Promoting Change

Small Business Reform and the Multilateral Investment Fund

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The views expressed in this report are the author's and do not necessarily reflect those of the Multilateral Investment Fund

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Chapter 1: Introduction

In spite of widespread structural reform in Latin America and the Caribbean, growth remains disappointing and there are still few signs of the increased prosperity that some hoped would occur. In the decade following reform, with a few exceptions, the growth rates of most countries have been modest, at best. Trade reform brought the harsh winds of foreign competition but in many cases, the benefits of more efficient local businesses did not follow. Disillusionment is widespread and as a result many countries have slowed down or even reversed liberalization. Financial market reform has meant that economies are subject to large inflows and outflows of capital which have resulted in substantial exchange rate movements or, in the case of tied currencies, large internal adjustments. Yet local financial markets have not evolved and small domestic firms still have virtually no access to credit.

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Policymakers have become increasingly anxious about how to generate the growth necessary to alleviate the poverty of the large number of poor in most countries in the region. Furthermore, they are facing pressures to "do something." Election results in some countries in the region have demonstrated the unpopularity of reform. Political pressures for relief from intensified competition have grown. However, policymakers face the inescapable judgments of the global economy regarding any measures that they introduce. Ecuador and Venezuela are salutary examples of the consequences of policy reversal. Both attempted to role back their reform programs but instead of improving the situation, both countries suffered high inflation and large declines in GDP. As many policymakers have come to realize, the reality of globalization is that markets are increasingly integrated and there is no way back to the inward looking policies of the past. Capital markets, mindful of past defaults in the region and concerned about the increased country risk, judge harshly any attempts to return to the inward oriented policies of the past. The result has been a flight of both domestic and international capital, which has put great pressure on banking systems of countries that are seen to be backsliding.

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The reason for the low growth of the past decade is that in most countries broadly based private sector development has not taken place. In particular, the widespread participation of smaller firms, which is the key to spreading the benefits of reform, has still not occurred. While some larger entrenched companies have prospered, new businesses have not sprung up and informal sectors have increased in size. The informal sector remains a pit of low productiv-

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ity and poverty. Small businesses in most countries have not responded to reform. There is a "missing middle" of small enterprises in the region. In the economies of most countries in Latin America and the Caribbean, there has been none of the "creative destruction" that has occurred in the United States, and to a lesser degree in other industrial countries. This process is characterized by the establishment of large numbers of new businesses. Many fail but some become highly productive and grow very rapidly, creating large numbers of new jobs. By contrast, new business formation in the region has been disappointingly slow.

Reforms do not create growth - companies create growth.

Results from the reform have been disappointing because they were incomplete not because they were too quickly implemented or were too radical.

Why has so much hope turned to anxiety, frustration and disillusionment? One explanation is that attention has been focused on the wrong thing. What has gone largely unrecognized is that reforms in and of themselves do not alleviate poverty. Reforms do not create growth - companies create growth. Increased growth rates, prosperity and the reduction of poverty arises from the reallocation of resources away from inefficient activities that characterized the import substituting economies of earlier periods, towards businesses and industries that can compete in the global economy. Results from the reform have been disappointing because they were incomplete not because they were too quickly implemented or were too radical. The necessary macroeconomic reform was not accompanied by changes in regulatory systems, property rights and institutions - the foundation of modern industrial and service economies. They provide the institutional foundation for companies to restructure and redirect their efforts towards greater efficiency. They promote the establishment and growth of small business. In most countries in Latin America and the Caribbean these conditions do not exist yet. This is not to say that such reforms are easy. Opposition from small, powerfully motivated pressure groups such as lawyers, notaries, "fixers", and others who profit from traditional ways of doing business, have resulted in institutional reform efforts facing a great deal of inertia. Nevertheless, radical progress in these areas is essential if the transformation of Latin America is to occur.

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The Multilateral Investment Fund (the MIF) was founded in the early 1990s to assist countries in the process of reform. One of its key mandates was to assist small business adjust to the realities of a globalized world. To this end it has implemented over 100 projects related to small business assistance since the beginning of operations in 1993/94. These projects include business development centers, training, financial sector reform, institutional reform, and business registration. The paper will point out that, through its ability to fund experiments, the MIF can make a unique contribution to assisting small business in Latin America and the Caribbean. The past six years have provided a rich learning experience which now enables the identification of the areas where the MIF is most effective and where changes can be made to enhance its impact.

The paper will focus on issues of particular importance to small business and will examine and review the contribution of MIF in each area. It will look at:

- Factors that affect the formation of small formal businesses
- Factors that promote small business growth
- How these factors relate to the private sector more generally
- The role of the MIF in helping small businesses in Latin America and the Caribbean

The paper will start with a discussion of why small businesses are important. It will then review the factors that are important in the establishment and growth of small businesses. While many of the issues are important to the private sector more generally, the paper will focus specifically on issues that are important to small business because this group has the greatest potential to generate employment and alleviate poverty in the region. The paper will then identify some of the areas in which the MIF has been active in assisting small business in Latin America and the Caribbean, pointing out some of the strengths and weaknesses of what has been done. Finally it will suggest some areas where the MIF can effectively focus to maximize its contribution towards assisting small business in the region. It will also make some suggestions regarding how the MIF can best implement small business projects. In the main, the paper will be issue rather than process oriented. With one or two exceptions it will not analyze the procedures in terms of which projects are initiated, designed, implemented and evaluated. However, it will point out areas where these issues impact MIF's effectiveness.

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Chapter 2: The Importance of Small Business

Before examining measures to support small enterprises, it is worthwhile to focus briefly on why this particular group of firms should be helped. Identifying their unique characteristics will also highlight how they can be helped.

