New Perspectives on Financing Small Business in Developing Countries

EDITED BY
ERNST A. BRUGGER &
SARATH RAJAPATIRANA

INTERNATIONAL CENTER FOR ECONOMIC GROWTH

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Edited by
Ernst A. Brugger
Sarath Rajapatirana

Coordinated by
Hanna Davidshofer

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PREFACE

In recent years, both policy makers and scholars have turned increasing attention to the role of small enterprises in development. Small enterprises are important for reasons relating to both efficiency and equity. Their efficiency is evident in their capacity for innovation, their labor-intensive production methods, and their resource utilization. Small enterprises also extend the benefits of development to the poorest groups, ensuring that they participate in the benefits of economic and social progress.

Among all of the problems facing small enterprises in developing countries, finance stands out as one of the most serious. Despite considerable work done on theoretical issues, a substantial need exists to increase understanding of practical issues related to the market-based mechanisms that will increase the availability of credit for small enterprises and to the enabling environments that will encourage creation and expansion of those mechanisms.

In October 1992, the Latin American Technical Department of the World Bank and the Fundación para el Desarrollo Sostenible (FUNDES) jointly sponsored a workshop in Washington, D.C., and invited an international group of specialists in this field to address these issues. The papers collected in this volume include those given at the workshop, together with some selected additions.

The papers address the whole range of issues related to finance, from the macro-policy environment to discussion of specific financial instruments to consideration of particular issues such as measures for reducing transaction costs of lending to small enterprises and measures for reducing information problems.

The authors do not all speak with a single voice; these papers reflect agreements on certain basic issues and then present a range of opinion in areas where debate continues. They share a common agreement, however, on the need to eliminate the many policy biases that continue to exist against small enterprises in many countries.

Small enterprise is an issue of great importance for the International Center for Economic Growth. We are grateful to FUNDES for the opportunity to publish this work, which we think will provide a valuable tool for both policy makers and practitioners working on this important issue in all developing countries.

Panama City, Panama
May 1995

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

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Sarath Rajapatirana

Issues in Financing Small Enterprises in Developing Countries

Economists have long noted the problems that small enterprises face in obtaining credit in formal credit markets. This has led some to argue that these arise from imperfections in credit markets and that government intervention is necessary to meet the credit needs of small enterprises. State funding for such enterprises has been the basic response as little incipient grassroots private sector financing has been available. It is now well known that state programs often create their own distortions. Equally, private sector financing is dogged by lack of property rights, inadequate collateral, and insufficient information to evaluate credit risks. Consequently, there is a dearth of intermediation between savers and small enterprises.

While there has been increasing focus on the theoretical issues that pertain to supply of credit, there is little understanding of how the credit markets actually work and even less understanding of the institutional issues that affect small enterprise credit. Meanwhile, in most developing countries there has been greater appreciation of the debilitating effects of financial repression, and policy environments have been reformed to permit more market-determined interest rates, reduced inflation rates, and more realistic exchange rates. Nevertheless, there has been hardly any discussion of the institutional aspects of small enterprise finance and even less appreciation of market-based mechanisms to meet the challenge of providing adequate credit.

To address the issues, obstacles, and challenges in this area, as well as to report on the new institutional arrangements relating to the financing of small enterprises, this book presents the elements of programs that have been successful in addressing the credit needs of small enterprises and strives to show how to create the most conducive environment for such programs to take place.

The authors of the articles in this publication do not give the same answers to the central questions posed. In this respect, the book reflects the diversity of the development policy dialogue, which represents a concerted attempt to find better—for example, more effective—solutions to development problems. Despite their differences of opinion, however, there are several fundamental lessons to be learned from the past about which the authors are unanimous.

In Part I, Bernhard Fischer, Eduardo Lizano, Luis Mesalles, and Fernando Romero identify basic conceptual and thematic insights. First, they reiterate the basic theoretical arguments for intervention in support of small enterprises. A major argument in favor of small enterprises has been based on their positive externalities and public good characteristics generated by their labor-intensive techniques of production, greater efficiency in resource utilization, and higher rates of innovation. Another rationale for intervention has been market failure in credit markets that could arise for a variety of reasons—for example, imperfect competition, asymmetric information, adverse selection, the inadequate delineation and enforcement of property rights, or the higher transaction costs involved in lending to small enterprises. More importantly, however, policy-induced biases against small enterprises need to be offset. Such biases might be manifested in high inflation, protectionism, and financial repression. High and volatile inflation not only inhibits the supply of credit generally but also compels the financial market to concentrate on the short term. This works to the larger detriment of small enterprises because of their greater shortage of and need for investment capital. Protectionist trade policies also benefit large enterprises as these are concentrated in industries that are typically the beneficiaries of protection. Financial repression arising from interest rate controls biases credit allocation toward well-established large enterprises, as lending to small enterprises is commercially viable only at very high rates that are precluded by such controls.

