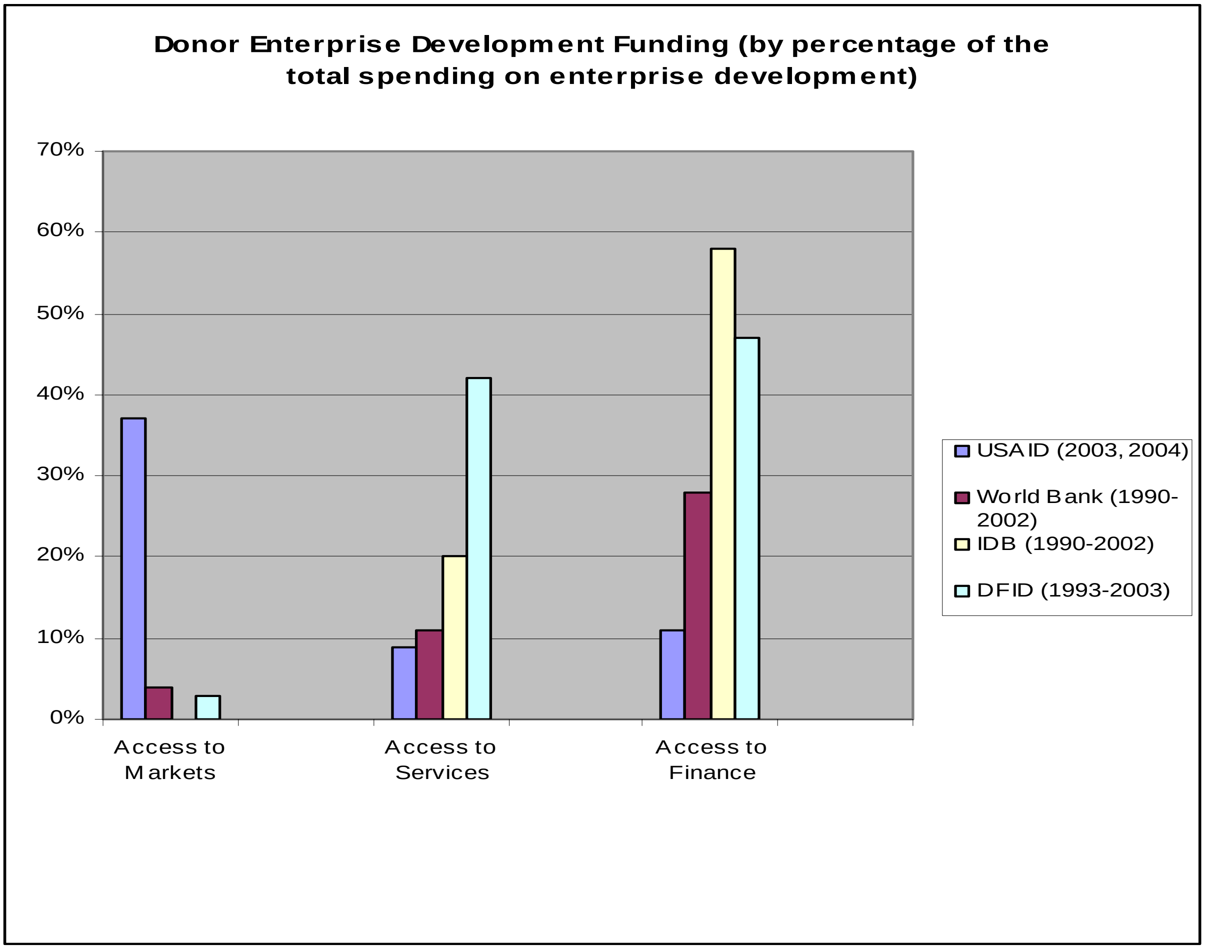
The relative emphasis on the business environment, as compared with the private sector supply response, is the most fundamental issue in donor-funded interventions to promote enterprise growth. The orthodox view is that an open and non-distorting business environment puts private entrepreneurs in a better position to make business decisions than donors or policy makers, who may try to "pick winners." Critics of this orthodox view charge that, in many cases, reforms failed to have the desired or predicted impact. To this, defenders of the orthodox position may retort that the reforms did not focus sufficiently on micro-level issues, were not implemented with sufficient vigor, or were not given enough time to show results. The critics, notably Michael Porter, contend that policy reform is not enough: work to stimulate the supply response is also needed. Some seek a middle position, arguing that supply-side intervention is appropriate only if the overall business environment is sufficiently favorable to permit enterprise development measures to work.

In practice, donor programs generally include a mix of activities to improve the business environment and the private sector supply response, with a marked orientation in one direction or the other. When donor portfolios are disaggregated with respect to access to markets, capital, and services, further distinctions are apparent (see Figure 4). In recent years, USAID has favored trade facilitation, whereas other donors have stressed better access to services and finance and attendant reforms. An active participant in the development of microfinance and business

Table 1: Enterprise Intervention Options for Economic Growth

Improving the Business Environment	Improving Private Sector Supply Response
Business environment: Promotes open markets and maximum competition via “market-augmenting government”—enacts, implements, and enforces market economy laws and policies and related institutional capacity building (neutral toward firms).	**Supply response:** Accelerates the supply response (investment by firms) to an improving policy environment—provides support and incentives to for-profit enterprises and NGOs to address market imperfections and promote market development (supports selected firms and industries).
Macroeconomic Stability **Monetary policy:** discount rates, open market transactions, reserve ratios, etc., to control money supply, contain inflation, interest and foreign exchange rates. **Fiscal policy:** tax regime (personal income, corporate profits, VAT, payroll taxes, etc.); budget formulation/execution, deficit/debt management, fiscal decentralization policies. **Structural and Sector Level Policy, Legal, and Regulatory Reforms** **Privatization:** land, enterprises, banks, strategic industries, utilities, housing, municipal services, etc. **Financial system:** banking and securities laws, bank supervision, stock exchanges, regulation of capital markets and non-bank financial intermediaries. **Trade and investment regime:** WTO compliance, trade agreements, tariffs/customs, non-tariff barriers, foreign investment laws, quality standards, intellectual property, etc. **Commercial law regime:** company law/registries; contract law, collateral registries/law, bankruptcy law/implementation; land titling/registration; other property rights. **Accounting standards:** international accounting and audit standards for private firms and banks; public sector accounting for government entities. **Property rights:** collateral registries, land titling, laws and regulations. **Competition policy**: anti-trust, breaking monopolies, fair trade, consumer protection, and regulation of natural resources. **Labor law:** wage/benefits policy, trades unions/collective bargaining, occupational safety regulations, encouragement of maximum labor mobility. **Human and “knowledge” capital:** investments in education at all levels, specialized training, technological research and development. **Physical infrastructure:** energy (electricity, gas, coal, etc.), transport (roads, rail, ports), communications (telecoms, Internet, etc.), water resources (environmental protection). **Social infrastructure:** health system, pension system, other social safety nets (unemployment, disability insurance, etc.).	**Improve Business Strategy and Performance** **Business institutions:** corporate governance and representative institutions (such as trade associations) for value chains, industry clusters, networks, and trade and investment promotion. **Public-private partnerships:** strategies to reposition industries, commodities, and enterprises through research and development, innovation networks, and upgrading. **Improve Access to Markets and Services** **Product and service markets:** local, regional, and international access through improved value chains, networks, standards harmonization, quality assurance, infrastructure, technology. **Input markets:** improvements in access for key inputs. **Land and water:** agricultural production and efficiency; infrastructure services. **Labor:** work force development for promising clusters; university linkages. **Capital:** financial intermediation for savings mobilization and resource allocation; bank lending; equity capital, non-bank finance (leasing, factoring, bonds, etc.); credit unions, co-ops; microfinance institutions; financial and insurance services for risk mitigation to reduce transaction costs for risk-taking enterprises pursuing innovation (risk insurance, shared risk, new market linkages). **Business services:** access to information on markets, technology, and business; technical assistance and management training through wholesale brokers and retail providers; business-to-business services for marketing, management consulting, auditing and accounting, market research, packaging and design; support services from government agencies such as on-line company registration, streamlined administrative procedures, customs clearance, etc. **Technology:** availability of research and development, innovation networks, university-business linkages, latest industry technology, training, processes, and skills. **Human capital:** business-university linkages for education and training programs. **Transport:** upgraded services for cold storage, logistics, roads, ports, packaging, etc.
Crosscutting policy and institutional interventions: judicial system improvements (court administration, judge training, etc.); administrative and red tape reduction; civil service reform; parliamentary strengthening; open and free media; anti-corruption programs; corporate governance initiatives.	**Crosscutting supply response interventions:** competitiveness improvements; industry sector strategies; cluster and value chain development and upgrading; investment and export promotion; agribusiness development; enterprise funds; market linkage programs (franchising, subcontracting, outsourcing, etc.); regional cross-border trade and investment projects; SME policy advocacy.

Figure 4: Donor Enterprise Development Funding



Data sources:

USAID: Enterprise Development Funding for 2003 and projected for 2004. Total: $1,041 million. Source: Congressional Budget Justifications 2003 and 2004.

World Bank: IBRD and IDA Cumulative Lending by theme for 1990-2002. Total: $282,280 million. Source: World Bank Annual Report (2002).

IDB: IDB Group Activities to Support SMEs (1990-2002). Total: $14,965 million. Source: IDB Group Support to the SME Sector (2003).

DFID: DFID Enterprise Development Department supported projects (1993-2003). Total: £192 million (approximately $318 million). Source: DFID.

services, USAID is now leading efforts to work with individual firms, clusters, and value chains to strengthen directly the private sector's response, while it continues to work with government and the private sector to improve the business environment.

THE FOCUS OF IDB, WORLD BANK, IFC, AND DFID

The main goals of the **Inter-American Development Bank** enterprise development strategy have been to remove regulatory barriers that hinder the growth of SMEs and to improve the competitiveness of SMEs by lowering transaction costs, improving access to credit, increasing access to market-related information, and strengthening market linkages. Facilitating access to financial services is the bank's largest program area, which includes SME credit programs and venture capital funds. The IDB's support for improving the business environment includes sectoral reform loans and lending to facilitate international trade and improve regulatory frameworks. Business development services include increasing access to innovation and technology, improving the quality of management, promoting entrepreneurship, and setting up regional economic development and competitiveness initiatives.

The **World Bank's** enterprise development programs emphasize enhancement of the investment climate through the improvement of regulatory and microeconomic policies. Previously, the World Bank emphasized macroeconomic reform, but in the last few years it has paid increasing attention to microeconomic reform. The World Bank also provides direct support to firms through market-oriented financing and advisory services targeted at institution and capacity building, but it believes that if the business environment is highly distorted, enterprise development efforts will have little success. It also gives significant emphasis to increasing firms' access to basic infrastructure and social services, often through privatization. Financial and private sector development is the largest category of International Bank for Reconstruction and Development (IBRD) and International Development Association (IDA) projects, along with improvements in the policy environment and physical infrastructure.

The **International Finance Corporation (IFC)** began direct firm assistance programs in the late 1980s, focusing on technical assistance to help enterprises prepare business plans for project finance. This approach helped the lending programs, although the fees did not cover costs and it was difficult to measure development impact and the demonstration effect. In 1997, the IFC started project development facilities to develop intermediary organizations such as banks, leasing companies, equity funds, and business associations to provide services, train management through local business schools, and improve the business environment.

The **U.K. Department for International Development's** primary focus is technical assistance to firms aimed at improving access to sustainable financial services, markets, skills, and technologies. Significant support also targets local organizations that provide business development services to enterprises, such as local consulting firms and enterprise development centers. Increasing access to finance and firm-level technical assistance, including the strengthening of business development services, are the two largest funding categories for DFID-supported private sector development programs.

THE FOCUS AND EXPERIENCE OF USAID

USAID is generally perceived as having special interest and expertise in the private sector. It tries to support investment, risk-taking, and entrepreneurship by private businesses and is interested in defining better practice. In the past, like other donors, USAID concentrated on efforts to improve the business environment and on occasion found the private sector response to reforms to be strong. It also experimented with other approaches, including MSE development, microfinance, technology transfer, business services, export promotion, and competitiveness. Although there have been significant successes, the challenge remains finding the right combination of measures to accelerate private enterprise growth in developing and transition countries.

Tying USAID's experience to specific country settings illustrates the difficulties faced by program designers and implementers. USAID currently has enterprise development projects in 36 developing countries, which differ significantly from one another in characteristics important for enterprise growth. In terms of current income, the group includes 19 low-income countries, 15 lower middle-income countries, and 2 upper middle-income countries (see Table 2). Recent rates of economic growth also vary widely. Of the 19 low-income countries in which such projects exist, 9 experienced economic decline or stagnation in 1990-2002, while 5 are in the slow-growing group and 5 are in the fast-growing group. Among the lower middle-income countries in which USAID operates enterprise development projects, 7 were stagnant or declining in 1990-2002, 7 others grew slowly, and only 1 (Sri Lanka) was growing quickly.

USAID also had enterprise development projects in 18 of the 27 post-socialist transition countries (see Table 3). Such projects were under way in all 10 of the worst performing transition countries—those that have not yet regained their 1990 levels of per capita income and experienced little or no per capita income growth between 1993 and 2002. Another 5 program countries are still below their 1990 income levels but are experiencing significant growth. Finally, USAID has enterprise development programs in 4 of the 9 countries that have exceeded their 1990 per capita income levels and continue to grow: Albania, Azerbaijan, Bulgaria, and Croatia.

Most of the transition countries in which USAID has enterprise development projects are small and poor. Only Russia has a GDP that exceeds $50 billion and only Russia, Ukraine, Uzbekistan, and Kazakhstan have populations greater than 20 million.

Most of the 36 developing countries with USAID enterprise development projects have small populations and low levels of GDP. Twenty-seven had populations of less than 20 million in 2002, while just 7 of these countries (Bangladesh, Brazil, Egypt, Ethiopia, Nigeria, the Philippines, and Vietnam) produced goods and services worth more than $50 billion in 2002.