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Small firms are important because they create large numbers of new jobs. Whether these jobs are permanent is a subject of controversy. However, there is no doubt that those firms that start small and grow into large companies make a lasting contribution to employment. Furthermore, economies in which large numbers of small businesses are being established are usually dynamic and provide substantial rewards for entrepreneurship. If economies in Latin America encourage and reward dynamism, they are more likely to grow rapidly and provide opportunities for a larger sector of the population than is now the case. Currently, entrepreneurs in Latin America are faced with high risk and the cost of failure is greater than it is in industrial countries, particularly the United States.

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People who work in the large informal sectors[1] which characterize many countries in Latin America may possess substantial entrepreneurial ability which is being wasted. Harnessing these skills and energy through the establishment of formal small businesses would reap enormous benefits in the form of poverty reduction, improved income distribution and higher growth rates. Instead, energetic entrepreneurial people, particularly those with technical skills, can obtain much higher rewards by migrating to the industrial countries, particularly the United States and Canada where potential rates of return are higher and risks are lower. In this way, scarce entrepreneurial skills are drained from many countries in the region

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Examining the problems of small businesses provides insight into larger problems faced by the private sector. It provides a focus for looking at the business environment as a whole. In economies where entrepreneurship is rewarded, firms grow from small to medium to large. In economies where the business environment is deficient, small firms tend not to grow and there are very few small *formal* firms. Such economies are usually characterized by large informal sectors at one end of the firm size spectrum, and a small number of dominant large firms at the other. There is a "missing middle" of small and medium sized enterprises. In economies such as this, formal firms tend to be "old." In some countries in Latin America, the average age of small firms exceeds 20 years. This is a startling statistic. In the United States where the small business sector is bursting with dynamism, over 70 percent of new small firms do not last

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more than five years, yet the small business sector is prospering as never before[2] .

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A crucial question in analyzing and formulating small business policies, is whether small businesses are unique. Are they somehow different from both larger firms and the microenterprises that characterize the informal sector? If there is a difference, does it require a specific set of policies that give them special dispensations and privileges? Advocates of specific sectoral policies point to the large number of jobs that small businesses create and justify interventions on these grounds. However, there is little evidence supporting programs aimed at encouraging and subsidizing small businesses specifically. Many countries which have implemented targeted policies aimed exclusively at small businesses have languishing economies.The main problem in formulating small business policy and one of the reasons why it remains so unfocused, is that there are few basic principles on which to base policy formulation.

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Broadly speaking there are three views on the importance and role of small businesses.

- The traditional macroeconomic view is that firm size is not a relevant determinant of economic growth - focusing on small business may even adversely affect growth rates because traditional economies of scale are lost. Data on the creation of jobs by small businesses are ambiguous. A high rate of small businesses formation creates large numbers of new jobs. Paradoxically, it also results in a high rate of job destruction because in dynamic economies, small businesses fail in large numbers. There is controversy over the net effect. The macroeconomic view considers this to be irrelevant.

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- The second view can be described as the ad hoc approach. It is typified by small businesses policies in many European countries. It is characterized by numerous interventions to supply support services and financing to small business in an attempt to promote small firm formation and employment growth. Because the assistance is ad hoc, many different schemes have been tried covering a wide spectrum. These include subsidized consulting, training schemes, regulations favoring small businesses, preferential financing, and registration services. In both Europe and Japan, substantial resources have been expended on these small business assistance schemes. Yet small business creation and growth is far lower than in the United States which has far less extensive support programs for small business. What lessons does this experience have for Latin America? Even if these schemes

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(O)ver 30 years....the half life of small business....in Texas.... had declined by 50 percent. The average age of businesses in the Austin area is less than 7 years. At the same time, this region has the fastest growing number of jobs and the highest wages in Texas

have been successful at the margin, it is straining credulity to argue that the main reason for the relatively low numbers of small businesses in Latin America (the "missing middle" in the size distribution of firms) is that there are insufficient small business services and support schemes in the region. The fundamental problems appear to be systemic. Furthermore, substantial resources have been expended with little effect on similar efforts in Latin America - which countries in the region can scarce afford.

- The Schumpetarian view of economic growth provides an alternative framework in which to view the importance of small businesses. It is based on the notion that innovation and growth depend on new firms entering existing markets and developing new ones. This in turn creates new demand that stimulates growth. In Schumpeter's view, growth and new firm innovation are synonymous with large numbers of new firms being created and large numbers failing. It is this process of creative destruction that leads to dynamism. The process of "dynamic capitalism," - of firm formation and growth - leads to net job creation and provides some direction for small business policy. It has significant implications for how the MIF can assist small business in the region. It redirects policy away from trying to assist small businesses through targeted interventions towards promoting an environment for small business that encourages company formation and growth. Comparison of the state of the small business sector in the United States and Europe lends further support to this viewpoint. In Europe, there are far more direct services and assistance programs for small businesses but the environment is far less conducive to business growth. By comparison, the US has much less ambitious small business assistance programs. However, firm formation is encouraged by low barriers to entry and great flexibility of product and factor markets, in particular, the labor market. The result has been that both business formation and job creation in the US has far outpaced that of Europe even though the rate of small business failure is far higher in the United States[3].

The paradox that large numbers of businesses fail in a high growth economy results from an economic system which encourages experimentation and risk. It runs counter to policies in many countries which reflect the view that businesses should not fail easily and bankruptcy laws should protect business owners against creditors. New evidence, however, shows that such measures are counterproductive and hamper the formation of dynamic businesses – they have unintended negative effects. Donald Hicks studied a sample of small businesses in Texas over a 30 year period. He found that during this time, the half life of small businesses had declined by 50 percent[4]. The average age of businesses in the Austin area is less than 7 years.