A primary reason for the limited access of small enterprises to formal credit markets is the high transaction costs for the financial institutions given the small size of the loans. Other reasons relate to the absence of borrower credit history or track record, the riskiness of small enterprise projects, asymmetric information, and the lack of adequate collateral. Lack of collateral comes from the poverty of the borrowers, the labor-intensity of activity, the low value of their machinery and equipment, which is often secondhand, and inadequate property rights.

While the focus is the problem of inadequate financing available to small enterprises, this is hardly the only obstacle before them. Small enterprises also incur higher costs of production reflecting their inability to reap scale economies, higher risks and negotiating costs, and higher management costs. Moreover, small enterprises face market-related constraints. Market problems may exist because of low domestic demand due to low growth and lack of access to distributional channels. Markets may also be small, especially if trade liberalization is not linked to financial liberalization. Oligopolistic markets, too, may preclude small enterprises from achieving their earnings potential. And, as mentioned earlier, policy-induced biases also work against small enterprises.

Part II of the book is devoted largely to the body of practical experience gathered. The central question here is: What form should measures to enhance the access of small enterprises to formal credit markets take for them to have a realistic chance of success?

While Elisabeth Rhyne and María Otero, Doug Salloum, and Richard M. Hook examine the credit market for microbusiness, Nanno D. Kleiterp and Eckart Oehring look at the problems typically faced by small businesses and the opportunities open to them. Marguerite S. Robinson completes the picture with her study of the elementary significance of saving for investment. The results can be summarized in six sections:

First, an enabling environment is essential for success. This relates to macroeconomic stabilization, financial liberalization, incentive reforms, and legal, regulatory, and prudential reforms. In particular, increased competition among lenders should be encouraged through financial liberalization and a reform of the incentive structure. This can be brought about by abolishing restrictions on bank activities, allowing the entry of foreign banks, removing interest rate controls, eliminating subsidized credit, and privatizing government-owned financial institutions. This would increase the supply of credit for small enterprises at more competitive rates. Legal reforms should include better delineation and enforcement of property rights. Regulatory and prudential reforms should not only guarantee the security of deposits but also move to correct existing regulation-induced biases that promote large customer lending in banks' portfolios.

Second, lending should be on a commercial basis, and borrowers should be charged the market rate of interest. This alone can generate the right type of incentives and opportunities. It also emphasizes profit as the key to success. The experiences of BancoSol in Bolivia and the Unit Desa program in Indonesia have conclusively shown that lending to small enterprises on a commercial basis is a viable proposition.

Third, credit guarantee schemes can be effectively used to provide small businesspeople with the collateral they need to become fully creditworthy. These should, however, ensure that the guarantees only be granted to financially sound projects and companies and that the guarantee schemes should have complementary programs that provide training, professional advice, and other services.

Fourth, although loan financing is normally emphasized when examining financing for small enterprises, alternative and innovative methods of financing should also be promoted. These include credit cards, leasing, suppliers' credit, and equity financing. Credit cards can provide financing for working capital while, at the same time, helping small businesses keep their accounting records in order. Moreover, when property rights are ambiguous or collateral is scarce, leasing and hire purchase practices can also provide an attractive alternative to the purchase of machinery by small enterprises, as in the case of Chile. These can resolve part of the problems associated with poor quality loan guarantees and are also important solutions to the information problems that are endemic to the financing of small enterprises. The system of suppliers' credit has also worked well, even in chaotic macroeconomic settings such as Brazil's, in enhancing loan security and reputations. Equity financing may be more appropriate, especially for start-up firms.

Fifth, measures to reduce transaction costs might include (1) knowledge of clientele and business that replaces credit analysis or collaterals, (2) loans in a communal setting using loss of reputation as a deterrent to defaults, (3) loan logistics to ensure actual investment and better recoveries, and (4) linking bank staff salaries to the collection records of clients.

