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ENTERPRISE SCALE,  
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AND DEVELOPMENT

Evidence on Policy Biases,  
Firm Size, Efficiency, and Growth

Robert C. Young

INTERNATIONAL  
CENTER FOR  
ECONOMIC GROWTH

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Firm Size, Efficiency, and Growth

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An International Center for Economic Growth Publication

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## ACRONYMS USED

AID	United States Agency for International Development
APRE	AID's former Bureau for Asia and Private Enterprise
DAI	Development Alternatives, Inc., Bethesda, MD, USA
DEVRES	DEVRES, Inc., Bethesda, MD, USA
EEPA	The Employment and Enterprise Policy Analysis Project (prime contractor: HIID; subcontractors: DAI & MSU)
GDP	Gross Domestic Product, a measure of national income
GEMINI	An AID-funded DAI microenterprise project
GNP	Gross National Product, another measure of national income
HIID	Harvard Institute for International Development (Cambridge, Massachusetts, USA)
IFAD	International Fund for Agricultural Development, Rome, Italy
ILO	International Labor Organization, Geneva, Switzerland
ITDG	Intermediate Technology Development Group, London, UK
MSU	Michigan State University, East Lansing, MI, USA
NGO	Non-Governmental Organization
OECD	Organization for Economic Cooperation and Development, Paris, France
PVO	Private Voluntary Organization
R&D	Research and Development
SMIE	The Small, Micro and Informal Enterprise Office of AID
SMEs	Small and Medium Enterprises
SSEs	Small Scale Enterprises
UNDP	United Nations Development Program, New York, New York
UNIDO	United Nations Industrial Development Organization, Vienna, Austria
USA	United States of America
USAID	See: AID
USDOL	United States Department of Labor, Washington, D.C.

## PREFACE

The International Center for Economic Growth is pleased to publish *Enterprise Scale, Economic Policy, and Development* as the fifty-second in our series of Occasional Papers, which feature reflections on broad policy issues by noted scholars and policy makers.

In this paper Robert C. Young discusses evidence on the role and efficiency of the small-scale business sector. Small-scale enterprises, or SSEs, are most efficient in traditional, labor-intensive industries in less industrialized countries, where they provide essential, although often small, incomes for the poor. As nations industrialize, medium- and large-scale enterprises generally become more efficient. In some cases, however, small firms retain efficiency, despite agricultural, financial, and trade policies that are biased against them. Such biases may even offset the positive effects of direct credit or technical support to small businesses.

Young explains how government policies frequently direct resources prematurely into large-scale manufacturing, shortcutting the gradual evolution of firms from small to medium sizes (and perhaps eventually to large). This creates a “missing middle,” or a shortage of modern, complex, and efficient mid-scale businesses, which would also provide a more politically stable industrial structure.

The author points out the dramatic contrast between the success stories of Taiwan and South Korea. Taiwan is distinguished by its small- and medium-scale enterprises, while conglomerates predominate in South Korea. Big companies enjoy the obvious advantages of scale and easier access to credit, technology, markets, expertise, and foreign exchange. Small-scale enterprises, however, have worked well not only

for Taiwan but for Japan and Hong Kong and are critical to the survival and development of the less-industrialized world.

The author concludes that small and medium enterprises should be encouraged as a complement to large industry by removing undue policy constraints and biases. He recommends that policy reform leading to an optimum mix of businesses of different sizes be pursued through collaboration among donor country, host country, and the public, private, and academic sectors, as well as labor groups and nongovernment organizations.

Robert Young has studied micro, small, and informal enterprise issues for more than twenty years. Young's synthesis of material on small-scale enterprises, drawn largely from the Employment and Enterprise Policy Analysis Project of the United States Agency for International Development, as well as other sources, will prove a valuable resource to those exploring the role of scale in economic development.

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International Center for Economic Growth

Panama City, Panama  
March 1994

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Robert C. Young has been an adviser to the U.S. Agency for International Development, on detail from the U.S. Department of Labor, since 1979. At the time he authored the present paper, Mr. Young was in USAID's Bureau for Private Enterprise and Office for Small, Micro, and Informal Enterprise. Mr. Young recently moved to USAID's Bureau for Africa, Office for Analysis, Research and Technical Support, Division for Economic Analysis. His publications have dealt with issues relating to health, manpower, economic policy, and small enterprise development. Mr. Young has also worked for the International Labor Organization, the Ohio State University, and the Ford Foundation. He received his Ph.D. in economics from Indiana University.

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Robert C. Young  
USAID/USDOL

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# **Enterprise Scale, Economic Policy, and Development**

## **Evidence on Policy Biases, Firm Size, Efficiency, and Growth**

### **Overview**

In the process of industrial transformation, medium- and large-scale enterprises are often more efficient than the small. This is particularly true in more advanced stages of development and in sectors with complex and indivisible technologies. Yet, in both less- and more-industrialized countries, there are important and complementary linkages between small and larger firms.