Table 2: Developing Countries: GDP per Capita in 2002 and Average Growth Rate, 1990-2002
(Countries with USAID enterprise development projects shown in ***bold italics***)

Low-Income Countries	Lower Middle-Income Countries	Upper Middle-Income Countries
Declining/Stagnant from 1990-2002		
Afghanistan	Algeria	Gabon
Angola	Colombia	Libya
Burundi	Cuba	Oman
Cameroon	***Honduras***	Saudi Arabia
Central African Republic	Iraq	Uruguay
Chad	***Jamaica***	Venezuela
Congo Dem. Rep.	***Jordan***	
Congo Rep.	***Nicaragua***	
Côte d'Ivoire	***Paraguay***	
Gambia	***South Africa***	
Guinea Bissau	Swaziland	
Haiti	***West Bank/Gaza***	
Kenya		
Korea Dem. Rep.		
Liberia		
Madagascar		
Malawi		
Myanmar		
Niger		
Nigeria		
Papua New Guinea		
Rwanda		
Senegal		
Sierra Leone		
Somalia		
Tanzania		
Togo		
Zambia		
Zimbabwe		
Slow-Growing from 1990-2002		
Benin	***Bolivia***	Argentina
Burkina Faso	Ecuador	Botswana
Cambodia	***Egypt***	Brazil
Ethiopia	***El Salvador***	Costa Rica
Ghana	***Guatemala***	Mexico
Guinea	Iran	Panama
Indonesia	***Morocco***	Trinidad & Tobago
Lesotho	***Namibia***	
Mali	Peru	
Mauritania	***Philippines***	
Nepal	Syria	
Pakistan	Tunisia	
Yemen	Turkey	
Fast-Growing from 1990-2002		
Bangladesh	China	Chile
Eritrea	Dominican Republic	***Lebanon***
India	***Sri Lanka***	Malaysia
Laos	Thailand	Mauritius
Mozambique		
Sudan		
Uganda		
Vietnam		

NOTE: Declining/stagnant means that GDP per capita declined, was constant, or grew at less than 1 percent per year; slow-growing means that it grew at 1-3 percent on average; fast-growing at 3 percent or more. Only countries with 1 million or more population are included. USAID also has an enterprise development project in Guyana and a Caribbean Regional Program.

SOURCE: World Bank, World Development Indicators (on-line database).

Table 3: Recovery and Growth in Transition Countries, 1993-2002
(Countries with USAID enterprise development projects shown in ***bold italics***)

1990 income level not yet recovered, little or no growth	1990 income level not yet recovered, but growing	1990 income level recovered, continued growth
Bosnia & Herzegovina	***Armenia***	***Albania***
Kyrgyz Republic	Belarus	***Azerbaijan***
Macedonia	***Georgia***	***Bulgaria***
Moldova	***Kazakhstan***	***Croatia***
Russia	Latvia	Czech Republic
Tajikistan	Lithuania	Estonia
Turkmenistan	Mongolia	Hungary
Ukraine	***Romania***	Poland
Uzbekistan		Slovak Republic
Yugoslavia*		

*USAID had enterprise development projects in Kosovo and Montenegro.

NOTE: Countries in the first column had not recovered their 1990 level of GDP per capita and had declining GDP per capita or growth at less than 1 percent a year from 1993 to 2002. Countries in the second column also had not recovered their 1990 level of GDP per capita by 2002 but did experience growth of GDP per capita at more then 1 percent a year on average (1993-2002). Countries in the third column had recovered their 1990 level of GDP per capita by 2002 and experienced growth of GDP per capita of more than 1 percent a year (1993-2002).

SOURCE: World Bank, World Development Indicators.

Enterprises in most USAID-assisted countries faced small local markets with low purchasing power. To raise sales faster than national GDP—which, as we have seen, was growing slowly or not at all in many cases—they had to rely substantially on the export market.

Regardless of income level, countries in which USAID operates have had to contend with highly unfavorable business environments. The World Bank (2004) notes that the poorer the country, the higher the cost of doing business, or opening or closing a business, measured in both money and time. The *Global Competitiveness Report 2002-2003* ranked 80 countries by a measure it called “growth competitiveness.” Relatively few developing or transition countries were included in the ratings, but 7 of the 10 lowest positions were awarded to countries in which USAID has enterprise development programs (Nigeria, Bangladesh, Honduras, Ukraine, Bolivia, Zimbabwe, and finally Haiti, which ranked last among all countries surveyed). Other countries hosting USAID programs ranked a little higher—namely, South Africa (32), Brazil (46), and Jordan (47)—while Namibia, Morocco, El Salvador, Croatia, and Jamaica were ranked between 50 and 60.

The difficulties faced by enterprises with respect to market size and market environment reaffirm the importance of integrating interventions for enhanced private sector response and business environment into enterprise growth initiatives. The mechanics of the process are explored in Chapters Five and Six, which distill recent donor interventions into general approaches, guiding principles, and best practices.

CHAPTER FIVE
DONOR-FUNDED INTERVENTIONS: GENERAL FINDINGS

Our review of project evaluations included interim evaluations, end-of-project evaluations, and multicountry evaluations, in addition to interviews with practitioners and policy makers. Some evaluations examined specific program areas and post-project implementation results (for example, beyond end-of-project reports), such as USAID's review of export and investment promotion programs over the past 10 years, IDB's review of competitiveness initiatives in Colombia and El Salvador, DFID's review of five projects worldwide, or the World Bank's assessment of direct assistance to private firms.

Our review of donor evaluations of enterprise projects highlighted the importance of improving the rigor, standards, and resources of the evaluation systems that support effective management and efforts to upgrade performance. USAID's evaluation system was displaced in the mid-1990s by re-engineered information systems imposed by the Executive Branch. Interviews with USAID officials reflect their frustrations with the current approach. A huge amount of relevant USAID work on this topic is not documented or available at the Center for Development Information and Education's (CDIE) Development Experience Clearinghouse (www.dec.org). Many evaluations conducted in field missions were never filed in CDIE. Technical officers in Washington have only fragmentary knowledge of what field missions are doing. We found it equally difficult to find relevant evaluations at the IDB and the World Bank.

Generalizations across projects are problematic because the evaluations lack consistent methods of analysis and consistent information on results, impact, sustainability, and cost-effectiveness (see Table 4 for summary of findings). Many evaluations displayed difficulties in assessing attribution and causality. Few contained time series data that would allow monitoring and evaluation of program activities over time. Some evaluations provided cost-effective assessments, while others did not. The accuracy and relevance of some evaluations remained uncertain, particularly regarding controversial issues and failures.

This chapter summarizes the findings and conclusions of our review of 42 evaluations included in Annex C.

Table 4: Composite Findings across Evaluations

Topic	Elected Evaluation Methods	Gaps in Analysis
Results	▪ Surveys of service providers and client firms conducted ▪ Cost-sharing data of grants and services to client firms documented ▪ Fees collected or paid to providers for services documented ▪ Estimated increases in bottom-line performance by clients through surveys	▪ Very few projects used time series data and unclear if baseline data established ▪ Specific results targets sometimes identified after selecting commodities or industries ▪ Unclear if firm's financial books are valid ▪ Financial services had strong monitoring of inputs, limited information on outputs or firm impact
Impact	▪ Surveys with opinion leaders in government and private sector conducted ▪ Commercial service providers assessed post-award ▪ Innovation generated beyond project interventions by counterparts	▪ Few post-project evaluations conducted ▪ Surveys capture perceptions, which are valuable, but not conclusive ▪ Attribution and causality often difficult to determine
Sustainability	▪ Macro export data assessed ▪ Financial viability of service providers ▪ Financial viability of associations from services fees and membership ▪ Changes in laws, regulations, policies	▪ Replication of project-supported services in commercial marketplace assessed through intermediaries
Cost-Effectiveness	▪ Calculate project budget and estimated sales from client firms ▪ Calculate estimated FDI attributed to project support ▪ Calculate cost-sharing amounts, direct and indirect	▪ No consistent data across project evaluations provided in reports ▪ Interim evaluations usually did not have such data ▪ Evaluators often did not have access to such data ▪ Causality and attribution difficult to determine

Despite the serious shortcomings in evaluation techniques and the lack of information available, clear patterns of successes and failures emerge from our interviews, literature review, and review of evaluations. These patterns lead to our recommendations for strategy, guidelines, and best practices for future enterprise interventions.

PROJECT DESIGN AND IMPLEMENTATION

Many of the findings noted below about project design and implementation are relevant for any development project. Rigorous commercial principles and practices are particularly important in design and implementation of enterprise projects to ensure their ability to address market failures and leverage market dynamics to achieve improved enterprise and economic performance. This theme recurs throughout this chapter.

Effective, high-impact projects often establish brand identity, credibility, and strategic partnerships with key policy makers and private sector leaders. Evaluations and our review of the experience of other donors suggest that a 5- to 10-year project timeframe, with thresholds for review and opting out, is necessary to achieve meaningful institutional reforms and significant project impact.

While government agencies have certainly had mixed results as delivery partners, they should not be dismissed entirely. They are important stakeholders and often perform well in properly structured public-private partnerships. The New Economy Project in Jamaica, for example, originally intended to work primarily with private sector providers but found the participation of key government agencies was crucial for improving business services for enterprises, particularly with respect to regulations and government-controlled procedures such as on-line company registration.

Utilizing local capacity is often cost-effective and contributes to sustainability. Successful projects typically have highly qualified local staffs who work closely with expatriate advisors. These projects use as much local consulting and training as possible, building their capacity through on-the-job and targeted training. This approach leaves greater capacity behind among local organizations and professionals who participate in delivering valued services.

Program designs should carefully factor in incentives to change enterprise performance. The objective is to identify what firms are willing to pay (effective demand) by setting appropriate schedules for fee-based services and non-fee services (such as corporate governance and policy research). Fee-based services should directly improve bottom-line performance through firm- and cluster-level activities such as upgraded standards, trade missions, and so on. This rigorous approach avoids the slippery slope of projects over-subsidizing services and thereby crowding out commercial providers.

Rigorous Monitoring and Evaluation for Reform

The Agricultural Policy Reform Program (APRP) in Egypt operated one of the most robust examples of policy reform combined with rigorous experimentation to improve agricultural productivity from 1997 to 2001. An important lesson illustrated in this project is the need to identify measurable performance indicators at the outset, and monitor them during the course of implementation. Following many years of USAID involvement in agriculture in previous projects since 1985, the policy reform program linked reforms to specific benchmarks and results indicators negotiated between USAID and the Government of Egypt. A Monitoring, Verification, and Evaluation (MVE) Unit, jointly managed by the GOE and USAID consultants, monitored performance through a sophisticated database of 151 benchmarks and 242 indicators. By input or output commodity areas, these indicators focused on areas of APRP involvement in cotton (51), seed (22), water management policy (18), and rice (14). Outputs (88 indicators) and inputs (89) were equally important, as were major thrusts in information (12), development of public institutions (11), research and extension (10), and development of private institutions (5). Five sets of USAID payments to the GOE were linked to achieving specific performance benchmarks established in advance by USAID and the government. Reforms required careful analysis of market systems for key commodities, such as cotton and rice, and inputs such as land and water, to identify and test market interventions that resulted in improvements in performance. The project established appropriate roles for public and private institutions to achieve mutually beneficial objectives. Improved productivity was directly linked to cooperation between ministries, as well as between government and private sector institutions.

Projects should develop transparent methods for selecting counterpart organizations, local service providers, and enterprises as clients, and they should use commercial-type documents, such as contracts, memoranda of understanding, and task orders that spell out objectives, expected results and outcomes, local service providers, payment terms, cost sharing, pricing, and deliverables. If firms breach confidentiality or agreements, it is important to terminate agreements to set a standard of compliance and commercial discipline.

Many projects that work directly with enterprises and business associations—including the Technology Initiative for the Private Sector (TIPS) Project in Sri Lanka, the Small Business Support Project (SBSP) in West Bank/Gaza, and the South Africa International Business Linkage (SAIBL) Project—developed formal written agreements with business owners and executives for specific project-financed engagements. Current and former project managers noted the importance of structuring these agreements properly to ensure commercial practice and rigor and to establish the project's credibility in the private sector.

Good enterprise projects build in rigorous learning and innovation processes to test and improve services, client engagement, and demand-led initiatives. Such projects also survey client firms regularly for results and outcomes and provide multiple feedback loops for continuous improvement. They are innovative and entrepreneurial in strategy, approach, and implementation. Most project managers admitted that it took time to design and develop working relationships with counterparts and devise agreements, subsidies, and relevant services.

Successful projects identify key champions in the public and private sector to support, lead, and drive reform initiatives. Change is difficult and complicated and should occur from within, from local leaders and institutions. These projects also work closely with other donor-funded initiatives to complement and leverage resources. One former project manager said that it was imperative to cultivate working relationships with public and private sector leaders with common views on economic growth. Some projects never figured out how to position their projects with the right ministers and associations. Several similar projects failed because they aligned with a minister who supported protectionist industries.

Good projects systematically analyze economic and business dynamics to identify intervention opportunities. They take a venture approach that is both opportunistic and strategic and that is grounded in reliable and timely information. One good example of this approach highlighted in greater detail later in this chapter is Business Partners in South Africa, a venture-minded private company that has attracted investment from the IFC as a model for its work in Africa. Business Partners combines debt and equity products with consulting services because enterprises need a full range of integrated services to improve their performance. Unlike less successful projects that offer one-size-fits-all solutions, Business Partners and projects like it engage enterprises, associations, and other counterparts with tailored assistance that meets real market opportunities.

DONOR ROLES

Donor agencies play a critical role in defining the important issues or policies, as well as conditions, for success in the reform process that may complement or undermine project implementation. According to evaluators, USAID/Nepal failed to follow through on local currency transfers to reinforce with the government the importance of supporting a market economy for three successive years for the Market Access for Rural Development Project. On the other hand, USAID/Egypt learned a hard lesson that government rhetoric for liberalization did not work during the 1980s and 1990s, and finally developed a sophisticated Monitoring, Verification, and Evaluation Unit for the Agricultural Policy Reform Program from 1997 to 2001 to link economic payments to changes in the business environment, supported by innovative programs in the private sector supply response.

The strategic positioning and sequencing of the reform intervention is important. As examples, USAID/Morocco achieved effective results in export and investment promotion because it recognized that a liberalized exchange rate encouraged trade, and there was a supportive services sector to support promotion efforts (Wichterman 1994). On the other hand, USAID/Egypt's efforts in trade and investment promotion failed because the policy environment was not conducive to trade, and the mission did not adequately analyze the services sector, which was too weak to be effective, according to evaluators.

Faced with budget and policy constraints, donor bureaucracies tend to divide projects into pieces that do not always allow the most effective market interventions and strategic integration. Projects that do not have a policy component, for example, limit the ability of managers to act on the valuable insights into legal, regulatory, and policy constraints that inevitably are gained through direct private sector assistance in the marketplace. If the policy component or another critical component, such as improving financial services, is separated from market entry initiatives, it is often difficult to achieve the greatest impact because managers cannot address policy or financial linkage issues directly. This observation implies that where necessary, projects should be multifaceted, including components that address relevant market failures to fully leverage the project's impact.