Sixth, to overcome the informational problems faced by small enterprises, support mechanisms and direct programs can be set up to improve the entrepreneurial, financial, and administrative skills of the small enterprises. This can be done, for example, through training programs, professional advisory services, the dissemination of banking information and procedures, and better communication between banks and small enterprises. With respect to the latter, publicly owned banks should be provided with information about the special characteristics of small enterprises and trained to handle new procedures to be applied to small enterprises.

What small businesses need is "not development aid but business-like partnership." In Part III (conclusion), Ernst A. Brugger captures the quintessence of the findings about the role of the state. All the authors are circumspect about the interventionist role to be played by the government. While there may be a case for infant industry protection in the financial sector, this does not imply an implicit subsidy but rather a one-time offset to provide information and institutional know-how, process loans, and cover first-time lending risks. More importantly, the government should concentrate on its fundamental functions in providing an appropriate macroeconomic environment, ensuring property rights, and enforcing contracts. However, greater activism was sought from the World Bank and the international community in documenting and disseminating successful credit extension programs for small enterprises and for using their policy dialogue with countries to bring about changes in the regulatory environment and the macroeconomic framework.

Economists and noneconomists alike who are interested in this vital area of concern to developing countries will find in this volume the actual experiences of practitioners rather than a review of theories of finance or resource allocation. This should facilitate a better understanding of the realities of the problem of financing small enterprises and by that induce a faster resolution of the problem.

Part One

The Conceptual Framework

Bernhard Fischer Chapter 1

The Basic Problem in Financing Small Businesses

A discussion of issues in financing small enterprises (SEs) in developing countries should take into account that small enterprises are homogeneous only as a notional construct. In reality they consist of numerous types and display different characteristics, comprising such diversely organized activities as household production, handicrafts, artisans, cottage production, and small maintenance and repair units, as well as fairly sophisticated technologically advanced manufacturing enterprises. These activities are located in either rural or urban areas, are continuous or only temporary in nature, and may be classified as belonging to either the formal or informal sector of an economy. The financing problems not only differ according to the characteristics of the small establishment but also vary depending on the stage of development, country-specific socioeconomic conditions, the existing policy framework, the type of capital required (seed corn capital, fixed assets, or working capital), and the complexity of the financial system. The following attempt to build up a conceptual framework in respect to the financing problems of and the assistance to small enterprises in developing countries has necessarily to abstract from many aspects those that may be most relevant in reality.

The role of financial systems in development has been comprehensively discussed in the *World Development Report 1989* (World Bank 1989). Chapter 8, which deals with the financing problems of small-scale producers and enterprises, concludes by saying that governments have underestimated the difficulties of supplying services to this sector and "that government programs have benefitted the few people fortunate enough to receive cheap credit, but in general they have failed to reduce costs or to facilitate the transfer of resources from those with surplus funds to those who can make use of them or to promote viable financial institutions" (121). Despite these unsatisfactory results, bi- and multilateral donors have continued to launch support programs for small enterprises in many developing countries.

The proponents of supporting small enterprises emphasize the supposed characteristics of SEs, policy-induced biases in product and factor markets, and, in particular, lack of access to institutional credit as a rationale for specific assistance programs. Some of these justifications have been increasingly challenged by analytical and empirical evidence. In particular, lack of access to institutional credit as the major impediment to the growth of SEs might have been somewhat overemphasized in the past, taking into account the close interrelationship among entrepreneurial ability, asset accumulation, and creditworthiness. The relatively unsatisfactory results of direct assistance programs seem to reflect these reservations. Strengthening competition in the formal financial sector and improving the business environment by reducing institutional biases against SEs are suggested as important and hitherto rather neglected policy areas to support the small-scale sector in developing countries.

The Rationale for Supporting Small Enterprises (SEs)

Three types of arguments have been put forward by the proponents of supporting SEs: first, the supposed characteristics of SEs; second, the need to compensate for policy-induced distortions in product and factor markets working against SEs; and, third, market failure, in particular of credit markets.

The Supposed Characteristics of SEs

There is a long-standing controversy about the relative merits of the small-scale sector compared to large enterprises (LEs) in developing (and industrial) countries. A number of characteristics and functions in economic development have been attributed to SEs, making them important in development strategies. SEs are considered to have advantage over large-scale establishments because:

1. SEs are labor-intensive and use relatively simple techniques of production that correspond to the abundance of labor and the