Because of both their employment and productivity, small enterprises are vital to development. While small is not always beautiful, small firms are often more efficient in total resource use than the larger ones, most notably in sectors where the small predominate. Moreover, small enterprises are often efficient despite policies that are biased against them, particularly agricultural, financial, and trade policies. Such biases often limit the small firms' viability, growth into larger enterprises, and contributions to national income.

There are no policy panaceas. Nevertheless, substantial evidence is examined and important patterns do appear. In countries with the lowest incomes and untapped agricultural potential, reform of agricultural policies often must receive top billing, due to the policies' potential

impacts on macroeconomic efficiency, economic growth, and small enterprises. Where incomes are above \$500 per capita, other trade and industrial policies become increasingly important. Additional policy guidelines are discussed, including those for a small- and medium-scale emphasis, a conglomerate emphasis, the soft state, and Africa.

Policy reforms conducive to more-efficient small enterprises, to a more dynamic industrial structure, and to broad-based economic growth are outlined and should be pursued through donor, host country, and public, private, labor, NGO/PVO, and academic sector collaboration.

### **Industrial Transformation and Small Enterprise**

Rapid growth with considerable equity is possible with a large-enterprise emphasis, as dramatically illustrated by South Korea. Large firms humble the small in appearance, are impressive political symbols, and dramatically demonstrate apparent benefits of large enterprises as the means to growth. Bigger enterprises have relatively more access to the credit, technology, markets, and expertise needed for development. Moreover, large firms have the advantage of economies of scale and an impressive potential ability to earn precious foreign exchange. Whether they always use their impressive resources more efficiently in developing economies is another matter.

Although small-scale enterprises (SSEs) are not universally acclaimed, in the less-industrialized world's struggle for survival and development, SSEs are critical. As many as a billion or so very poor workers may own or work in such firms.<sup>1</sup> In the words of an International Labor Organization report from the late 1970s:

for the greater part of the poverty group the small enterprise is the only activity in which they can usefully hope to be engaged, particularly in the immediate future.<sup>2</sup>

Small enterprises have been widely assumed to offer significant development potential. The small-scale sector played an important role in classic development success stories—for example, Japan, Taiwan, and Hong Kong—and, incidentally, continues to be important in developed

economies.<sup>3</sup> As stated in a popular development economics text, it was hoped that SSEs would “generate more employment, permit greater decentralization, promote income equalization, and mobilize latent entrepreneurs.”<sup>4</sup>

This paper reviews important evidence on the role of the small-scale sector, its relative efficiency and interactions with the larger-scale enterprises, and policy biases inhibiting the development and efficient evolution of the small-scale sector in industrial development.

### **The Importance of Policy Analysis for Efficient Enterprise Scale and Development**

There is widespread agreement that appropriate policies are a vital, necessary, but not sufficient part of any effective development strategy. The World Bank has proposed two equally important elements in its strategy for sustainable development. The first is to “promote the productive use of the poor’s most abundant asset—labor” (the second: basic social services for the poor). “Policies that harness market incentives” are central to that first element. Similar chords may be heard in other literature: United Nations Development Program (UNDP) *Human Development Report 1990*, for example, refers to “much controversy on the appropriate policy environment,” but also refers to the “modicum of agreement” concerning the “essentials for equitable growth,” which relate well to policies with which the World Bank and USAID would feel quite comfortable, including “sensible and flexible use of prices to reflect opportunity costs,” the “opening of market systems,” and “supportive policies towards investment, technology and human resources.” Similar basic concerns with a less biased policy framework may be found in the International Fund for Agricultural Development’s 1992 report on *The State of World Rural Poverty*: “Reduce tax and expenditure biases . . . reduce distortion in product and factor markets . . . eliminate biases of financial institutions against the rural poor” . . .<sup>5</sup>

Though there is a strong empirical argument for assuring that the policy environment supports broad-based economic growth, that concern should include the impact of the policies upon the distribution of

enterprises by scale. For instance, although the World Bank, UNDP, IFAD, ILO, the PVO/NGO communities, and many governments recognize the important role that may be played by small enterprises, heavy demands upon scarce development resources preclude providing direct assistance to the vast majority of them. Nevertheless, providing an improved policy climate and removing undue policy constraints can support the majority of SSEs.

In this vein, analysts have known for some time that the policy environment for SSEs should be a healthy one, lest the efficiency of the sector be lost and the economy as a whole be crippled.<sup>6</sup> To alleviate this concern, a priority for such policy reform was recently reaffirmed by an OECD seminar on the informal sector:

As for how to intervene, the analysis suggested that donors should prioritize their actions first to sort out policy-related problems, improve effectiveness and efficiency of institutions, and lastly to focus on direct, supply-side support.<sup>7</sup>

As late as the early 1980s, however, little research had focused on the impact of policies on SSEs or the dynamics of SSEs through the long-term development process.