An example of limited leverage is USAID's elimination of commercial justice activities from the Support for Private Enterprise Expansion and Development Project (SPEED) in Uganda because it did not fit within the Support for Economic Growth and Institutional Reform (SEGIR) contract. SPEED's core focus on fostering market linkages between producers and other enterprises through extension services identified many commercial law issues that could not be addressed strategically once USAID removed that component from the project. If project managers have to rely on other donor projects to address such issues, the evidence suggests that the ability to achieve results is often compromised. The evaluation of SAIBL noted the missed opportunity to leverage financial services provided by other projects and local service providers to further strengthen transactions facilitated by the project. In addition, SAIBL did not have a mandate to address industry issues that could have a broader impact on improving enterprise performance. While successful as a firm-level project, SAIBL did not maximize its impact by addressing policy and industry issues.

Donor coordination is a good idea: it can work, and it has shown good results, but it depends on the parties agreeing on key programmatic objectives that allow integration of donor resources to achieve specific reform initiatives. Successful cooperation usually requires agreeing on key reform objectives and then aligning the incentives (resources) to encourage progress. The process requires rigorous monitoring and evaluation of clearly defined benchmarks and indicators negotiated between the donors and the government, as well as effective implementation. Examples of excellent donor cooperation include the cooperation of the World Bank, USAID, and Asian Development Bank with the Government of Mongolia to reform the financial sector and support the turnaround and privatization of the Agricultural Bank of Mongolia. The memorandum of understanding clearly spelled out the objectives, roles, obligations, and commitments of each party to implement the program. Without agreement on fundamental issues, many projects fail to achieve their objectives.

Other modes for effective donor cooperation would combine comparative advantages of one donor with the strengths of another. For example, USAID's New Economy Project in Jamaica focuses on demand-led services interventions. In the absence of adequate resources to invest in business surveys, USAID and the World Bank/IFC should share information generated from extensive business surveys already undertaken by the World Bank that would provide rich information about bottlenecks and constraints and areas for new services. Generating timely and reliable knowledge about enterprise behavior and constraints is expensive, and this knowledge could be shared among donors to improve project design to benefit enterprises and supporting institutions.

PROGRAM PURPOSE

Three main thematic areas are the mainstay of donor programs for enterprise growth: access to markets, access to capital, and access to business services. Policy reform is often integrated with projects in these three areas.

- **Access to markets** includes projects that focus on agriculture and agribusiness; market linkages; trade, investment, export promotion, and trade capacity building; and competitiveness, clusters, and value chains targeting specific industries. Within these major areas, programs tend to work with public-private partnerships, industry associations, or individual companies to promote access to market information, upgrade product and quality standards, and improve access to domestic, regional, and international markets.

- **Access to capital** includes donor funding to support micro and small business lending and to improve the productivity of financial institutions that provide credit lines, make equity investments, and support entrepreneurship. Projects often focus on financial sector strengthening and technical assistance to microfinance institutions (MFIs) and banks offering financing to SMEs.

- **Access to services** includes projects offering direct technical assistance, both at the firm level (retail) and at the industry level (wholesale), aimed at improving business services. This category includes activities intended to improve access to technology; upgrade human resources development and business skills training; increase the capacity of the local consulting industry and providers of business services; and build institutions by strengthening business associations, NGOs, and public and private sector organizations offering services to entrepreneurs.

IMPROVING ACCESS TO MARKETS

Over the past few years, the main focus of USAID's enterprise development projects has been to help enterprises develop products and services that meet customer specifications in highly competitive markets. The largest share of USAID programs focuses on agriculture and agribusiness initiatives to improve productivity, raise household incomes, and alleviate poverty. Challenges include the movement of populations from rural to urban areas; uneven income growth; the importance of food security; and the increasing importance of supermarkets that drive purchasing, standards, and consumer demand in global markets. The most successful projects combine policy and institutional reform; productivity improvements in selected commodities (especially nontraditional exports); and improved efficiency in the use of key inputs such as land, water, technology, services, and finance.

Donors support trade capacity building and trade and investment promotion initiatives to help countries attract foreign investment and improve trade opportunities for enterprises. USAID's involvement in this area was curtailed in 1992 by concerns in Congress that promotion would take jobs and business away from the United States. USAID's trade capacity-building strategy includes a broad range of activities to improve economic policies and institutions, encourage the development of the private sector, establish a sound investment climate, support the President's trade negotiating agenda, and better participate in the multilateral trading system. Recently, USAID reinterpreted the policy guidelines for the recurring Congressional mandate, "Impact on Jobs in the United States," that foreign assistance funds for trade and investment activities not be used for activities that would likely result in the loss of U.S. jobs or contribute to the violation of workers' rights. The new policy guidelines allow for a broader spectrum of trade and investment activities.

Many projects address improved market entry through interventions that work through value chains and industry clusters. The primary objective of these projects is to improve competitiveness by upgrading enterprise performance in response to specific market opportunities. These interventions attempt to create public-private partnerships, such as national competitiveness councils, cluster-based trade associations, and other key stakeholder groups, to encourage cooperation and improve productivity. Some of these projects, particularly those referred to as competitiveness initiatives, were reviewed recently by The Mitchell Group (2003), which found the most important determinant of their success to be the "sweat-equity" invested by cluster participants. The private sector must own and drive cluster development. Of note, the Mitchell evaluation was regarded as tentative because of the newness of the projects and the absence of quantitative measures of results.

A review of project evaluations by USAID, the World Bank, the IFC, DFID, and the IDB suggests several conclusions about programs that seek to improve access to markets:

- **Strong market linkages enhance program results and impact** by concentrating on increased demand, new buyers, new markets, and new distribution channels. Helping business owners respond to new profit opportunities through improved performance (such as increased sales, productivity, and profits) creates incentives for restructuring and upgrading. Several projects, such as SAIBL and TIPS, were very successful in direct firm-level assistance to help firms improve profitability, sales, and performance through market linkages. These projects, however, had no explicit mandate to improve the business environment or address larger industry issues and did not leverage financial services as effectively as they could have (or parallel projects in the mission's portfolios or work by other donors that may have filled the gap). Projects that operated at the industry cluster and commodity levels rather than at the individual firm level, such as agribusiness projects like the Agriculture Technology Utilization and Transfer Activity (ATUT) in Egypt and Investing in Developing Export Agriculture (IDEA) in Uganda, achieved greater impact for a larger number of firms in horticultural products and other nontraditional exports.

- **Enhanced competitiveness is important across all enterprise projects, not just industry cluster initiatives.** Many projects in agriculture and agribusiness, which absorb the largest share of USAID expenditure, as well as firm-level assistance projects, have provided perhaps the most extensive experience in enterprise development through commodity systems, value chains, and policy reform initiatives. However, many projects that strive to improve competitiveness are not recognized as such because competitiveness initiatives are generally classified as national competitiveness councils and industry clusters. In reality, every enterprise growth initiative should improve the competitiveness of enterprises and industries. All of the trade and investment promotion and trade capacity-building projects noted in Annex C were designed to improve exports and competitive performance of enterprises in multiple industries.

- **Increased productivity for the creation of higher-value products requires integration of critical inputs**, such as capital, labor, technology, and services; upgraded business processes; and removal of specific obstacles that block enterprises' access to new markets. In this regard, the World Bank evaluations of its lending programs noted that many financial services projects were not integrated because they focused on increased credit flows and the sustainability of financial institutions without assessing the impact on enterprise performance.

- **Direct firm-level assistance provides valuable learning and insights into actual business problems and policy obstacles** that can guide effective advocacy of reform by donors and private sector organizations. While less cost-effective than broader approaches, direct firm-level interventions create opportunities for establishing bottom-line improvements that translate into new jobs, increased sales and market share, and increased productivity. These projects also build credibility with progressive private sector leaders and organizations for donor-sponsored reform initiatives. SAIBL and TIPS, the Firm-Level Assistance Group (FLAG) in Bulgaria, and the Enterprise Development Center in Rafaela, Argentina, achieved good results at the enterprise level, but they did not leverage the project's position or insights for greater impact by improving the business environment and addressing industry issues.

- **High-growth enterprises of any size are an important element of market access projects.** Cost-sharing grants for technical assistance to increase access typically focus on business owners who are risk-takers and undertake entrepreneurial investments to improve technology, production efficiency, market research, and responsiveness to buyers. Promotion of nontraditional exports and increased productivity in Bolivia, Egypt, El Salvador, Kenya, Kosovo, Nepal, South Africa, Sri Lanka, Uganda, and West Bank/Gaza focused on selected dynamic enterprises of any size. The Export and Investment Promotion evaluation in Latin America and the Caribbean noted performance improvements among the 162 firms surveyed. Although successful at the enterprise level, many of these projects did not achieve improved export performance at the national level.

- **Project capital contributions are strategically managed as co-investments with growth enterprises in successful projects.** Many projects have used a technical assistance fund for cost-sharing grants. The Kenya Export Development Support (KEDS) Project used an Export Development Fund, a cost-sharing mechanism to promote nontraditional exports, as the cornerstone of success for firm-level assistance. Some projects start with heavy subsidies and reduce the subsidies entirely, such as the Small Business Support Project in West Bank and Gaza that used a 50/50 cost-sharing formula that decreased over the life of the project. SAIBL in South Africa and FLAG in Bulgaria did not charge for some services, and surveys indicated that at least half of the firms surveyed during evaluations would prefer not to pay fees for services. This raises serious questions about effective demand and sustainability. The more

Improving Trade Opportunities and Services

A USAID evaluation of 10 countries (CDIE 1994)—including Costa Rica, the Dominican Republic, Guatemala, Chile, India, Indonesia, Korea, and Thailand—surveyed 300 exporters to evaluate 33 services provided by 90 service providers, including government trade promotion departments and investment promotion boards, private non-profit organizations such as trade associations, retailers, importers, and foreign investors. Export success was measured by how much sample countries grew in manufactured exports compared with developing countries from 1985 to 1990. No single policy was a predictor of export success, but a composite measure that combined macroeconomic and trade policy and business environment ratings (procedural requirements for investment taxes, quotas, and restrictions) correlated positively with export success for all the countries where exports grew faster, except Egypt and India, which fell far behind other countries. Rates of return for four promotional organizations ranged from 12 percent to 26 percent. Attributions of success varied by region: firms in the Caribbean region gave promotional interventions high attribution, but Asian firms gave hardly any to USAID-assisted institutions. A sound macroeconomic policy framework and partial trade reform are preconditions for export success and effective use of donor-subsidized promotion services. Once a favorable climate exists for some exporters, the evaluators recommended focusing on the export support services market. If the market is not ready to respond, subsidized support services can stimulate development of competing private service providers, but the subsidy should be terminated once a well-functioning services market exists. Interventions should focus on service strategies that fill specific gaps facing particular firms:

- Domestic manufacturing firms often need foreign market information and buyer contacts for long-term business relationships, especially for newly exporting firms;
- Foreign manufacturing firms often require services for decision making about joint ventures or wholly owned subsidiaries; and
- Exporters of nontraditional agricultural products need commercial services to obtain new technology and crop-specific assistance.

effective projects strive to minimize subsidies and eventually exit entirely, allowing local service providers to deliver services on a commercial basis.

- **Direct firm-level assistance is the lowest risk approach, particularly in environments where government is ineffective**, such as conflict or post-conflict scenarios in Kosovo, the Palestinian Territories, and Zimbabwe. Such projects are an effective way of learning what works and what does not, how to make markets work to provide food security and create new jobs, who are the progressive private sector leaders, and where are the leverage points for moving into more cost-effective interventions, such as working with wholesale intermediaries, industry cluster approaches, and efforts to improve the business environment. Direct firm-level assistance projects provide quick traction and results, building credibility and partnership with private sector counterparts for more advanced and sophisticated reform initiatives in environments where public institutions are weak and change is sometimes easier than in more established and stable countries. The Kosovo Agribusiness Development Program worked effectively with farmers, processors, input suppliers, and distributors to improve production and marketing in a post-conflict environment from 1999 to 2003 (Baanante 2003).

- **Direct firm-level intervention is optimized when projects use commercially rigorous incentives to share risks with businesses**, even in the most difficult business environments. Capital contributions should be used strategically to introduce commercially viable innovations that facilitate market entry. These subsidies should end as quickly as possible and be replaced by commercial solutions in a more dynamic marketplace. Projects that leverage nascent commercial initiatives of enterprises rather than provide grants or resources as the primary incentives for client firms tend to be more successful. FLAG in Bulgaria and NEP in Jamaica did not phase out fees, raising concerns among evaluators about sustainability. In contrast, the Private Investment and Trade Opportunities Project in the Philippines adopted private sector practice by incorporating fees for services, cost sharing, and project reflows to approximate market mechanisms.

- **Flexible approaches to improving productivity in industry clusters and value chains often achieve the greatest impact with larger firms**, such as exporters, processors, and firms that can upgrade productivity throughout the value chain for firms of all sizes. Prescriptive designs that dictate firm size requirements (for example, a project that can only work with microenterprises) often make it impossible to achieve the greatest impact across an industry or a value chain. Some of the most successful microenterprise projects were inspired by sound business strategy and not by donors intent on working with microenterprises. Many agribusiness projects have assisted small producers in commodities that had growth potential. The Morocco Agribusiness Promotion Project (MAPP), for example, assisted thousands of strawberry producers by deregulating trucking, creating linkages with a California grower of high-quality plant material, and helping exporter groups sell their product in European markets. Agribusiness projects in general were more successful because they had very focused market priorities. Joint upgrading efforts through Inter Jeans, a membership-based marketing organization, improved performance for 40 firms in the apparel industry in Guadalajara. Competitiveness initiatives in Colombia and El Salvador had mixed results.

- **Informality in value chains, clusters, and the economy limits effective cooperation and productivity**. Conventional thinking suggests that the informal sector comprises primarily microenterprises. In reality, informality operates throughout the economy in many poor-performing economies where rules, regulations, and procedures either do not exist or are unevenly implemented and enforced. Informality also includes rent-seeking behavior and many forms of "corruption" where enterprises make payments to ensure that containers get processed more quickly through ports or tax collectors are paid not to look too closely at the books. Informality also includes off-budget arrangements between ministries and state-owned monopolies, deals between enterprises and policy makers to achieve monopolies, back-channel deals to expedite government registration and licenses, and other rational behavior to conduct business in difficult environments. McKinsey's analysis in Argentina revealed the role of larger informal enterprises in stifling productivity growth. The important conclusion is that informality indicates a lack of rule of law and enforcement, as well as inappropriate international business practices. Informality generally reflects and results in inefficient economic behavior and relatively uncompetitive performance.