At the same time, this region has the fastest growing number of jobs and the highest wages in Texas. Yet public sector support for small businesses is irrelevant in this region.[5] There are important lessons from this example. Economies in which businesses are easily started are also those in which they fail in the largest numbers. However, they are also the ones in which the small business sector creates the largest number of jobs. It seems to be the case that protecting businesses from failure results in less business creation. It also implies that the cost of business failure should not be so high as to discourage entrepreneurs who have failed from trying again. Many large successful businesses in the United States were founded by entrepreneurs who had experienced prior bankruptcies.

The implication of this discussion is that there is no magic formula for small business promotion. Countries, like Japan, which have been lauded in the past for supposedly successful small business assistance, are now ones in which small businesses are especially struggling. The evolutionary maxim that if the weak are protected, in the long run they will be more unhealthy seems to apply particularly to small businesses.

Conclusions Regarding the Importance of Small Business

The implication of this analysis for the region is that policy towards small businesses should focus attention on:

- Removing barriers which discourage the formation of new firms.
- Removing constraints on the ability of financial markets to finance new companies and to finance growing companies.
- Eliminating personnel and labor practices that reduce incentives to hire and which inhibit job mobility.
- Modifying bankruptcy laws to allow small businesses to fail quickly[6] and not to penalize entrepreneurs overly heavily, although not to protect them either.

Reforms of this type will reduce transactions costs for small businesses, thereby reducing some of the disadvantages the face. Since many transactions costs are not related to firm size, they disproportionately impact small businesses. Larger firms can hire specialists to deal with complex regulations – small businesses have to rely on the scarce time of the owner or outside help which is costly in relation to sales. Large firms have access to credit even in underdeveloped financial systems. In virtually every country in Latin America and the Caribbean, small businesses must rely on internally generated funds. Large businesses have more flexibility to deal with labor laws

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and taxes. Small businesses can be ruined by misguided labor legislation. Although higher transactions costs for small businesses have been used as justification for implementing targeted small business programs, these are no substitute for systemic reform to lower the cost of doing business–in the absence of reform such assistance is not sustainable.

Historically, Latin America and the Caribbean does not have a strong entrepreneurial culture. In many countries, economic power and political power were synonymous. Wealth and prosperity depended upon influence. In sharp contrast with the United States, for example, there was no tradition of a dynamic small business sector trying to compete with entrenched larger businesses. Examples of small businesses that grew to be large were all too rare in the region. With competition increasing as a result of reform, businesses have struggled with the entrepreneurial challenge of adapting to the new circumstances. If strong prosperity is to occur in Latin America and the Caribbean in the face of the forces of global competition, dynamic entrepreneurship is vital.

Chapter Endnotes

1 In reality, there is no sharp line between formality and informality. Most people who operate in the informal sector have some formal relationships, perhaps through their dealings with some formal suppliers. Many formal small businesses in the region engage in informal behavior by, say, not declaring all their revenues to the tax authorities or by ignoring regulations. For the purpose of this paper, formal firms are those who are formal registered entities.

2 In the 1990s, the failure rates of small businesses in Canada rose sharply, yet the number of net new businesses also rose at an unprecedented rate.

3 Canada had a similar experience. Compared with the 1980s, the rate of small business failure rose sharply in the 1990s, yet the latter period was one of much higher growth and wealth accumulation than the former.

4 The half life of a sample of businesses is the time it takes for 50 percent of the sample to close down.

5 Although the SBA is often cited as an example of how small businesses are assisted in the United States, the actual number of businesses that it helps is very small. See Kelly [2000].

6 In many countries in the region, it can take 5 to 8 years for a business to go through all bankruptcy proceedings.

Chapter 3: The Features of a Good Business Environment – What Helps Small Businesses Start and Grow

Overview

Emphasizing higher prospective rates of return and improved profitability for small business focuses attention on how to create a business environment where small firm potential is maximized. Examining the nature of economic development, which is broadly synonymous with industrialization and technological progress, provides a guide to small business policies.

Economic development is broadly synonymous with industrialization and technical progress.

Economic development involves a massive increase in the number and complexity of transactions as well as growing specialization and division of labor. As it progresses, it leads to larger scales of production and transactions in geographically more widespread markets. Greater specialization requires substantial investment in human capital. The growth in the number of business dealings and the distances over which they occur implies that transactions become less personal and require improved communications and transport infrastructure. Access to markets, both domestic and international, grows. A key feature of specialization and higher productivity involves technological change, which requires investment in new production methods. The time period increases between investment decisions being made and the consummation of sales. This in turn requires capital to finance the investment. The result is that the complexity and riskiness of transacting rises. In order to sustain the process of development institutions are needed which keep the cost of transacting as low as possible and which allow risk to be managed effectively. Therefore, to support economic development, institutions and infrastructure are needed which:

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- Minimize transactions costs
- Provide efficient conditions for assembling and allocating capital in an impersonal way – the ability to raise capital should not depend upon “contacts”
- Give a clear definition and protection of property rights
- Allow firms to enter into contracts without interference and which have clearly defined rules that can be enforced
- Provide clear rules of law governing commercial transactions
- Ensure equality in the administration of rules of law in civil disputes
- Supply good quality infrastructure

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Many studies of the private sector in countries in the region observe that many, if not most, of these features are missing – they constitute the incomplete elements of the reform agenda. By contrast, there has been substantial progress in the areas of macroeconomic reform, trade reform and privatization, without which, additional advancement would not be possible. Because of their importance, and because standing against reversal is so important, a brief review of the accomplishments is warranted.

Macroeconomic Stability and Incentive Policies

Eliminating Inflation:

Price stability supports private sector growth, and especially small businesses and entrepreneurship.