To improve understanding of the relationship between policies and small and medium enterprises (SMEs) in development, and building upon a program of research on SSEs,<sup>8</sup> USAID established the Employment and Enterprise Policy Analysis (EEPA) Project. This project's objectives were to

- analyze
  - policy constraints upon the small-scale sector
  - policy climates conducive to the efficient development of small and medium enterprises in a macro, long-term, and broad-based industrialization process
  - tactics for the political economy of policy reform
- participate in related technical cooperation
- disseminate the project's findings

To guide this program, the Harvard Institute for International Development (HIID), with a distinguished history of policy analysis in developing countries, was selected as the prime contractor. HIID subcontracted with Michigan State University (MSU) and Development Alternatives, Incorporated (DAI), to mobilize their extensive experience in analyzing the economics of small enterprises.

To limit the scope to resources available, the project focused on the impact of policies on manufacturing enterprises, analyzing that sector by scale, defined by number of employees. The manufacturing emphasis was determined by manufacturing's unusually important role in development, such as in technology and productivity improvements and the earning of critical foreign exchange. This sector's growth invariably appears to accompany any successful increase in status from a low- to high-income country. Although services too are clearly important in the industrial transformation, for they also increase in relative importance, research appears to demonstrate their dependence on manufacturing, rather than vice versa.

### **Small and Medium Enterprises in the Industrial Transformation**

**Dynamic and Cross-Sectional Perspectives.** Although small enterprises typically are pervasive in both developing and developed countries, their relative importance changes over the course of economic development. The longer-term evolution of the distribution of manufacturing (also referred to in this discussion as "industry") enterprises by scale was reaffirmed early in EEPA's research.<sup>9</sup> Both cross-sectional and time series data confirmed that industrial enterprise scale increases with development and that a general pattern appeared in industrial transformations:<sup>10</sup>

- Cottage-shop manufacturing (in microenterprises, with one to four workers) predominates in the low-income countries (roughly, up to \$500 in per capita national income).
- Small- and medium-scale workshops (five to ninety-nine workers) are dominant in the emerging economies (roughly, \$501 to \$1,000 in per capita GDP).

- Large-scale firms (100 or more workers) prevail in the more advanced countries (over \$2,000), displacing the cottage-shop and most of the workshop and small factory enterprises.

This increase in average firm size along with national economic development is due to two primary phenomena. First, on the supply side, in more-developed countries, economies of scale (for example, technology, marketing, and access to influence and information) can more readily be achieved and thus provide an impetus to growth. These economies are supported by the integration of national markets through declining transport and communication costs, which undercut the natural protection favoring SSEs in less complex economies.

The second phenomenon raising the average firm size, this one on the demand side, is the shift in the pattern of aggregate demand over the course of development to one weighted more heavily toward industries dominated by capital-intensive and large-scale enterprises. In other words, as examples, the share of national income spent on food and clothing declines relative to the share going to steel, transportation equipment, and petrochemicals.<sup>11</sup>

Yet, for a variety of reasons, relatively inclusive information on the smallest enterprises is often inaccurate or not available, one reason being that small enterprises frequently are not included in standard industrial data reporting systems; moreover, their prevalence is often underestimated. Many are located in relatively remote rural areas, but whether urban or rural, they are commonly so small that they are not obvious to the casual observer, often being located in the home and not visible from the street or the village path.

To overcome the inadequate database and thus understand with more precision the role of SSEs as growth proceeds, a number of detailed cross-sectional surveys were carried out in developing countries. Their broad conclusions were as follows:

- Small firms (less than fifty workers) were a significant and frequently dominant (in terms of employment) component of the industrial sector (in thirteen of fourteen countries, with the SSEs generating an average of 71 percent of manufacturing employment).

- Most of the small-firm employment was located at the smallest end of the industrial spectrum; for example, detailed data revealed that in five of seven countries surveyed (Bangladesh, India, Sierra Leone, Zambia, Honduras, Egypt, and Jamaica), more than half of SSE employment was in one-person firms and 85 percent or more of firms employed fewer than six workers.
- This importance of SSEs for employment creation is related to per capita national income, with their contribution being more prominent at the lower end of the distribution of national per capita incomes.
- SSEs contributed handsomely to value-added in manufacturing (37 percent in seven countries for which data were available)
- On the other hand, SSEs contributed a relatively small but significant share of total national income (2.9 to 8.2 percent in the seven countries mentioned above) because of the small share of manufacturing in GNP.<sup>12</sup>