- **Channeling enterprise assistance through public agencies tends not to work**. There are examples when public-purpose organizations are effective for research and development, grant making, innovation initiatives, and export and investment promotion. But such organizations typically have strong participation from private sector leaders and organizations. Evaluations conducted by the IDB, the World Bank, and USAID, particularly in the area of export and investment promotion, indicate that public agencies are not effective unless there is strong private sector participation. The Market Access and Poverty Alleviation Project in Bolivia used a quasi-public-private model for agricultural foundations that were privately owned and managed but authorized to use public funds to assist private firms. Private sector representatives understand the needs of enterprises better than government bureaucrats and should play a major role in business-related, public-purpose organizations.

- **A strong focus on specific industry clusters or products provides standards and practices for restructuring enterprises and upgrading performance.** For example, pharmaceutical standards are the same for pharmaceutical firms in South Africa or the Palestinian Territories, and manufacturing of stone and marble is similar in Italy, France, the Palestinian Territories, and the United States for firms that compete in global markets. At the same time, the bottom line or profit motive creates strong incentives for enterprise change in response to buyer requirements that supersede cultural and historical differences across countries. McKinsey conducted an analysis of construction workers in Houston, Texas, and India to assess productivity performance among uneducated workers. Migrant Mexican workers in Houston were much more productive because they used appropriate technology (such as wheelbarrows) and worked within an efficient management system, whereas illiterate Indian construction workers carried heavy materials on their heads and did not benefit from well-managed construction sites. Industry-, commodity-, and product-specific approaches were successful for projects in many different kinds of countries and environments, from agribusiness in Kosovo to pharmaceuticals, furniture, and construction in the Palestinian Territories to high-value horticultural products in Bolivia, the Philippines, and Uganda.

- **Greater leverage is achieved when a policy component is incorporated into strategies to increase market access for enterprises**. Direct firm assistance provides the opportunity to test innovations with risk-taking enterprises and build momentum for implementing reforms that revitalize productive enterprises and industries. Every enterprise growth initiative should have an explicit policy component. Many project evaluations did not explicitly test the relevance or effectiveness of direct firm-level assistance on shaping the policy agenda because it was not in the project design in the first place. The Agricultural Policy Reform Program in Egypt is an excellent example of the importance of linking specific commodity and input indicators to policy reform initiatives to achieve impact. Evaluators found in Uganda that the Agricultural Non-Traditional Export Promotion Project achieved some notable successes in the macroeconomic environment but that it should focus on some remaining policy constraints that undercut enterprise performance. Explicit inclusion of policy reform provided the opportunity to proactively monitor and address policy issues.

- **Global benchmarking improves productivity in enterprises and industries in competitive markets**. Donor interventions that improve linkages with foreign buyers and suppliers, increase foreign direct investment, and help firms adopt international product and quality standards, technology, and management practices achieve better results in improving productivity in target enterprises. Agribusiness projects are good examples of global benchmarking and upgrading in a variety of areas that improve competitiveness. All of the agribusiness projects, although with varying degrees of success, improved product quality and production yields, upgraded cold storage and logistics infrastructure, and addressed agricultural policy issues related to biotechnology, regulatory issues for health and phytosanitary standards, and tariffs and pricing.

- **Wholesale approaches to improving trade and capital flows, such as investment and export promotion, depend on a favorable business climate and effective intermediaries.** A favorable policy environment is a precondition for export and investment promotion initiatives. Public sector intermediaries are generally less effective in assisting enterprises than private sector organizations such as trade associations, foundations, and mixed public-private partnerships that aim to improve market access. USAID’s evaluation of export and investment promotion projects in 10 countries (CDIE 1994), the Work Bank’s assessment of similar activities in 75 countries, and a comparison of similar projects in Egypt and Morocco (Wichterman 1994) concluded that the business environment is a key factor.

- **Business associations can be effective wholesale intermediaries if they focus on policy advocacy and wholesale services** that do not crowd out direct service providers. They must also provide relevant services—such as market information, standards upgrading, and training—directly linked to improving an enterprise’s ability to meet buyer and market requirements. Associations generally fail when they focus on political rather than business objectives or on the narrow interests of a few business leaders rather than on strategies to upgrade productivity for the whole industry. Sometimes the association is seen as an end in itself, rather than a vehicle for improving productivity and industry performance. The evaluation of the Market Access Program in the Palestinian Territories noted that building modern business associations to address policy issues and broker services is crucial to improving the business climate. Projects successfully worked through a wide range of business associations in key industries to increase market entry, including: high-value horticultural commodities in Bolivia, Egypt, Kosovo, and Uganda; nontraditional exports in El Salvador through FEDEXPOR; and trade and investment promotion in countries worldwide.

- **Approaches implemented through a variety of implementation modalities can achieve excellent results and high impact** if they follow rigorous commercial and market principles—including market linkages, clusters, value chains, trade capacity building, and trade and investment promotion—and operate through wholesale and firm-level assistance. At the same time, projects that oversubsidized services did not achieve market rigor or good results. Annex C presents a wide range of program areas where projects achieved success in improving enterprise performance.

- **Institutional sustainability—defined as the ability of public and private institutions to adjust continually to market trends, threats, and opportunities—is a critical success factor.** Defining clear roles for public and private institutions, as well as public-private partnerships, requires leadership from government and business. Even in cases where there are no formal public-private partnerships, there are almost always champions in the public sector that facilitate and support a new or larger role for private organizations to perform functions previously and unsuccessfully performed by government.

IMPROVING ACCESS TO CAPITAL

By far the largest share of donor-financed enterprise development programs tries to increase access to capital. Development finance for microenterprises is one of the most advanced areas for experimentation, performance monitoring, and commercial solutions. There is less experience or success, however, in the area of SME finance in the range of $50,000 to $1 million. Lack of access to finance for growth enterprises or risk-taking firms may significantly impede investment in equipment and thus limit business expansion, innovation, and job creation.

Based on a review of more than 40 SME projects, there does not appear to be sufficient information about how business births, deaths, and expansion are affected by this financing gap. The fact that few microenterprises grow into larger firms, however, suggests that microfinance may not make a large contribution to firm growth, although it is valuable for income generation among low-income households.

Although many surveys indicate that access to capital is a major constraint, improving access to capital to support enterprise growth is not simply a supply-side solution. Many firms that perceive access to capital as their binding constraint often have more fundamental problems that need to be addressed first. It also appears that few projects effectively integrate, or even have a mandate to address, financial and nonfinancial services at the same time, which is critical for risk-taking enterprises. For example, more working capital (or overdraft facilities available to many firms at high annualized interest rates) may not be a solution for enterprises that have poor production and inventory management. Without solving internal efficiency problems by improving production and upgrading to industry standards, an enterprise may continue to operate inefficiently, even with additional financing. Sustained financing of investment-ready firms may be impeded by fundamental flaws in the legal and regulatory environment for the financial sector, including, for example, ill defined property rights or inadequate procedures for financial disclosure. Even in conducive environments, improving the financial sector by upgrading the innovativeness and competitiveness of financial service providers is important for improving productivity across many industries.

Our review of literature and evaluations of projects that focus on improving access to capital yields the following findings:

- **Financial services in most emerging markets fail to meet the needs of high-growth enterprises that need to borrow to sustain growth.** While most growth-oriented enterprises can raise $50,000 for start-up capital from personal sources, they cannot raise additional funds for working capital or fixed capital needs. These firms fall within a financing gap because they do not qualify either for microfinance programs (up to $10,000) or for commercial bank lending in the $50,000 to $1 million range, which typically requires collateral of at least 1.5 times the amount borrowed. Donor projects often do not recognize the reality of the business environment. One development finance expert speculated that the largest source of financing may actually be deferred tax payments, or tax avoidance, by firms that underreport. Most small businesses have multiple sets of accounting books: one for the authorities, one for the family owners, and one for other owners. In most countries, small firms are unable to pledge business assets or personal property as security for financing. Thus, the rich firms can comply with most banking requirements, and the smaller firms, which may be the most important source of growth, are at a distinct disadvantage.

- **Closing the financing gap is a potentially important way to accelerate enterprise growth and economic growth in developing and transition economies.** Companies need access to various kinds and sizes of credit during different stages of growth. Increasing the number of firms that grow to larger scale is an

Mixed Performance for World Bank Lending

A recent study by the World Bank (Batra 2003) found no evidence that government and donor subsidies for credit leads to higher growth rates for more firms. Subsidized credit has resulted in financial institutions that are not sustainable because they do not recover the cost of capital and operating expenses. More importantly, subsidized credit reflects a mindset that is not conducive to rigorous financial management in banking and non-banking institutions that support small business. The first obligation of a lending institution should be financial sustainability for continuing lending operations. World Bank-supported credit lines have operated through one or more financial intermediaries which on-lend to private enterprises. Technical assistance is often combined with credit lines to build capacity in intermediary financial institutions. The objective of these credit lines is to complement recent reforms, support export industries, and improve supply response from enterprises by helping to expand capacity, improve productivity, and diversify lines of business through investment and enterprise restructuring. A review of 30 lending projects from 1997 to 2002 indicated that 16 projects appear to perform well (based on input indicators such as disbursement of loans from credit lines rather than impact within the firms receiving the loans—the demand side). The other 14 projects had poor disbursement records due to macroeconomic instability, economic uncertainty, and availability of other, cheaper lines of credit. The World Bank study noted that its own procedural requirements sometimes contributed to a relatively high cost of borrowing for SMEs.

important aspect of dynamic growth. In the United States, 90 percent of enterprises fail within the first 10 years, but 10 percent grow to larger sizes. Evidence suggests that microenterprises participating in donor-supported microfinance institutions such as Grameen Bank and Bancosol rarely grow out of the microfinance category. Microenterprises are important for smoothing consumption, generating employment, increasing production, and reducing poverty, but they seem to have little capacity for improving value-added productivity and growing in size.

- **Weaknesses in judicial and legal enforcement often make it impossible to develop sustained financing for firms.** Such weaknesses may make it impossible, for example, for banks to foreclose collateral on non-performing loans, yet they maintain strict adherence to collateral lending practices. Collateral requirements act as a screen that selects wealthy borrowers and crowds out many enterprises with high growth potential.

- **Enterprise growth requires multiple financial instruments for different stages of growth.** Typically, risk-taking entrepreneurs will finance start-up companies using personal sources of capital up to $50,000. The next stages of growth—to expand operations; hire more employees; purchase services, technology, and systems; and improve management and productivity—require financing in the range of $50,000 to $1 million. One financial expert noted that all of the financial institutions in Africa, with a few exceptions, require high collateral and offer no innovative financial products, such as equity and debt products, alternative collateral methods, and consulting, for growing SMEs in this range.

- **In more sophisticated developing economies, mixed equity and debt instruments are, nevertheless, generally not available to high-growth enterprises to fill this financing gap.** Donor programs have not adequately addressed this critical financing gap, which severely constrains small businesses with high growth potential. This underserved group fails to qualify for financial services, either donor-supported or purely commercial. Studies suggest that better-capitalized start-ups have a much higher chance of surviving. Effective corporate governance improves the ability of firms to structure capital to sustain growth strategies. Donors should explore more creative project designs that support innovation within the financial services industry through financial sector reform to increase competition and support commercially sustainable financial institutions like the American Bank of Kosovo and Business Partners in South Africa.

- **Improving productivity and innovation in the financial services industry is critical to improving productivity in other sectors.** Examples of successful donor support to create commercially viable financial service providers for micro and small business include the American Bank of Kosovo, the Agricultural Bank of Mongolia, Business Partners of South Africa, and venture capital funds in Latin America. These successes are commercially viable enterprises—such as banks, fund management firms, and finance companies—that combine financial innovation with world-class management, technology, and systems to improve productivity.

- **More applied research is required to understand SMEs and enterprise growth dynamics (birth, death, and growth factors) often associated with credit.** One hypothesis is that donors should strive toward the 10 percent rate that prevails in the United States in an effort to increase the percentage of small businesses that grow to larger sizes and increase productivity by offering more innovative financial services.

- **Subsidized credit programs are unsustainable and unnecessary.** Reducing transaction costs and increasing innovation and productivity among financial service providers are more important. As noted above, a recent study by the World Bank (Batra 2003) found no evidence that government and donor credit subsidies lead to higher growth rates for more firms.

- **Many projects did not adequately link financial services from other donor-supported projects with their business service activities**. There are examples of firm-level projects that improve enterprise performance, thereby improving the quality of the deal for SME lenders and reducing their risk. The IFC's project development facilities had mixed results in improving lending performance through technical assistance because their transaction costs were unsustainably high (Batra 2003).

- **The lack of technology and innovation is a major impediment to improved financing of business growth.** A major objective of enterprise projects should be to increase productivity and competition within the financial services industry in order to spur innovative financial services delivery to enterprises.

Innovative Services for Growth Enterprises

Business Partners is an investment company in South Africa that invests capital, skills, and knowledge into SMEs in a wide range of industries, from professional and personal services to manufacturing, retailing, tourism, and coastal fisheries. Business Partners estimates there are more than 600,000 SMEs in South Africa, and its portfolio to serve them includes:

- Investments: structured investment capital as equity, quasi-equity, and term debt, from $15,000 to $1.5 million;
- Loan terms: extended for four to six years at variable rates, normally at prime rate, with risk on interest offset by royalties and equity appreciation;
- Client attributes: focus on honest, entrepreneurial, risk-taking, “doing,” and business-skilled clients;
- Equity positions: take 25-45 percent of share capital, with client holding remainder and right of first refusal to buy back shares for duration of loan;
- Royalties: collected as percentage of revenues or free cash flow, included in the contract at the higher of planned or actual;
- Security: client pledges collateral of not more than 60 percent of loan;
- “Aftercare”: provided by a mentor to enhance business results or for turnaround if required; and
- Exit terms: included in initial contract based on long-term cash flow projection to determine best share repurchase schedule.

As a private sector firm, Business Partners has developed special products—risk partner, incentive partner, and equity partner—to overcome some of the traditional barriers facing SMEs in traditional lending facilities. Business Partners is an aggressive, innovative commercial company that provides methods to reach growing enterprises. In 2002, investment targets were $6.8 million. The IFC is developing a management agreement with Business Partners to extend its business model to three other African countries and dynamic growth enterprises.

IMPROVING ACCESS TO SERVICES

Most enterprise projects provide business services in one form or another to improve enterprise performance. Businesses require a wide range of services, including accounting, audit, quality assurance, telecommunications, Internet, business planning, legal advice, training, production engineering, market research, packaging, and design services. Many donors have established business centers to provide such services to micro, small, and medium-sized enterprises. The results of these interventions are decidedly mixed. Few have achieved sustainability. As a result, donors have rethought the process and committed themselves to a business service market development approach that moves away from direct service delivery by brokering services through local consulting firms and business associations.