It is impossible for the private sector to flourish in a high inflation environment. Price stability supports private sector growth, and especially small businesses and entrepreneurship, by reducing uncertainty arising from large fluctuations in relative prices and by lowering the uncertainty regarding the value of assets. Besides increasing business risk, inflation greatly increases the cost of transacting. Assigning the highest priority to efforts to drastically reduce the inflation that plagued so many countries in the region was the correct decision. When the variance of macroeconomic variables is high, negotiating contracts becomes more difficult and time consuming, thereby sharply increasing transactions costs. Brazil is a classic example of the high costs of hyperinflation – during the period when prices were rising at double digit rates monthly, a large part of the entrepreneurial skills of the Brazilian business community was devoted to trying to minimize the effects of inflation (Holden and Shepherd, 1995). Macroeconomic uncertainty raises the risks of doing business, thereby reducing the incentives for investment and damaging long term growth prospects. Business behavior tends to favor risk avoidance rather than innovation.

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With the exception of a very few countries, macroeconomic reform in Latin America is virtually complete which is a great achievement when considered against the disarray in which so many countries found themselves in the 1980s. In 1998, annual inflation in the region was reduced to an average of 10.8 percent compared with an average of 550 percent in the 1990 – 1992 period, an achievement of enormous benefit to small businesses. Moreover, the ability of countries to deal with external shocks also increased - there were two major economic crises in the 1990s; most countries in the region weathered them relatively well.

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Trade Policy:

Trade policy is a powerful determinant of private sector activity. In the past, the distorted trade regimes that prevailed in Latin America encouraged inefficient production for the domestic market. Earlier attempts to liberalize trade regimes in the region and provide neutral incentives between domestic and the international markets failed due to macroeconomic uncertainty and the lack of strong, long-term commitment to liberal trade policies. The most recent round of reforms began in some countries as early as the mid 1970s, but others undertook reforms in the mid to late 1980s, as a part of an overall economic reform package. Changes in the incentive structures for private sector activity improved the efficiency of local producers, encouraged production for the foreign market and diversified exports. With more stable macroeconomic policies and greater commitment to liberal trade, the reforms changed the character and competitiveness of the private sector in many countries in Latin America. Unfortunately, the progress with trade reform in Latin America and the Caribbean was not matched by a similar opening in most industrial countries particularly for textiles and agriculture goods, the production of which have substantial potential to alleviate poverty in the region.

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There has been some backsliding in trade policy in Latin America over the past few years. The failure of the private sector to respond as quickly as hoped has led to some countries raising barriers to imports although to nothing like the levels of the past. In addition, reform of the institutions of trade, particularly customs administrations and processing is still in its infancy with the result that processing imports and exports is still time consuming and expensive in most countries in the region, which effectively imposes a tax on foreign trade[1] .

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Privatization:

The experience with privatization in the region has been strongly positive in terms of realizing the proceeds of assets sold, enhancing efficiency in the newly privatized industries and promoting investment by the new owners. The greater benefits, however, may not stem from these improved efficiencies. The degree of state ownership of resources is an indicator of the extent to which the government is prepared to intervene and control the economy. Privatization reassures potential risk takers (investors, both local and foreign) that governments are serious about reform. The more extensive a privatization program, the more difficult it is to reverse, thereby providing credible commitment to reform, an important step because in the history of Latin America, there have been many short-lived reform episodes. For ex-

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ample, the extent of the privatization program in Peru was most likely one of the major reasons for the overall reform program being so successful in such a short time. The breakneck speed with which the Argentinean privatization program occurred was at least partly dictated by the need to bring hyperinflation under control by sharply changing expectations. Privatization was an important instrument in changing inflationary expectations.

Infrastructure:

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The quality of the infrastructure network is closely linked to issues of privatization. Its contribution to small business competitiveness has often been overlooked. Virtually all businesses require reliable sources of power to run efficiently. In an increasingly international business environment, the importance of improving highways, railroads, ports, and other means of transportation cannot be overstated. Reliable transportation is essential to foster the development of agriculture and rural businesses. Any business hoping to compete in the global economy must have access to good telecommunications – having access to the World Wide Web is of little use if inexpensive telephone service is not available. The same holds true with respect to reliable and low cost power supplies, particularly electricity. Small businesses cannot afford their own generators; unreliable electrical power supply puts them at a huge competitive disadvantage compared to countries where electrical power fails only rarely.

The effect of poor infrastructure amounted to a tax which fell especially hard on small businesses because of the high fixed costs of overcoming the deficiencies.

At least partly because of privatization, the quality of infrastructure in the region has registered dramatic improvements. In many countries in the pre-reform era, delays in getting telephone service could run into years or even decades. Power supplies were haphazard at best and road infrastructure was in a state of near collapse, due to the ongoing low level of public sector investment. The effect of poor infrastructure amounted to a tax which fell especially hard on small businesses because of the high fixed costs of overcoming the deficiencies.

As a consequence of reform and of widespread privatization, many of these problems have improved dramatically. Telephone systems, power generation and distribution, and national roads have been privatized in many countries. Sometimes, in order to provide evidence of credible commitment to the overall reform program, privatization was done in haste without careful attention to longer term effects. Long term monopolies were granted and regulatory frameworks were often created without attention to incentive structures. These problems are beginning to be resolved and the MIF has been active in assisting with regulatory structures. In this area, the tax on small business appears to be declining. The MIF has strongly supported privatization and regulatory reform in the region. It has undertaken 60 projects which have supported a wide range of legislative and regulatory reforms and helped develop technically oriented regulatory capacity.

Property Rights:

Secure individual property rights are the foundation of an efficient market economy.