**Transformation at the Firm Level: The Birth, Growth, Death, and Phoenixlike Rebirth of SSEs.**<sup>13</sup> Although, as discussed above, the pattern of what happens to SSEs at the macro level over the long term is relatively clear, their microdynamics over the medium term is much less clear, with very little pertinent data available. Birth rates per year (ratio: new firms/existing firms) in the three countries for which data are available ranged from 8 percent (Colombia and the United States) to 12 percent (Sierra Leone). For new firms, roughly three-quarters were microenterprises (India and Philippines data). Births appear to be positively related to the demand for these firms' commodities, but also partially related to the weak demand for labor in other sectors, so that some of the smallest enterprises represent "labor sponges" during periods of hardship (see "'Hard' and 'Soft' Employment").

Mortality rates appear to be highest for the smallest firms and lowest for the larger firms, as one would expect, and mortality rates are also the highest during the first three to four years of a firm's existence, after

which the probability of survival is substantially enhanced. A strong negative relationship between a firm's age and mortality rate is characteristic of both developed and developing countries. Mortality data, however, must be interpreted cautiously: in one instance 20 percent of firms reported as moribund had simply moved. Moreover, the death of some firms simply is part of a phoenixlike rebirth through the learning process as entrepreneurs move on to better opportunities, taking with them lessons of earlier ventures. In Taiwan, for example, industries with the highest productivity growth rates also had the highest entry/exit turnover rates.<sup>14</sup>

Only scant data exist on what happens to individual firms over time in developing countries. The available evidence suggests that the modest "graduation rate" of microenterprises into small, medium, and large firms yields only a minority of medium and large businesses with origins among the very small. This rather low average graduation rate varies substantially among countries, being relatively high in India, with its heavy support for small business. Africa's generally low graduation rate appeared partially caused by an "entrepreneurial bottleneck," a deficiency in indigenous enterprise management performance for those firms with more than ten workers. The low overall rate also appears related to the "missing middle" in the distribution of employment by enterprise scale discussed later. Possible prejudicial consequences of this gap for economic growth are discussed in the policy section along with possible policy-related determinants. In any case, a moderately low graduation rate may not be as alarming as it might appear: given the large number of microenterprises, the graduation of a majority to "large" status would not be necessary to generate a dynamic economy.

**"Hard" and "Soft" Employment.** In examining employment in small firms at different levels of development, EEPA's distinction between "hard" and "soft" employment is useful.<sup>15</sup> Basically, "soft" employment refers to "supply driven" job creation, that is, people driven to look for or create new jobs, even with low incomes, as a result of unemployment or underemployment (very marginal incomes) in their former jobs. These jobs may be considered "dead-end traps . . . characterized by low levels of economic efficiency."<sup>16</sup> "Hard" employment refers to "demand driven" job creation, jobs created as a result of people



being drawn into high-productivity and high-income sectors as a result of higher-level technologies, new markets, or other innovations.

This “soft”/“hard” distinction is pertinent to our small/large discussion because much of the employment in the small-scale firms and particularly microenterprises of many very low income developing economies is of the soft variety. Moreover, the low incomes and productivity of these soft jobs, like the wage gap between small and large enterprises, are to an important extent determined in segmented labor markets created by misconceived policies.<sup>17</sup>

More specifically, soft jobs are those jobs such as microscale self- and solely-employed vegetable vendors, shoerepairpersons, or newspaper and magazine hawkers, who hold their very low income jobs only out of desperation. Expansion of employment in the soft sector is often not a sign of economic health but of stagnation. Thus, one must look beyond raw employment statistics to the quality of the jobs involved. Where the expansion reflects hard employment, is demand driven, and involves relatively well-paid and productive jobs, a healthy growth process is underway. The converse generally is true where employment growth reflects predominantly soft jobs. This brings us to the question of whether small firms are, in general, efficient.

**Enterprise Efficiency, by Scale and Sector.** Small is beautiful . . . sometimes! But so are medium and large . . . sometimes. It all depends on the enterprise and sector. The smallest enterprises (particularly, those with merely one worker<sup>18</sup>), however, are rarely the most beautiful in terms of their productivity per worker. The evidence is difficult to interpret and may appear superficially contradictory.

EEPA's MSU subcontractor conducted in-depth field surveys using comprehensive efficiency measures that include both labor and capital costs and a social benefit-cost approach. MSU's findings were that, indeed, in those economic sectors where SSEs are most prevalent in numbers, small enterprises were the most efficient. More precisely, “there appears to be a direct relationship between efficiency and firm size for the micro and small enterprise size categories.”<sup>19</sup> In the four countries for which such data are available (Jamaica, Honduras, Egypt, and Sierra Leone), on average one-worker firms were yielding very low returns per hour of labor (substantially less than US\$1.00) and zero or