Supporting commercial value-added services that improve productivity, profitability, and firm growth is a crucial donor activity. Effective demand—the willingness to pay for services—is critical to the market development approach. Partial subsidies may be appropriate to introduce services that have never been used before or in environments where there is no tradition of consulting. However, subsidies distort the services market and crowd out local service providers. Donor-subsidized services should be strategically positioned to stimulate the services market, with the objective of establishing commercial service transactions and permitting an early exit by the donor.

Following are findings and conclusions with respect to business service interventions:

- **Business services can increase productivity in all sectors, much like financial services.** Such services include management consulting, information and communication technology services, market research, quality assurance and certification, packaging and design, and so on.

- **Donor interventions should support more effective trade in business services**—the concept of commercial transactions in a services marketplace—to ensure rigor, impact, effective demand, commercialization, and sustainability. Most service providers are themselves small businesses and are part of the productivity value chain or network.

- **Effective demand—the willingness of enterprise customers to pay fees for services—is crucial to the development of services that improve productivity and accelerate enterprise growth.** Successful project interventions to improve business services charge at least 50 percent of the actual cost of services; the enterprise pays

Supply-Driven Technical Assistance Fails

Many projects are designed to work directly with SMEs to improve productivity. If they focus primarily on inputs, they tend to fail. The World Bank evaluated five SME projects that closed between 1997 and 2001 and four SME projects in the Philippines from 1988-1992. Three of the five closed projects reported success on the input side and substantial use of technical assistance (TA), but only one reported significant positive results, with two reporting partial success. A comprehensive World Bank study examined TA to SMEs from 1973 to 1993, involving 70 projects, $142 million in finance, and $5.68 million for TA. Most TA failed to meet its objectives in the quantity and quality of services delivered for three main reasons: services poorly designed and unresponsive to the real needs of SMEs; inadequate management by the bank, particularly where implementing agencies were weak; and poor performance by public institutions.

fees directly to the service provider. This ensures that the services provided have value to their users (assuming that businesses do not buy services unless value is exchanged) and also that users value the services provided, leading to sound commercial relationships. Surveys of client firms of SAIBL in South Africa and FLAG in Bulgaria indicated that firms were not inclined to pay fees for services. This should cause project managers to rethink the value of services subsidized by the project and evaluate better ways to leverage project resources to improve enterprise performance.

- **Successful projects broker commercial relationships between local service providers and enterprises in a wide range of services that improve productivity,** including ISO and quality standards, Web site designs, market research, production realignment, and management or financial restructuring. They do not crowd out local service providers through direct service provision but do foster competition and clear standards of performance among local service providers. In the Palestinian Territories, for example, the Small Business Support Project conducted competitive procurement for most consulting engagements among local service providers to achieve the best value and ensure commercial quality. Many project evaluations did not provide much insight into the role of local service providers, which should be relevant to improving commercial trade in services.

- **Demand-led initiatives for business services use criteria that ensure self-selection** among private sector actors who lead, design, and take risks, in partnership with donor-sponsored interventions. Relevant business services also include government services that provide more efficient and effective fee-based registration services, container processing at ports, and other important trade-related services that are increasingly Internet-based. NEP in Jamaica and other projects solicit applications from government agencies and business organizations that propose innovative services to improve enterprise performance.

- **Many entrepreneurs in the SME range have the management skills and capability to innovate, combining labor, capital, and other inputs to achieve higher productivity**. Evidence suggests that successful technical assistance projects work effectively with firms with high potential for growth through cost-sharing schemes for acquisition of technology, business services,

Brokered Services Leverage Commercial Transactions

The Small Business Support Project (SBSP) subsidized 16 quality assurance certification programs in the Palestinian Territories from 1996 to 1999, serving as a vehicle to restructure company processes and improve access to global markets through Hazard Analysis at Critical Control Points (HACCP), ISO 9000, and Good Manufacturing Practices (GMP). The first ISO 9000 consultancy took two years and cost $32,000, with SBSP subsidizing 80 percent and the client paying 20 percent. By the time of its last ISO consultancy, SBSP paid only 25 percent in subsidy, and the real value-added role of the project was in brokering commercial relationships between local consulting firms and clients. By 2001, more than 220 firms had acquired international quality certifications through local consulting firms. SBSP got “out of the business” of brokering, was not involved in the direct delivery of services, and leveraged commercial incentives between manufacturing firms and local consultants to generate a sustainable market for quality assurance services that substantially improved the productivity of manufacturing firms and established new standards across the manufacturing sector. By 2003, ISO was a standard in the stone industry, for example, which exported to 33 countries.

upgraded productivity, and management restructuring, but there are limited financial services available. SAIBL, TIPS, SBSP, the Market Access Program (MAP) in the Palestinian Territories, NEP in Jamaica, and many other projects used cost-sharing schemes with varying degrees of subsidy to assist risk-taking entrepreneurs. Total cost-sharing arrangements ranged from $1,000 to design a Web site to $20,000 for ISO 9000 compliance.

- **Donor-subsidized services should be strategically positioned to stimulate the services market** to increase enterprise productivity in product markets, with the objective of establishing commercial transactions in services and an early exit for donor subsidies. NEP introduced on-line services for company registration and outsourcing, which did not exist before; the Kosovo Agribusiness Development Project leveraged input suppliers to distribute fertilizer and seed to farmers; and SAIBL introduced small black businesses to large corporations for industrial cleaning services.

- **These projects use technical assistance venture funds** that share costs up to 50 percent with growth enterprises for specific services that result in improved bottom-line performance. Such projects are entrepreneurial in sharing risks with the service provider. Sometimes these funds exist in reality—more often they are grant-sharing schemes that support investments in local service providers and firms. The return on investment is measured in terms of increased sales, higher profits, and reduced operating costs.

- **Demand for highly subsidized services is artificial.** Subsidies can distort services markets, crowd out local service providers, reinforce the wrong incentives, and perpetuate the belief that consulting firms do not add value. In the worst cases, donors create dependency by paying per diems and fees for enterprises to participate in training programs. Projects should focus on effective demand, whereby the enterprise owner or manager is willing to pay for most, if not all, of the service. There were few examples of projects that systematically reduced subsidies as quickly as possible because the projects aimed to achieve their own performance targets of services provided and numbers of firms served. Performance measures should monitor subsidy rates and the extent to which local service providers participate and continue services on a commercial basis.

- **Donor-created service providers, such as business service centers, usually are not sustainable.** While they may succeed in achieving some development goals, they are often inefficient and ineffective and cannot be converted into commercial operations. The IFC created project development facilities to provide technical assistance, training, and technology upgrading for SMEs. The Mekong Project Development Facility (MPDF) completed 96 financial advisory projects and 13 technical assistance projects by the end of 2001, contributing $40.2 million in financing commitments. A report in 2002 noted that two-thirds of its clients believed these services improved competitiveness, but one-third believed services made no difference. MPDF collected roughly 4.8 percent of the total cost of services, well below the 10 percent cost recovery originally projected. The lack of detailed cost-benefit analysis precluded final conclusions by the Bank, but the PDFs do not appear to be cost-effective.

- **Projects can operate as temporary brokers or facilitators of services using local service providers.** A challenge is to ensure that services are demand-driven and identified and paid for by the clients. The IDB found that business service centers in Argentina could provide value-added services, but the centers were not sustainable commercially. The Enterprise Development Center in Rafaela, Argentina, relied on outsourcing services from local consultants and delivered high-quality services through 1,892 consulting projects. While the center was not commercially sustainable, consulting became a valued service for the first time in the region.

- **Local service providers are enterprises that must add value to other enterprises** in order to achieve commercially sustainable relationships after the broker's role has ended. Projects that broker outsourcing relationships between firms should structure deals so that the buyer pays for services that improve its bottom line. TIPS in Sri Lanka developed an effective method of linking local enterprises to service providers through contractual agreements.

- **Subsidies should be managed strategically** to stimulate new services through commercial transactions. Newly introduced services, such as ISO 9000, market research, and Web design, succeed when subsidies are limited and local service providers improve their bottom-line performance. Many donor-sponsored business services operate on Western business concepts that do not work in difficult business environments. A business plan, for example, offers no advantage to SMEs in Kazakhstan, Uganda, Ukraine, or other countries where bribes, special deals, and connections dominate business transactions. Enterprises will pay for services if there is clear value and improvement in their profitability; thus, projects should encourage minimal subsidies to ensure that enterprises' willingness to pay is a measure of how they value a service.

- **"Business development services" is a donor term** that does not exist in the commercial market. "Business services" is a term that more accurately reflects the trade in services that donor interventions should support. Projects supported a wide range of business services brokered through local providers, including marketing, product design, market research, quality assurance, production improvement, Web design, Internet services, business plans, feasibility studies, technology upgrades, and management restructuring. Business services also refers to a host of imbedded services provided through firm-to-firm transactions.

The common theme in enterprise projects is the importance of establishing commercial principles and practices to help enterprises, industries, and business organizations improve enterprise growth. Subsidies can be useful if they do not distort commercial behavior and provide positive incentives for change. These findings inform the discussion in the next chapter on strategic directions and options for enterprise growth initiatives.

CHAPTER SIX
FUTURE DIRECTIONS AND STRATEGIC OPTIONS

The discussion in previous chapters suggests that donors should craft integrated and strategic programs for enterprise growth that are responsive to country context and the overall political and economic environment in which enterprises are to flourish. Depending on the country, programmatic packages should include policy and institutional reform, as well as interventions for improving the productivity and profits of private enterprises. Specific activities may occur at national, sectoral, cluster, and/or firm levels. The design and sequencing of program elements should not only address systemic constraints to enterprise growth but also take into account other donor efforts and national government attitudes toward private sector development. In the process, greater attention should be paid to such issues as the nature and impact of existing and possibly new incentives driving enterprise behavior; the usefulness of rigorous experimentation that leverages commercial initiatives and mobilizes the private sector to advocate change; and the need for better monitoring of performance and impact.

STRATEGIC MANAGEMENT OF ENTERPRISE GROWTH INITIATIVES

Enterprise growth initiatives provide donors with the opportunity to revitalize and reform market institutions, provided that their interventions are backed by adequate analysis and strategic thinking regarding market linkages and market dynamics. We offer below several entry points into the process of program development.

Market Analysis

Donors operate in countries where for-profit companies often fail to overcome market failures and compete in global markets. Such failures raise serious challenges for designing successful enterprise growth initiatives. Successful designs require analysis of the existing enterprise structure to identify promising growth industries, export-oriented sectors, and opportunities for improving productivity. The importance of coalitions for reform—in the form of private sector associations and public-private partnerships—should not be overlooked. Change-minded enterprises can be outmaneuvered by rent-seeking coalitions unless they are organized with a clear agenda that offers greater benefits than the existing economic regime.

In Table E-2, we present a conceptual framework for assessing strategic opportunities for enterprise growth initiatives at the national, sector, and enterprise levels. The framework covers project design and implementation with respect to improving access to markets, capital, and services. Any country analyses underpinning program design should investigate and shed light on the prospects for improving the business environment, increasing growth in demand, improving productivity, and leveraging economic growth initiatives.

Strategy Leverages Market Dynamics

Donor-supported economic growth initiatives often occur in difficult or unstable environments and economic circumstances that present harsh conditions in which to reduce poverty and promote growth. But even in unstable political and economic environments such as Kosovo, Zimbabwe, and the Palestinian Territories, enterprise growth initiatives have played significant roles in improving food production, food markets, and commercial incentives to support reform, reconstruction, and rehabilitation. In Sri Lanka, for example, where conflict was limited primarily to a geographic region, relatively high growth provided a positive environment for enterprise growth initiatives.

Strategic management of enterprise growth initiatives involves broad, systematic thinking about how to identify and achieve specific objectives. Most countries shift in political and economic openness during the 5- to 10-year timeframes of most initiatives because of political coups, regime changes, conflict, economic cycles, and so forth. Strategic management requires continuous adaptation to market conditions and emergent opportunities for change. Cost-effective enterprise growth initiatives should ride the wave of positive market trends and sidestep or ameliorate, where possible, negative trends.

Strategic management entails four steps that focus on global markets:

- Analyzing market dynamics with key public and private sector stakeholders—and focusing on trends, demand opportunities, and threats—to build consensus among key stakeholders for repositioning a country, its industries, and enterprises;

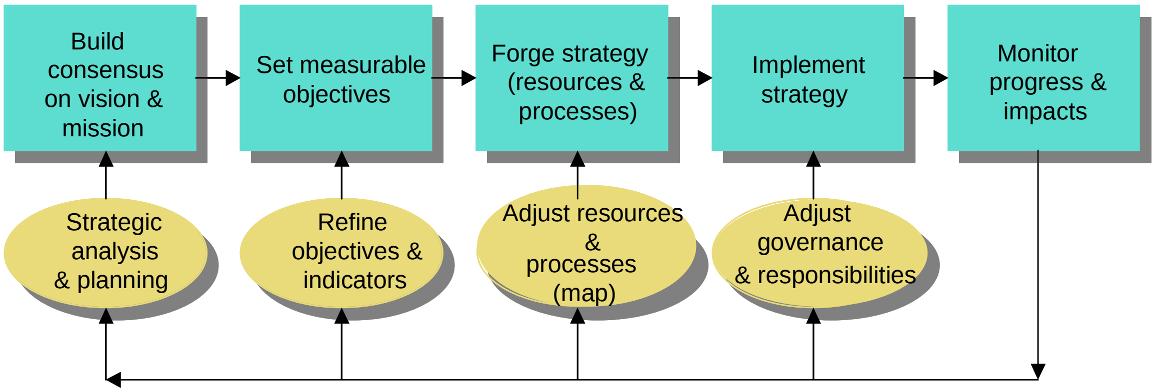
- Setting measurable objectives by developing realistic performance indicators for improving the business environment, strengthening industry performance, or restructuring and repositioning enterprises;

- Organizing resources and building the governance capacity of market-focused institutions such as cluster-based trade associations, trade promotion organizations, research and development organizations, venture capital funds, and standards institutes; and

- Monitoring results, assessing the initiatives' impact at multiple levels—national, industry, and enterprise—and adjusting strategies and resource management accordingly.

Figure 5 illustrates the strategic management process, including the dynamic interrelationship between strategy, governance, implementation, and learning for economic growth initiatives. The process is challenging because it requires a rigorous analysis of market conditions, proper attention to critical variables (such as open versus closed political and economic systems), and strategic decisions about which counterpart organizations to support and which interventions are likely to have greatest impact. The finite pool of financial resources also requires integrating initiatives, as appropriate, with other activities in USAID's portfolio in a given country, as well as complementing other donor programs for optimal results and impact.