Secure individual property rights are the foundation of an efficient market economy. The multiple effects of secure property — the motivation to invest effort and resources to obtain and improve property, to put it to productive uses and to freely sell it — have often been underestimated as factors in economic development. The effects on the poor have been especially overlooked. Secure property rights allow the ownership of property held by occupational right to be converted into wealth through registered title. These rights give the poor a stake in the future and an incentive to invest, not only in their properties but also in their human capital and that of their children. "The United States, Canada, Japan, and Europe – the 25 developed nations of the world – have prospered so much more than those without their kind of accessible, integrated formal property systems that today no one would seriously propose economic solutions that disregarded the need for formal property." [de Soto, 2000, p165]

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In the developed world, effective and secure property rights are the basis for a large proportion of the lending that occurs and are frequently used by small business owners to finance startups and business expansion. These rights are the foundation of wealth creation. Financial systems cannot develop without them. They consist of the ability to purchase, obtain secure title and register real estate and to use movable property as collateral. Unfortunately in virtually every country in the region, rights for both fixed property (real estate) and movable property (machinery, inventory, accounts receivable, etc) are so poorly protected that either they are worthless as collateral or securing them is so expensive and risky as to make their usefulness to small business owners virtually non-existent. As a result lending secured by movable property is rare and fixed property mortgage markets are inefficient and expensive.

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Weak fixed property rights have another adverse result. In many countries a significant portion of the population does not have street addresses, which greatly raises the cost of transacting in such areas as law enforcement, credit information and the mail system.

What helps Small Businesses:

A business environment that encourages small business growth is no different from one which is good for businesses of any size. However, *Because dealing with many of the problems that firms in the region face carries with it high fixed, small businesses suffer most.*

(D)oes the formal legal/regulatory framework matter for small businesses at all? ..It matters a great deal.

Formal rules which are inadequate, costly, frequently and unpredictably changed, arbitrarily enforced or abused for rent-seeking purposes provoke economic agents to develop alternative informal arrangements.

the reverse may not always be true. When obstacles to doing business exist, they often impact disproportionately on small business. Because dealing with many of the problems that firms in the region face carries with it high fixed costs, small businesses suffer most. As a result, in many countries even formal small businesses retreat into a half world between formality and informality which enables them to cope with the problems by not using the formal institutional framework. For example, if a small firm has no access to credit, keeping the accurate accounts which lenders require becomes a disadvantage when it comes to predatory tax officials. However, small businesses that do not keep accurate records find planning, financial analysis, and business control, far more difficult. Behavior of this type effectively reduces small businesses' long term prospects.

Small Businesses and Formal Rules

Since informal small businesses carry out a significant portion of their business-related transactions outside the formal institutional framework, does the formal legal/regulatory framework matter for small businesses at all? It matters a great deal for the following reasons:

- Small businesses are subject to many of the controls and costs associated with formal, legal, and regulatory structures, whether they participate willingly or not. For example; the burdens of indirect taxes, federal state and municipal ordinances, and public services that require user fees apply equally to formal businesses regardless of size and to many informal businesses.

- Business transactions always entail costs in terms of obtaining information, finding and dealing with business partners, financing and arranging exchanges and assuming risks of non-compliance. Formal rules which are inadequate, costly, frequently and unpredictably changed, arbitrarily enforced or abused for rent-seeking purposes provoke economic agents to develop alternative informal arrangements.

While in the short terms these parallel structures are sometimes more efficient than the rules prevailing in the formal system, in the longer term they impede the efficiency and growth potential of individual businesses, particularly those that are smaller.

Stone, Levy, and Paredes (1992) conducted a comparative analysis of the legal and regulatory environment for business transactions in Brazil, with its detailed interventionist policy and complicated institutional environment and in Chile, which undertook systematic reform to reduce the size and role of government in markets to impersonalise the rules of economic competition. While Chilean business transactions benefit from relative legal simplicity and consistency of enforcement, Brazil's complex regulatory environment creates a high level of conflict for firms. Given the lack of consistent enforcement in Brazil, there exists alongside the rigid formal law, a quite separate practical system for ordering market entry and business transactions.

When a growing enterprise becomes more visible or starts needing formal sector services, it must comply with complex, non-transparent, often incalculable, legal and regulatory requirements of the formal sector. Thus, the frontier between formal and informal can establish a threshold that creates disincentives to the growth of firms, thereby limiting gains from economies of scale as well as providing a barrier to investment that will enhance productivity.

In the longer term this has harmed the potential of small businesses. When a growing enterprise becomes more visible or starts needing formal sector services, it must comply with complex, non-transparent, often incalculable, legal and regulatory requirements of the formal sector. Thus, the frontier between formal and informal can establish a threshold that creates disincentives to the growth of firms, thereby limiting gains from economies of scale as well as providing a barrier to investment that will enhance productivity.

The Basis for Business Contracting

For SMEs to grow and become a significant part of a prosperous economy, institutions must be in place to allow them to grow from micro-enterprises to small businesses, and then to medium, and to large-scale enterprises. Among the most important of these institutions are those that facilitate "arm's-length" transactions. As businesses grow, they move beyond the circle of family, friends, or neighborhood acquaintances in which they initially operated. Where it may not have been necessary to write contracts for agreements between family members or close acquaintances, business agreements between firms that do not rest on personal relationships often require formalization to ensure the compliance of both parties.

When the judiciary is unable to enforce contract obligations, a disproportionately large number of transactions take place in the spot or short-term markets, where the opportunities for contract breach are much lower. The informal sector is the most extreme manifestation of short term markets – most transactions are paid for in cash or very short term credit.