Figure 5: Strategic Management Process



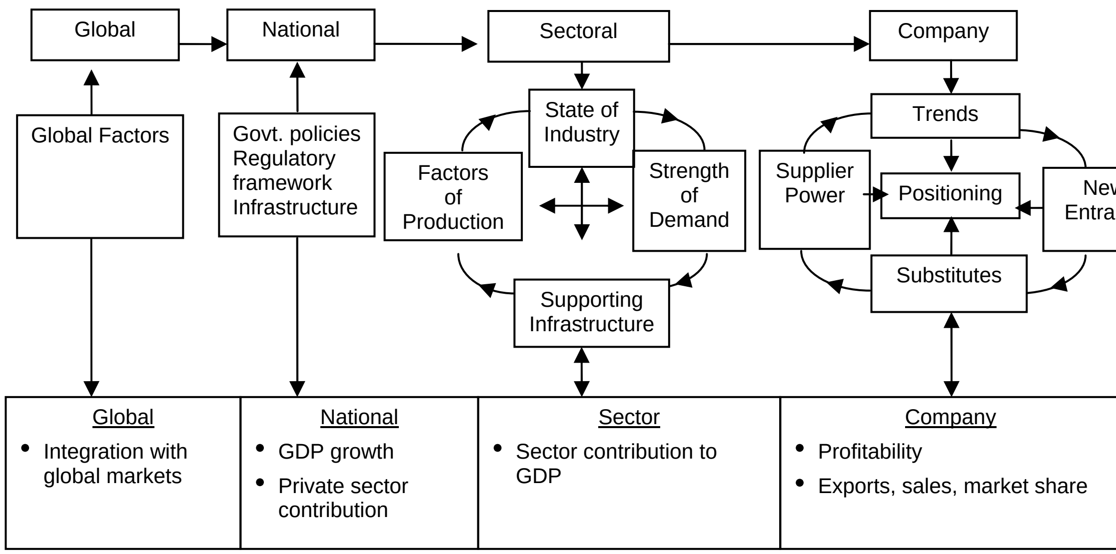
Multiple Levels of Engagement

The global market is the benchmark for harmonizing market dynamics at the national, sector, and enterprise levels. The global market sets the bar for enterprise performance, as perhaps best illustrated by the expanding or contracting market share of local enterprises in the face of competition from foreign ones. Whether local or foreign, enterprises with the most favorable business environment and greatest aptitude for meeting client demands and international standards within an industry or sector are ultimately the strongest competitors. This dynamic, captured in the business literature, explains how cooperation and rivalry for market share encourages innovation and growth among enterprises.

Figure 6 depicts the Global Market Framework and the number of market environments in which enterprises often operate. This figure shows the market dynamics facing enterprises, industries, and countries as they develop strategies and policies in response to global market factors. To be successful, enterprise growth initiatives must operate strategically in all these market environments in order to improve alignment of the local economy with the global one. In the process, initiatives will assist governments and private sector leaders to respond to localized and broader market trends, opportunities, and threats.

At the national level, enterprise initiatives should help public-private partnerships and governments to reach economic stability and shape the business environment by, for example, investing in social capital and building infrastructure. Whenever possible, policy reform measures should be accompanied by sector and enterprise activities which demonstrate that harmonizing to global markets attracts foreign investment, expands trade opportunities for restructured enterprises, and improves the productivity and bottom-line performance of enterprises.

Figure 6: Global Market Framework for Enterprise Growth Initiatives



At the sector level, enterprise initiatives should assist relevant stakeholders and local leaders with the development and implementation of appropriate growth strategies for industry clusters, commodity systems, and value chains with promising growth potential. Further support can strengthen private-sector inputs for needed reforms, build local capacity for sector and industry innovation and leadership, and provide cost-sharing resources for pilot testing new ways of doing business.

At the enterprise level, initiatives can focus on direct firm-level assistance as a way of improving company profitability and company positioning. Alternatively, initiatives may opt to work through local intermediary organizations and service providers to build credibility, trust, and momentum for revitalizing market institutions.

Table 5 amplifies on the framework by presenting a range of programmatic interventions which may occur concurrently or sequentially. The priority and emphasis on these activities and the concomitant weighting of resources by level will depend upon several variables:

- **Leadership:** the willingness of key government and business leaders to undertake reform at the national and sector levels. If there is little willingness or confidence initially to lead reform initiatives at either the national or sector level, then direct firm-level assistance may be the best way to build trust, credibility, and traction in environments where instability or closed political systems do not initially allow for relatively open and transparent decision making.

- **Political economy:** the degree of openness on the part of government leaders to engage with progressive private sector leaders may limit the effectiveness of public-private partnerships for economic governance. In such cases, donor support can focus on sector and enterprise levels where there are promising growth prospects and some existing productive capacity. Building credibility through improved performance will strengthen arguments for bolder reform initiatives at the national level.

- **Stability:** in conflict and post-conflict environments such as Kosovo, Zimbabwe, and the Palestinian Territories, a focus on sector and enterprise levels may be the only opportunity if government is nonexistent or antagonistic toward any form of opposition.

Table 5: Enterprise Growth Initiatives Operating at Multiple Levels

Levels	Analysis/Appraisal	Strategy	Results
Global economy	▪ Global market trends, demand opportunities, integration requirements	▪ Harmonize trade and investment standards	▪ Increased access to global markets
National economy	▪ Business environment ▪ Leadership, stability, political system ▪ Comparative benchmarking ▪ Country "brand" recognition	▪ Country repositioning ▪ Country branding ▪ Structural reforms ▪ Trade policy reform	▪ Increased employment ▪ Per capita GDP growth ▪ Reduced poverty ▪ Reformed business environment
Sectors (industry clusters, value chains, commodity systems)	▪ Internal strategic factors of key industries (strengths, weaknesses, stage of development, competition) ▪ External strategic factors (opportunities, threats, demand, competitive trends)	▪ Cluster upgrading ▪ Cluster repositioning ▪ Forward/backward integration ▪ Market linkages	▪ Increased value-added growth in key industries ▪ Increased contribution to GDP growth ▪ Revitalized market institutions ▪ Improved policies
Enterprise	▪ Business strategy analysis ▪ Global benchmarking	▪ Enterprise repositioning for lead firms ▪ Investment and innovation	▪ Increased profitability ▪ Increased exports, sales, market share ▪ Increased employment

Country Typologies: Development Phases and Key Variables

Economic growth initiatives operate in a variety of countries with different development phases and numerous variables. A stable business environment is critical to successful enterprise growth, yet most enterprise growth initiatives operate under extremely difficult business conditions. A country may regress or progress across different development stages, and experience rapid change in political and economic variables in a relatively short period of time. Zimbabwe, for example, after decades of peace and prosperity, experienced a dramatic descent into conflict and political chaos beginning in 1999. Donor programs suddenly had to deal with a closed political system, weak purchasing power in the domestic market, and political and economic instability after radical land reform confiscated land from commercial farmers who were the major producers, processors, and traders in the economy. USAID's enterprise growth project adjusted by concentrating on small farmers' production and marketing systems.

Simultaneously, it integrated HIV/AIDS activities that improved nutrition and health services for at-risk groups among project beneficiaries. As structured, the project helps to stabilize the economic situation of project participants and contributes an important humanitarian response, thereby maintaining important social relationships, which can be triggered for economic recovery when appropriate.

Variations in development—with a range of variables across countries or even within one country—require flexible strategies, which allow for adjustment and fine-tuning while responding to core economic growth objectives. Table 6 presents an overview of development phases and variables, with suggestions for appropriate intervention. Table E-2 presents questions for testing possible strategic approaches in different country typologies. These tables raise a series of questions and issues that policy makers and practitioners should address in order to design and manage successful projects. In responding to each country's unique combination of variables, each strategy will still need to take into account multiple levels of engagement, appropriate targeting of clients, and the correct sequencing of activities. In addition, the strategy should not lose sight of two key factors: the quality of the business environment (for example, the number and degree of legal or regulatory impediments faced by business); and the rate of economic growth. In all cases, enterprise growth initiatives should improve the business environment and expand economic growth by operating at multiple levels and under changing conditions.

While it is difficult to prescribe specific actions for donor-sponsored enterprise growth initiatives for all countries—because each country has distinct leaders and institutions; different political, economic, and historical factors; and industries differing in composition and structure—the fundamental principles described in this paper, regarding business environment, demand, and private sector supply response, should be upheld, and a venture-minded approach to managing these initiatives is crucial.

In cases where analysis supports a well-conceived strategic enterprise growth initiative, such initiatives can be cost-effective, affordable, and manageable for the average USAID mission, which has an annual program budget of $30 million, three expatriate staff, and up to 30 local staff, personal services contractors, and fellows. Approximately 10 percent of the total program budget, or $3 million per year, can support an effective strategic enterprise growth initiative with multiple components. USAID missions may increase or decrease their program budget commitments based on the results and outcomes achieved by economic growth initiatives over time.

Table 6: Country Typologies, Development Phases, and Political and Economic Variables

Variables	Conflict	Post-Conflict Recovery & Reconstruction	Transitional Economies	Developing Market	Emerging Market
Open vs. Closed Political System	▪ Consider firm-level TA to limit risks and leverage markets for food security, job creation, and household incomes ▪ Complement humanitarian aid by leveraging markets for food production, input supplies, and logistical support ▪ Consider focus on industry cluster work in agribusiness and employment generating industries that support reconstruction and future growth ▪ Explore commercial solutions for health services and local community action	▪ If open, consider supporting national, regional, and industry levels of public-private dialogue to strengthen business environment and key industries ▪ If closed, consider supporting industry clusters at regional levels to encourage collective action	▪ If open, encourage public-private dialogue, focus on improving business environment to complement industry initiatives in growth areas ▪ If closed, consider focus on export-oriented industries and specific legal and regulatory reforms in those industries; focus on supporting services	▪ If open, consider work at all levels to improve business environment and test pilot reform initiatives through public-private partnerships ▪ If closed, explore support for export-oriented industries and enterprises that advocate reform where possible	▪ If closed, consider supporting bottom-up policy dialogue at industry and regional levels and cluster upgrading through associations ▪ If open, consider supporting national and regional dialogue and partnerships for specific industries
Open vs. Protected Economic System		▪ If open, explore support for export and large domestic demand industries ▪ If protectionist, consider supporting export-oriented industries	▪ If open, consider encouraging public-private dialogue and partnerships to support growth industries ▪ If protectionist, consider focus on export industries and large domestic industry	▪ If open, consider promoting foreign investment and export promotion in growth industries ▪ If protectionist, support export-oriented industries and enterprises	▪ If open, support FDI and trade promotion, and improved business environment ▪ If protectionist, support export industries and progressive leaders with specific policy reform initiatives
Small vs. Large Domestic Economy		▪ If small, consider focus on export industries and strengthening export associations ▪ If large, consider focus on export and large domestic industries, and improved business environment for investment	▪ If small, consider focus on export industries and regional integration through trade agreements advocated by industry ▪ If large, consider supporting anchor firms and foreign investors and cluster upgrading in large domestic industries	▪ If small, consider supporting improved business environment for FDI and export industries ▪ If large, consider supporting FDI in large domestic and export industries and national policy reform initiatives	▪ If small, consider strengthening public-private partnerships for improved business environment and export and investment promotion ▪ If large, consider focus on partnerships for improving business environment

RECOMMENDED APPROACHES FOR FUTURE INITIATIVES

Economic growth is a dynamic, turbulent process that takes place in a competitive environment. Market forces generated well beyond the boundaries of the enterprise are often key determinants for enterprise growth. Profit incentives drive behavior, sometimes determined by varying degrees of openness in the competitive environment. These global, regional, and local factors require proactive, market-driven responses and strategies from both government and private sector leaders to continuously reposition enterprises and industries to compete more effectively in global markets.

Donors too must respond strategically to the range of factors affecting enterprise and economic growth. Strategic management of an integrated market approach—as well as simultaneous interventions to improve both the business environment and the private sector supply response—provides the best means for retooling enterprise growth initiatives for maximum impact.

Market Approach to Program Design

Figure 7 presents a market approach to enterprise growth and development. Relying on the dynamics of market forces, this approach emphasizes access to global markets as the driver for improving enterprise competitiveness. At the center or bulls-eye of this figure is the imperative to achieve improved competitiveness for enterprises in both input and product markets. Several conclusions arise from this approach:

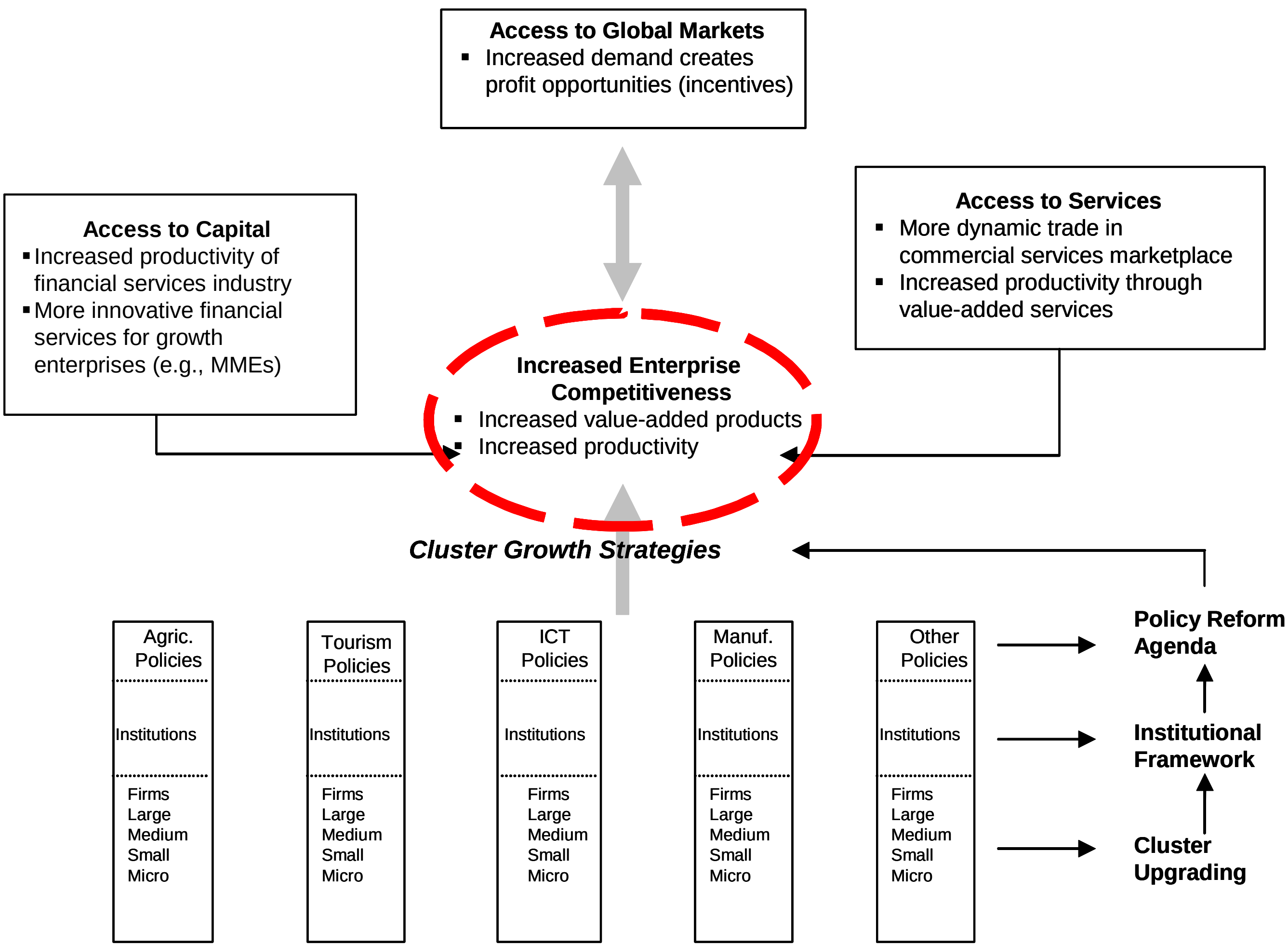
- Access to global markets requires rigorous benchmarking and restructuring of enterprises to meet product standards and buyer requirements. Entrepreneurs pay attention to profit opportunities and will be motivated to restructure their enterprises in response to demand in local, regional, and international markets. Reforms in policies, laws, and regulations are driven by a new awareness of the imperative for enterprises to compete in these markets.

- Access to capital requires improved productivity in the strategically important financial services industry. Supply-side interventions subsidized by donors are not solutions. A competitive financial services industry that generates innovative financial solutions for enterprises is the sustainable solution.

- Access to services recognizes that business services is a strategic industry that must generate innovative solutions for enterprises. Profit opportunities among enterprises across the economy will create demand for value-added business services.

- Cluster growth strategies in key industries must focus on growth opportunities derived from increased access to global markets, improving institutional capabilities among public and private actors that advocate policy change, and upgrading cluster capabilities in manufacturing and services. The cluster approach creates greater leverage and systemic reform in the business environment and market institutions than direct firm-level assistance.

Figure 7: Market Approach to Enterprise Growth and Development



Working with clusters and value chains to identify policy and regulatory issues critical to upgrading firms to global standards should yield clear benefits. At the same time, working in multiple value chains and clusters provides a reform aggregating effect and builds momentum for change through multiple institutions that can shape a national reform agenda. This approach can operate from the top down, through national competitiveness councils, as well as from the bottom up, through cluster initiatives that generate traction with enterprises, build incentives for changed behavior, and galvanize support for reform in the private sector. Each country presents a different set of opportunities and entry points that should shape the enterprise growth strategy.

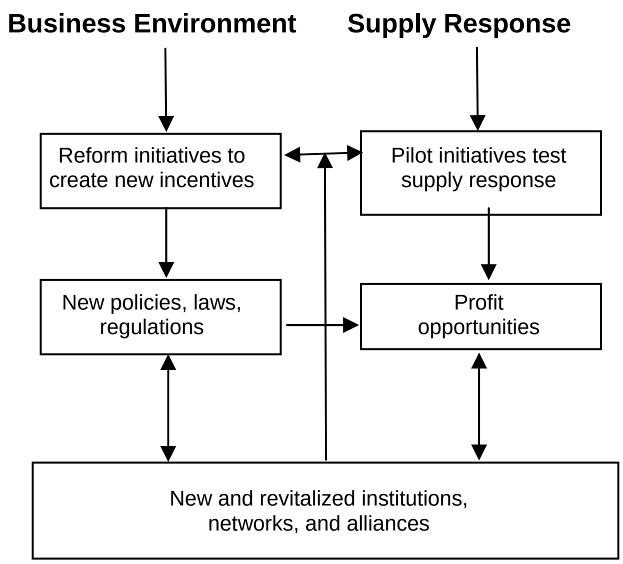
Use of Simultaneous Interventions in Program Design

Figure 8 illustrates how simultaneous interventions can promote economic reform and revitalization of low-growth economies. Working on the business environment and the private sector response, these interventions can help build needed institutional infrastructure, support public and private sector champions, and create profit opportunities for entrepreneurs through a process of rigorous experimentation that should achieve bottom-line results and sustainable commercial solutions.

Figure 8: Simultaneous Enterprise Interventions for Economic Growth

Business Environment Actions

- Analyze current business environment, incentives, institutions, and leverage points (baseline analysis).
- Establish benchmarks and indicators for anticipated results and impact of specific reform opportunities.
- Analyze results with relevant public and private sector leaders.
- Formalize and enforce policies, regulations, and laws that maximize profit opportunities.



Supply Response Actions

- With relevant local partners, launch pilot activities linked to specific policy initiatives and advocacy priorities of the private sector to test, analyze, and demonstrate the private sector supply response.
- Expand and replicate reforms that generate profitable opportunities for business.
- Support viable institutions, networks, and alliances among public and private institutions to create and sustain profit opportunities for enterprises.

The Agricultural Policy Reform Program in Egypt from 1997 to 2001 illustrates the utility of simultaneous intervention in difficult reform environments. It combined policy reform with experimentation through pilot activities to build support for policy change. Pilot activities were explicitly designed to test the impact of proposed policy changes by working directly with trade associations, enterprises, and public sector agencies. A separate Monitoring, Verification, and Evaluation Unit tracked 151 benchmarks and 242 indicators that measured the performance of critical inputs (such as land, water, seed, research, and extension) and products (such as cotton and rice) related to agricultural policies. The project achieved remarkable results through a rigorous process designed to measure the effect that policy changes on pricing, tariffs, and other factors would have on enterprises.

Another example of simultaneous intervention is the Market Access Program (MAP) in the Palestinian Territories. MAP has an explicit policy management component designed to reform policies and laws. The policy component was leveraged through two other components: an institution strengthening component, which worked with seven industry associations, a national trade promotion organization, and public-private partnerships, such as the Palestinian Standards Institute, to provide services to enterprises in growth industries; and a business services component, which designed and delivered cluster services through enterprise-related organizations to upgrade performance, harmonize production to global standards, and explore new market opportunities. These enterprise- and industry-level interventions provided valuable insights for policy makers and business leaders on how to reform laws, policies, and regulations, and how to build consensus in support of an emerging market economy.

In the examples of APRP and MAP, the projects had an explicit policy reform agenda. In many enterprise growth initiatives, particularly those that focus on market linkages and transactions, the policy component often does not exist or is not explicitly linked to rigorous experimentation in the marketplace. These projects also highlight the importance of the integrated market approach (Figure 7). Unless the initiative ultimately expands profit opportunities for enterprises and achieves improved value and added productivity, it is hard to build momentum among private and public sector stakeholders to support reforms aimed at improving the business environment.

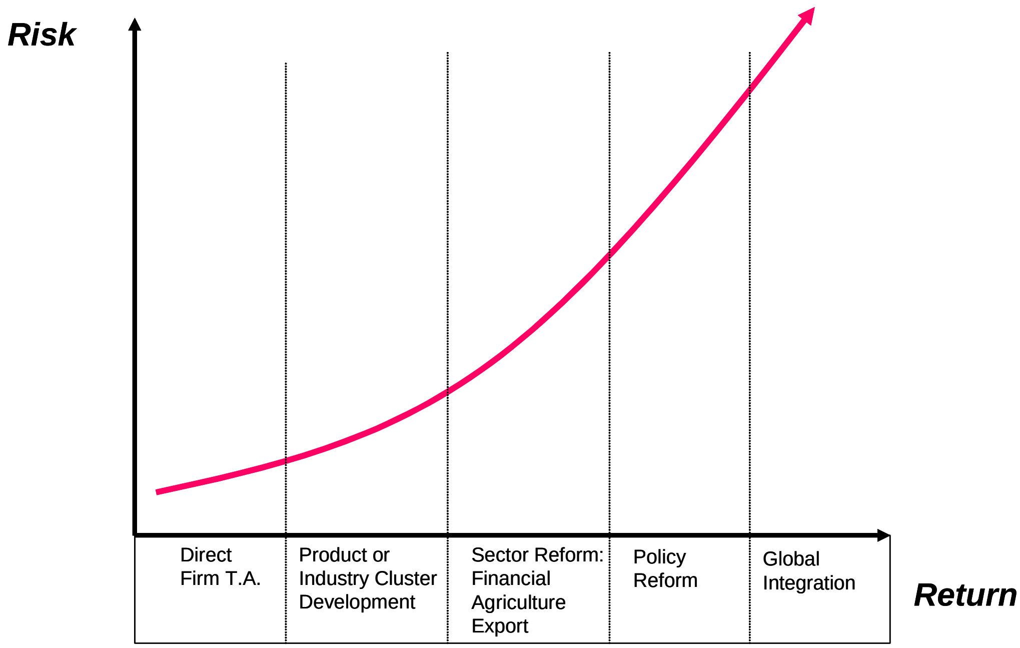
Maximizing Impact in Program Design

Evidence suggests that greater impact is achieved when larger numbers of enterprises are positively affected by enterprise growth initiatives. Figure 9 presents alternate types of interventions that constitute initiatives, as well as the anticipated impact of each class of intervention, which are defined here as the combined effect of risks and returns on individual enterprises and their aggregate.

In the past, the interventions in Figure 9 have been used sequentially, with adjustments and even reversion to lower risk and lower impact interventions to accommodate economic cycles and significant changes in the environment, such as war or recession. Increasingly, however, programs combine interventions to create greater opportunities for strategic impact. While combinations of interventions can increase program complexity and risk, the distinct and often complementary characteristics of each intervention generates important benefits, as follows:

Direct Firm-Level Technical Assistance. The lowest potential impact measured in terms of increased economic growth is attained through direct firm-level technical assistance that targets a limited number of firms. The projects evaluated in our review indicated that perhaps 300-500 enterprises may benefit from direct assistance in a given project. While these are important and measurable improvements, and the impact of this number of firms in a small economy such as the 3 million people in the Palestinian Territories can be significant, in large economies—such as Pakistan with 40 million people or Egypt with 60 million people—the impact is quite limited. Appropriately focused assistance to improve the performance of a strategic enterprise, such as the American Bank of Kosovo, can set a new standard for financial performance in the financial services industry and improve strategic financial services to large numbers of enterprises. Assistance to one banking enterprise can also set the stage for financial sector reform, which has a higher impact across the economy.

Figure 9: Maximizing Impact: Levels of Enterprise Growth Interventions



Firm-level technical assistance, while more costly than other interventions, can be the right choice in high-risk environments, such as conflict and post-conflict situations, and for positioning higher-impact activities that require strong partnerships between the public and private sector. Reform initiatives require champions, and donor projects can build the necessary trust and credibility by demonstrating bottom-line success at the enterprise level. Important positive externalities are achieved through firm-level assistance that can be leveraged in the next stages of enterprise growth initiatives for higher impact. Positive externalities of direct firm-level activities include:

- **Learning and experimentation** about what works and does not work at the enterprise level in the marketplace can inform policy makers about reforms in taxes, regulations, and other levers to improve performance;

- **Establishing credibility and building relationships** with key private sector leaders who pay attention to improvements in bottom line performance is crucial for the next stages of industry initiatives and policy reform. Reform requires champions who lead the change based on new incentives; and

- Piloting new reform initiatives or introducing new financial and business services or quality standards can create **demonstration effects** that proliferate in an industry and build momentum for reform.

These externalities are only valuable if donor agencies and project managers strategically leverage these valuable assets for higher impact at the next stages of an initiative.

Industry Cluster Initiatives. Many enterprise growth initiatives focus on a specific industry, commodity, or product with growth potential. Increased productivity of nontraditional agribusiness exports, such as cut flowers or processed seed oils, or growth industries such as automotive manufacturing or information technology where there are anchor investors such as General Motors or Intel, presents opportunities for impact. By working within value chains that include small producers, transporters, large processors and exporters, labor groups, trade associations, related research and development institutions, and universities, higher productivity is achieved through improved integration of previously fragmented industries. Often, critical policy issues such as intellectual property rights of plant material, cold storage facilities and services, trade agreements, quality standards, and tax incentives require collective action within the industry or value chain to improve performance. These initiatives work through cluster-based trade associations, public-private partnerships, and larger coalitions of interest groups to achieve greater impact when policies are harmonized to global standards to increase enterprise competitiveness at the national level.

Sector Initiatives. Improvements in strategic sectors of the economy, such as the financial sector or export-oriented sectors, can have far-reaching economic impact. The evaluations of financial initiatives indicate the importance of supporting more profitable, sustainable financial institutions within a more efficiently organized financial sector. This support requires important reform measures such as improved bank supervision and liberalization that encourages foreign investment and competition. Similarly, export and investment promotion requires changes in the policy environment as a prerequisite for improved performance of trade facilitation services, trade and investment promotion, and marketing activities.

Policy Reform. Policies that provide the private sector with new incentives increase sustained value-added productivity and have the greatest impact on enterprise growth. In an ideal world, government policies would automatically correct market failures. The right policies can provide the right incentives to change enterprise behavior to minimize rent seeking and maximize sustained value-added productivity.

Global Integration. Ultimately, effective integration into the global market will allow enterprises to achieve the greatest growth. This is not easily achieved for many countries without major shocks to major sectors of the economy that have been protected and cannot compete in an open market. The behind-the-border work to prepare enterprises, industries, and countries to understand competitive factors is crucial to reduce the risks and maximize the returns of global integration.

The challenge for enterprise growth initiatives is to achieve the highest impact in each stage and the most efficient overall performance over time.

GUIDING PRINCIPLES FOR ENTERPRISE INITIATIVES

Much can be learned from failed as well as successful enterprise interventions about how to best achieve impact. The following operating principles should underpin future enterprise interventions. Their active consideration will support achievement of program goals for increased enterprise productivity and economic growth.

Incentives Drive Behavior

Steven Landsburg captured a fundamental truth in *The Armchair Economist*: "People respond to incentives; everything else is commentary." The economic term "rent seeking" does not adequately grasp the entrenched interests, political power, informal agreements, corruption, and political relationships that dominate economic activity in many low-growth economies. Changing existing economic and business interests and incentives is particularly difficult when cronies and elites control political power.