When the judiciary is unable to enforce contract obligations, a disproportionately large number of transactions take place in the spot or short-

Box 1: Property Rights

When long term contracting can be undertaken with confidence and when property rights are secure, risk is reduced. Investments that carry rates of return that would be unacceptable in high risk environments become profitable in societies where risks are lower. People who live in countries which have been subject to periods of high or hyper-inflation, where property rights are insecure or where contracts cannot be enforced perceive that they face higher risks. Experience has taught them that the future is highly uncertain and that their assets are not secure. Such perceptions lead to much shorter term decisions regarding investment.

(H)igh-performance economies are characterized by a significant number of long-term contracts.This ability to take a long term view of the future is a foundation of economic development.

A contract that requires some future delivery of goods or services is more difficult to enforce and is correspondingly less common in countries where the judicial system does not function effectively – yet it is long term contracts that allow for the investment that ensures long term prosperity.

Another mechanism to avoid the expenses and the delays of the legal system is the use of Alternative Dispute Resolution Mechanisms (ADRs) to help resolve disputes.

term markets, where the opportunities for contract breach are much lower. The informal sector is the most extreme manifestation of short term markets – most transactions are paid for in cash or very short term credit.

Williamson [1994], observed that high-performance economies are characterized by a significant number of long-term contracts. This implies that the parties to long term contracts have long time horizons. Similarly, secure property rights provide people with the incentive to invest in their property and the education of themselves and their children over the long term. This ability to take a long term view of the future is a foundation of economic development.

Recognition of the importance of contracting and its effect on business behavior is not new. To a large extent, institutional economics is the study of exactly these issues. Douglass North [1990] asserts that the absence of a low-cost means of enforcing contracts is "the most important source of both historical stagnation and contemporary underdevelopment in the Third World." However, in the absence of a well-functioning judicial system, it is virtually impossible to engender the trust or security necessary to enter long-term relationships with confidence that contractual commitments will be honored. As a result, firms circumvent the judicial system altogether by vertical and conglomerate integration, turning arm's-length transactions into intra-firm ones. Purchasing goods or services that are to be delivered and paid for today ensures that the transaction will be completed to the satisfaction of both parties. A contract that requires some future delivery of goods or services is more difficult to enforce and is correspondingly less common in countries where the judicial system does not function effectively – yet it is long term contracts that allow for the investment that ensures long term prosperity.

If the legal system is defective, firms have to devise high-cost ways of contracting outside the protection of the law. They may even be discouraged from transacting altogether. De Soto [1989] shows how Peru's legal system stifles transactions. A more recent survey of businesses in Peru confirmed these findings [World Bank 1994]. It found that firms were reluctant to change suppliers even when offered significant price discounts because if the new supplier reneged they would have no legal recourse. Such an impediment to transacting can prove particularly daunting to SMEs that must move beyond their immediate circle if they are to grow. However, even in well-functioning legal systems, using the law is not costless. That is why businesses in countries with modern legal systems still use exchange agreements, credit bureaus, and other mechanisms that allow firms to avoid the courts, except as a last resort. Another mechanism to avoid the expenses and the delays of the legal system is the use of Alternative Dispute Resolution Mechanisms (ADRs) to help resolve disputes. Contracts with ADR provisions require that in the event of a dispute, the parties subject themselves to arbitration, mediation or conciliation. Frequently, the parties agree that the decision of an arbitrator will be binding. The arbitration clause was a particularly important component of the NAFTA agreement between Canada, Mexico and the United States and undoubtedly has helped promote trade between the three countries.

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The sections that follow will expand upon several of these key themes in order to identify more specifically factors that help small business. First, however, it discusses some indicators of how to identify a good environment for the private sector. While several of these do not apply exclusively to small business - they have more general applicability - they all impact small firms more strongly than they do large firms.

Chapter Endnotes

1 According to some estimates, the cost of the inefficiencies of trade institutions, such as customs, is equivalent to a tax on exports of 10 per cent or more [Holden, 1999].

Chapter 4: Indicators of a Good Environment for Doing Business

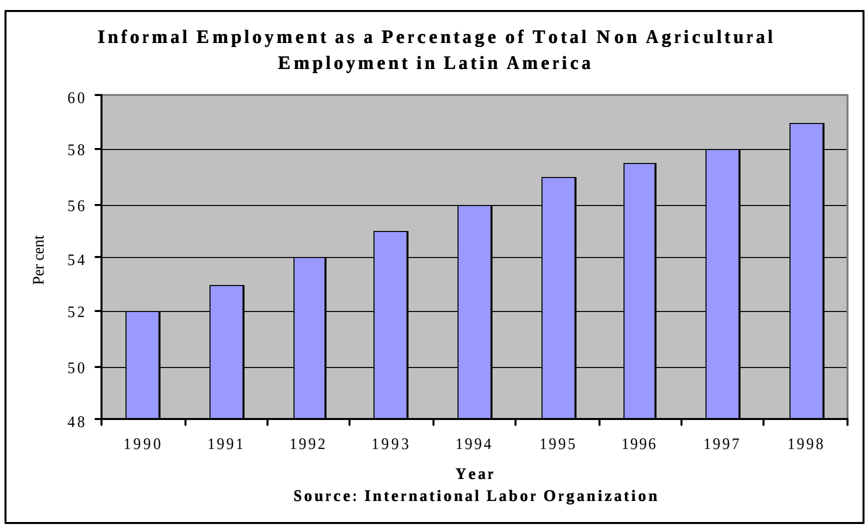
Informality

Informality represents the failure of institutions, especially markets, to function effectively. In developing countries, the large numbers working in the informal sector and the proportion of GDP produced informally, indicate that a substantial percentage of the working age population is excluded from the market economy.

Informality represents the failure of insituitions, especially markets, to function effectively. In developing countries, the large numbers working in the informal sector and the proportion of GDP produced informally, indicate that a substantial percentage of the working age population is excluded from the market economy. This is often not by choice. Surveys in many countries in Latin America and the Caribbean, indicate that the majority of informal entrepreneurs would rather have formal paid employment [Holden and Rajapatirana, 1995]. They are in the informal sector because the formal economy does not generate growth to employ those who seek work.

Only in developing countries is a large portion of the working population engaged in activities that are primarily outside the formal sector.

There is also informality in developed economies, but it takes the form of keeping a portion of business transactions off a company's books, engaging in barter or cash transactions or other behavior that minimizes tax payments or adherence to rules and regulations. Even street traders in developed economies are licensed and must pay at least some taxes and adhere to basic regulations. Only in developing countries is a large portion of the working population engaged in activities that are primarily outside the formal sector.



The institutions and regulations which underlie the market economy and the extent to which the state is supplying public goods determine the size of the informal sector.

The institutions and regulations which underlie the market economy and the extent to which the state is supplying public goods determine the size of the informal sector. For example, if there are myriad restrictions in the labor market in the form of high social security costs, compulsory payments to workers, restrictions on firing, and closed shop union agreements many otherwise qualified workers will find it difficult to be employed. If small businesses are effectively excluded from the benefits of such public goods as the legal system and secure property rights, but are subject to costly and intrusive regulation and taxation, there are few incentives for them to operate within the formal sector. Therefore, the size of the informal sector then shows how well or poorly the formal economy is functioning.

If small businesses are effectively excluded from the benefits of such public goods as the legal system and secure property rights, but are subject to costly and intrusive regulation and taxation, there are few incentives for them to operate within the formal sector.

In many Latin American countries, up to 50 percent or more of the population work in the informal sector and up to 30 percent of output is produced informally. Moreover, the size of the informal sector has been growing — see Chart 1 — which supports the view that job creation from dynamic small business is not occurring.

Informality carries with it substantial costs to the economy. Economic entities, typically micro enterprises, that are informal are essentially excluded from many of the public goods pertaining to economic activity that the state provides. These include:

Informality carries with it substantial costs to the economy.

- Access to the legal system to enter into contracts and settle disputes
- The formalization of property, both movable and fixed, that can then be used as a basis for investment and for securing bank loans
- Access to the formal banking system.
- Access to large formal firms and the public as suppliers of inputs

For small entrepreneurs, the decision to become formal is determined by the costs and benefits of formality. The benefits consist of the advantages of access to public goods such as the legal system as well as access to the financial system. The costs are determined by the expense of registering formal businesses as well as the tax burden and the costs of complying with laws governing the operation of a business, including labor laws and regulation.

For workers, labor laws contribute to informality by pricing them out of the formal labor market. Uneducated and unskilled workers have to earn a subsistence living in the informal sector when they would rather be part of the formal labor force. (See Holden and Rajapatirana [1995], for further discussion of informality.)

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Microfinance institutions attempt to alleviate the poverty that characterizes the pervasive informality of so much of Latin America by lending small amounts to micro entrepreneurs who otherwise have no access to credit. This lending provides a very real benefit to hundreds of thousands of poor in the region who are trapped in the cycle of low productivity and perverse incentives which characterize informality. There is no doubt that many of the microcredit institutions that have sprung up have contributed to poverty alleviation – their social impact has been positive and the achievements of some have been remarkable.

There is no doubt that many of the microcredit institutions that have sprung up have contributed to poverty alleviation – their social impact has been positive and the achievements of some have been remarkable.

However, the microfinance approach represents only part of the solution. It does not tackle the root causes of informality, namely the interference in markets and the failure of the state to adequately supply the public goods described above. Most advocates of the microcredit solution to poverty focus on delivering loans. However, microcredit can only improve the lot of the poor sustainably if it provides an upward path to the formal economy for successful informal sector entrepreneurs. Similarly, those informal entrepreneurs who would prefer to find employment in the formal economy will only do so after impediments to hiring and firing are reduced and the economies of countries which have large informal sectors are growing sufficiently rapidly to generate many new jobs. For this to occur, exactly the same changes are necessary as in the small formal business sector. Microcredit institutions will bring the most benefit when in addition to supplying microcredit, they lobby vigorously for changes that will ultimately make their institutions superfluous.

Microcredit can only improve the lot of the poor sustainably if it provides an upward path to the formal economy for successful informal sector entrepreneurs.

The Age of Businesses:

In an environment where businesses are being started in large numbers, they also fail in large numbers which is a feature of dynamic capitalism. In the United States, close to 2 million new businesses are started every year; the majority of them fail within the first 7 years. However, some succeed and grow to be large. The average age of small business is therefore low – approximately 7 – 8 years. By contrast, in Latin America small businesses tend to be "old." The average age of a small business in Uruguay is 35 years, in Mexico it is still nearly 30 years and in El Salvador it is around 17 years. This implies that the average small business in the region was established before the wave of reform of the 1980s and 1990s, an astonishing statistic when considered against the hoped for stimulus from reform.

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The Number of New Start Ups:

An important factor in determining the average age of businesses is the number of new start-ups that occur. The more dynamic the business environment, the larger the number of new (mainly small) businesses being started. Furthermore, when many new businesses are being established, many will also be failing which will also reduce the average longevity of small businesses.

Globalization, Competition and Efficiency:

Globalization is forcing many small firms to alter the way that they do business even if they are not directly involved in foreign trade. Pressure for change comes from several sources:

- Globalization is forcing companies that export to be more efficient, which also makes them stronger competitors in the local market against domestic companies that do not export. These companies are often large, but increasingly smaller firms are beginning to export as the example of East Asia indicates[1] :

- Lower trade barriers force local companies to be more efficient to compete against imports.

- The opening up of economies in the region has resulted in a surge of direct investment. Foreign companies bring more efficient business practices that they insist their local suppliers adopt. These firms become fierce competition for other local businesses which must then adopt more efficient processes or fail.