To change behavior through new incentives, successful projects must segment the existing economic actors and relationships, analyze the incentives that drive existing behavior, and identify the progressive businesses and leaders who support and benefit from change. Raising profitability by increasing sales, reducing transaction costs, improving efficiency, tapping innovations and technologies, and eliminating unnecessary administrative and regulatory bottlenecks creates new incentives that change the behavior of firms. Successful project managers leverage profitable demand opportunities and identify enterprises that have the best opportunity to capitalize on new incentives.

Demand Creates Incentives and Profit Opportunities

Demand creates new profit opportunities for entrepreneurs. The term "supply response" does not do full justice to the dynamics of supply and demand in the marketplace. To many practitioners, it does not capture the global market issues that affect industries and firms in supply and demand dynamics. Practitioners often work within value or supply chains and focus on governance, transactions and deals, cooperation, and business strategy. Global trade, defined in each country by the terms of trade in bilateral and multilateral treaties and trade policy, creates the incentives that drive the dynamics for supply and demand markets in which enterprises operate. Projects that focus on production and supply rather than global market demand—defined here to include local, regional, and international markets—fail to reposition firms and industries to compete.

Key Policy Reforms Are Crucial to Creating New Profit Opportunities

Policy reform to improve the business environment has become common in development language. In reality, enterprises respond to opportunities to make profits. Enterprise behavior is rational to a fault, insofar as the business environment may be closed and conducive to rent seeking and monopolies that hinder growth. Interventions to stimulate profit opportunities should address commercially viable opportunities linked to demand. Without growth opportunities in product markets, development is neither sustainable nor sensible.

Enterprises—Not Policies or Reforms—Create Growth

The enterprise is the productive unit and much more: it is also a philosophy of private ownership, risking capital for reward, innovation, and rational behavior. The enterprise creates wealth, jobs, taxes, profits, and household incomes, as well as externalities. Businesspeople listen to suppliers, buyers, and investors because transactions are the source of profits and the basis for economic activity. Enterprises provide a reality check for the policies and regulations that provide incentives and discipline for firm behavior. All enterprise-related activities in the business environment should have an anchor in the private sector to "ground truth" economic reality, using business surveys, economic data generated through tax returns, company and other registration data, and rigorous experimentation.

Not All Constraints Are Equal

Donor projects often catalogue a huge range of constraints facing private business through investor roadmaps and business surveys, including materials on business skills, land tenure, finance, technology, government intervention, and so on. The critical constraints are often the lack of demand, or lack of understanding among entrepreneurs of how to identify market opportunities and exploit them. More importantly, constraints change in importance and impact over time, requiring flexibility to address constraints in a timely manner as market dynamics change over the life of the project.

Economic Informality Goes beyond Microenterprises

The development community often identifies the informal sector with microenterprises. In fact, informality operates at all levels of the economy, including micro and large firms, among entrepreneurs of opportunity and necessity, in response to lax enforcement, political expediency, corruption, and avoidance of onerous tax regimes, inspections, and government red tape. Reducing the level of informality at all levels of the economy, not just in the microenterprise sector, should be a major objective of enterprise interventions.

Dynamic Growth Is More Important than Focus on Firm Size

Limiting interventions according to firm size is an artificial donor prescription that does not reflect market dynamics or allow for flexible interventions to maximize leverage points in the marketplace. Supporting a key service or a lead firm in a value chain may achieve greater performance through the value chain and among microenterprises than a traditional program earmarked for microenterprises.

Competitiveness Initiatives Are Broader than Currently Defined

A wide range of project interventions serves to improve enterprise competitiveness. Every enterprise intervention should improve competitiveness. The tendency to label competitiveness initiatives as national competitiveness councils and cluster activities is artificial bureaucratic language that reflects a limited understanding of market dynamics and underestimates or undervalues many other tools to revitalize and improve productivity by creating new incentives. As with other interventions, many "competitiveness initiatives" fail to demonstrate relevance and value to enterprises. Successful interventions typically work at multiple levels (such as macroeconomic policy, industry clusters, and direct assistance to enterprises) and create more commercially viable services.

Markets Create Winners and Losers

Many economists argue that picking winners is a bad thing for enterprise projects. They point to the old industrial policies that invested millions of dollars in losing industries and companies. Markets create winners and losers, for better or for worse. If the business environment is protectionist, the market tends to choose relatively uncompetitive winners; if it is more open, the environment tends to create a dynamic churn effect that winnows out winners and losers. Donor intervention should be designed to support winners within a context of global competition. Supporting winners among enterprises and industries with growth potential is fundamental to establishing reward incentives for improved productivity.

Donor Bureaucracies Are Not Effective Managers of Enterprise Interventions

Governments, including donor organizations, do not have the incentives or risk-taking values to work effectively with the private sector. It is artificial for large bureaucracies to intervene in the markets to stimulate private sector risk-taking and entrepreneurial, dynamic growth. The World Bank and IDB are increasingly outsourcing enterprise interventions to private firms as more effective intervention agents.

Many projects designed by bureaucracies suffer from over-design and prescribe the input and output indicators too narrowly, rather than setting key objectives and indicators, such as increased jobs, sales, and enterprise growth, and allowing implementers the flexibility to seize market opportunities. Moreover, bureaucracies generally avoid recognizing failure. Institutional inertia seeks success stories and tends to muddle through mediocrity as long as careers are enhanced and enough success stories are generated. The absence of rigorous performance evaluation criteria and methodologies found in most project evaluations, and the limited resources allocated for effective performance monitoring, are symptoms of inadequate attention to strategic management of these complex programs. Therefore, sufficient resources should be included in enterprise projects for the effective monitoring and evaluation of project impact. Donors can then use this information for improved management and performance by project managers.

Strategic Subsidies Generate Multiplier Effects

Poorly conceived subsidies can result in adverse impacts such as crowding out commercial incentives and distorting markets. However, carefully positioned subsidies can improve access for financial and business services and create demand and income. Interventions to raise agricultural incomes create markets and demand for a host of products for SME response. Similarly, housing vouchers create demand for building material and, together with the development of the mortgage market, can jumpstart a residential housing market.

More Rigorous Experimentation Is Critical to Improve Performance

Without effective monitoring and evaluation systems, rigorous experimentation that leads to learning and improved performance is almost impossible. Most of the evaluation surveys reviewed are based on rapid appraisal techniques that are anecdotal, lack time series data, and fail to measure results and impact effectively. The lack of reliable and timely information makes it impossible for donors, implementers, and counterparts to make effective strategic decisions about where to invest to achieve the greatest impact, which activities to drop, and which to expand. The results approach, if too narrowly defined, runs the risk of squelching innovation in pilot activities that are often required to achieve breakthrough changes.

BEST PRACTICE RECOMMENDATIONS

At the program level, our review of donor efforts suggests a number of concrete best practices for the design and implementation of enterprise growth initiatives. Table 7 presents a range of considerations with particular attention to access to markets, capital, and services.

Table 7: Recommended Best Practices for Future Interventions

Project Design and Implementation	▪ **Project designs should not be overly prescriptive or micromanaged.** They should clearly define desired results and then manage implementers against defined performance milestones. This requires effective monitoring and evaluation systems that provide timely and reliable information for decision making. ▪ **Project designs should segment more clearly the private sector market** in order to identify progressive industries and business leaders, analyze leverage points for change through incentives derived from increased demand and profit opportunities, and define policy issues that create strong alliances and advocacy agendas among private sector groups. ▪ **Effective enterprise interventions require much stronger evaluation efforts that support more rigorous experimentation and innovation.** Proper evaluations can demonstrate the effectiveness of different interventions and improve the design and implementation of programs. This requires rigorous time series data collection efforts (baseline and life of project) on program inputs, activities, and results. ▪ **Donor programs should allocate sufficient resources for implementers to design adequate monitoring and evaluation (M&E) systems.** Some practitioners said USAID gave little priority to M&E, while other missions actually added money specifically to design M&E systems. It should be USAID policy that all projects have resources allocated for effective monitoring and reporting systems.

Access to Markets	▪ **Improving the business environment is a *sine qua non* for enterprise growth** and economic growth in all developing and transition countries. All enterprise development projects should include components designed to improve the general business environment and, if at all possible, address the needs of specific subsectors or clusters of firms. ▪ **In enterprise development there is no way to avoid picking winners**, but these decisions should be made by private parties that meet self-selecting criteria (willingness to take risks, make up-front investments, and share at least 50 percent of costs). ▪ **Donor agencies are bureaucracies that often do not understand commercial incentives and risk management imperatives** or respond effectively to them. Donors should not be implementers, but instead should strategically manage portfolios of interventions to improve both business environment and private sector supply response. ▪ **Effective enterprise development projects can have a significant impact in reforming institutions and making the governance of market economies transparent.** The effective leveraging of incentives through increased market entry and efforts to support collective action among trade associations and public-private partnerships can accelerate reform initiatives. ▪ **Enterprise interventions that reform and revitalize market institutions have a strong impact on democratic economic governance** reflected in: – rule of law that improves confidence among investors; – corporate governance that includes representative institutions (trade associations and public-private partnerships); – transparency that creates incentives for fair competition in procurement and decision making; and – economic democratization that gives more households, employees, and entrepreneurs a larger stake in the economy. ▪ **An integrated market approach incorporates increasing access to global markets, focusing on demand and profit opportunities locally, regionally, and internationally.** ▪ **Viable public-private partnerships** should include cost-sharing grant funds for undertaking research and development and acquiring state-of-the-art technology. ▪ **Market access is best improved** through policy reform initiatives linked to direct firm experimentation and testing to improve productivity, galvanize private sector support and cooperation, and create momentum and incentives for change. ▪ **Competitiveness initiatives should be broadened to include market and demand-driven interventions that increase productivity**. Donors should focus on outcomes that achieve growth objectives, rather than prescribing one implementation method (such as limiting activity to work with microenterprises or national competitiveness councils).
Access to Capital	▪ **Donors should focus on improving the productivity and innovative capacity of financial service providers** so that they can provide products and services specifically designed to fill the financing gap, using a mix of equity, debt, and skills development. ▪ **More innovative linkages should be made between financial products that increase access to markets** and business services to increase the productivity of enterprises for growth opportunities. Technical assistance to improve emerging growth enterprises and deal flow could be leveraged by working more closely with financial institutions. ▪ **Donor-sponsored initiatives should focus on improving the deal flow of viable or bankable enterprises** as well as providing more innovative financial services. More rigorous experimentation with business incubators, venture funds, and other innovative approaches is required. ▪ **Establishing technical assistance venture funds** in donor-supported projects and organizations that share risks with entrepreneurial service providers promotes demand-led services and brokers commercial transactions. ▪ **Strategic management of enterprise interventions requires timely and reliable information to make venture decisions about investments.** The most effective projects respond to market opportunities to achieve impact through commercial outcomes and avoid cookie-cutter approaches that focus on inputs.

Access to Business Services	▪ **Private brokers and service providers operating through performance contracts based on commercial incentives are best positioned to help growing enterprises.** ▪ **Donor support should stimulate new business services that improve trade, market entry, and productivity** for enterprises through commercial transactions. ▪ **Donors should require that demand-driven service programs include provisions for monitoring inputs and activities** (such as the number of local service providers, number of participants, fees paid for services) as well as for assessing program outcomes (increases in productivity, sales, and profitability). ▪ **Donors should not be direct providers of services.** The transaction costs are too high and their commercial relevance limited. ▪ **Projects should serve as brokers and facilitators for wholesale and retail business services.** Direct firm-level assistance should rely on local service providers whenever possible.

CONCLUSION: THE IMPERATIVE FOR CHANGE

This study concludes that enterprise growth and economic growth are integrally linked, a finding that in turn leads to important conclusions about the role of donor-financed enterprise growth initiatives in transforming poor countries into more competitive market economies.

Economic growth and enterprise growth are turbulent processes that operate within complex market dynamics. The private sector, directly affected by these market dynamics, has a major stake in addressing the challenges facing enterprises and the business environment that conditions their success.

But the private sector is no more monolithic in poor countries than it is in rich countries. Winners and losers emerge with every trade agreement, regulatory adjustment, and policy change. The battles in the United States during negotiation and lobbying around the North American Free Trade Agreement, for instance, demonstrated that the stakes are high for each industry, for each enterprise, and for the United States and its trading partners in the region. Economic policies are linked to political agendas. Certain constituencies such as trade associations or politicians representing special economic interests will advocate economic change, while other vested interests will strive to maintain a status quo that benefits them.

For any given country, economic growth initiatives must carefully analyze the country's private sector to identify and understand the structure, composition, and agendas of the various constituencies, industries, and enterprises within the economy. Change is needed to accelerate the growth of enterprises and the economy, but it does not occur easily. Enterprise growth initiatives must generate more incentives and direct profits for enterprises that support the transformation of the business environment and market institutions toward market economies. Without real demand and capabilities within enterprises to compete in markets, there may not be enough supporters for reform.

Even when there is strong leadership for change in the public sector, there are important reasons why the private sector should be a partner in economic governance. Representative and effective private sector institutions have their fingers on the pulse of economic reality. Private sector leaders know what is working and what is not, and they have a stake in advocating the policies, laws, and regulations that will shape a more favorable business environment. In addition, enterprises are social, economic, and political institutions. They provide jobs and household incomes, generate profits, pay taxes, and produce essential products and services. They wield great influence in people's daily lives. With the right incentives, the private sector can be a powerful force to support market economies and democratic societies.

With the exception of exporting firms, enterprises operating in protected and closed economies are less aware of the larger forces shaping the world economy. Such business environments generate high transaction costs for enterprises, limiting their ability to compete against enterprises operating in more favorable economies. The rent-seeking behavior that arises through "informality" in poorly performing countries is rational behavior, symptomatic of business environments with high transaction costs and inefficiencies for enterprises.

Enterprises are driven by the bottom line. If more enterprises can compete in markets characterized by growth in demand, the prospects are better for growth in profits, jobs, tax revenues, and increasing numbers of firms. The business environment is like a screen through which enterprises receive incentives to produce. Countries can no longer operate as isolated economies: the global economy offers huge demand opportunities and presents formidable competitive forces that affect enterprises in protected and isolated poor countries.

Enterprise growth initiatives are more important in the global economy than ever before. The recent political problems associated with negotiations in Cancun, Mexico, to further global trade agreements reflect the challenges facing both wealthy and poor countries. Unless we see more tangible benefits from global trade for larger segments of the peoples and enterprises in under-performing poor countries, the process of globalization will stall and create a larger divide between rich and poor countries. Given the crucial importance of enterprises in transforming and revitalizing poor countries, enterprise growth initiatives can play a major role in working with private and public sector leaders to transform their economies into competitive market economies on the global stage.