Globalization is forcing many small firms to alter the way that they do business even if they are not directly involved in foreign trade.

As a result, if they are to survive, firms are forced to become more efficient, even if they are not directly involved in foreign trade. Many small businesses are not equipped to make the necessary changes that would enable them to compete. The business environment with which they are familiar is based on the inward orientation that characterized most countries in the region in the pre-reform era. While it is changing, many still remain relatively closed - the ratio of imports plus exports to GDP in Argentina is still only 14 percent nearly 10 years after the trade reform. While other countries in the region have a higher ratio of trade to GDP, they are in general less than half that of the so-called "Asian Tigers" that grew by opening their economies.

Foreign companies bring more efficient business practices that they insist their local suppliers adopt.These firms become fierce competition for other local businesses which must then adopt more efficient processes or fail.

Specific data available for El Salvador reflect the general pattern of small business in the region. Chart 2 shows the export orientation of a sample of small formal businesses in El Salvador. Not only is the majority of their business in-country, most of it takes place in the capital city. Only some three percent of small businesses export their products. While detailed survey data are generally not available for many countries, many observers working with small businesses throughout the region report the same inward orientation. This situation will undoubtedly change as the inexorable process of globalization continues but will bring many wrenching transformations to small businesses who will have to adapt the way they operate or face bankruptcy.

The inexorable process of globalization .... will bring many wrenching transformations to small businesses who will have to adapt the way they operate or face bankruptcy.

Chapter Endnotes

1 The example of Canada in the post NAFTA period illustrates the effects of greater opening on the economy. Between 1993 and 1997 the number of firms exporting rose by nearly 40 percent. Many of these are small businesses.

Chapter 5: Factors that Promote Business Formation

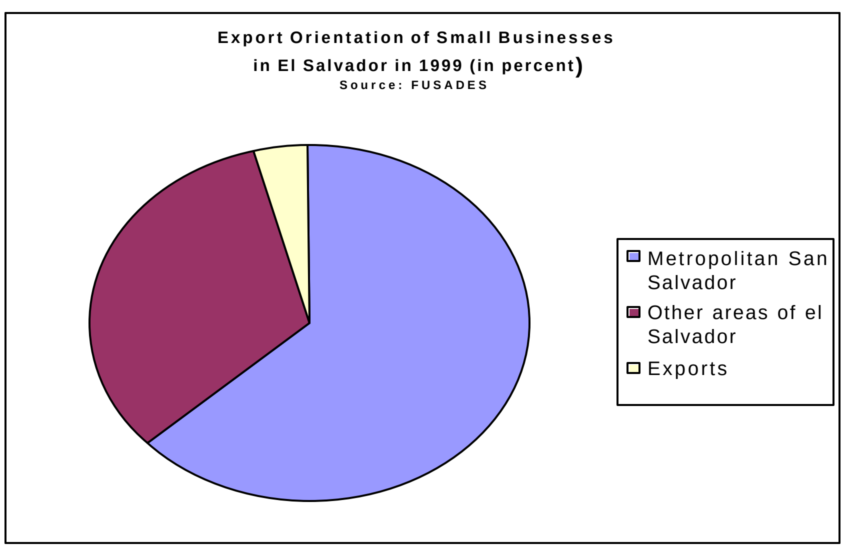
The advantages of limited liability companies that place a corporate "veil" between the owner and the business are well established. Benefits extend not only to the owner in terms of liability, contracting and corporate identity, but also to the state in terms of being able to deal with a single entity for taxation, information and regulation issues.

(M)any countries in the region place significant hurdles in the way of business registration.

Cost of Registration and Startup

The advantages of limited liability companies that place a corporate "veil" between the owner and the business are well established. Benefits extend not only to the owner in terms of liability, contracting and corporate identity, but also to the state in terms of being able to deal with a single entity for taxation, information and regulation issues. Yet many countries in the region place significant hurdles in the way of business registration. The well known empirical study by the Instituto Liberdad y Democracia in Lima under the leadership of Hernando de Soto (1989) was one of the first attempts to dramatize the costs to businesses of becoming formal. It took 289 days and over US $1000 to fully comply with all formal requirements to set up a small firm. Holden and Rajapatirana [1995] showed how costly business registration still is in many Latin American countries. More recent evidence from such countries as El Salvador and Venezuela shows that little has changed in this regard – starting a limited liability corporation costs in excess of $1000 in El Salvador and in Venezuela a new entrepreneur must go through over 140 steps to establish a new business.

Table 1 shows the cost of registering a limited liability company in a number of countries in the region. In many cases they are several times the average monthly wage in the countries in question and, in terms of the average wage, higher than the cost of registration in the United States by a factor of at least 14. The effective cost of new business registration is also substantially increased by both national and local regulations that new business founders must navigate in



Country	Cost of Registration in US dollars	Cost in terms of monthly wage	Year
Argentina	1018	1.4	1999
Columbia	789	2.1	1997
Costa Rica	600	3.2	1997
El Salvador	1025	4.6	1999
Mexico	799	2.5	1996
Peru	590	1.6	1999
Venezuela	853	2.3	1999
Uruguay	1121	1.9	1996
United States (Washington DC)	132	0.1	1999

In many cases, the cost of registering a limited liability company in a number of countries in the region is several times the average monthly wage in the countries in question.

order to get the business established. Other empirical evidence [Tokman, 1990] shows that formality is substantially discouraged by the cumulative effect of the regulatory requirements of different public agencies. In addition, these costs do not include the opportunity cost of the time - which frequently requires months of effort – in order to go through the bureaucratic steps necessary to register a business.

Regulatory Requirements for Startup

In several countries in the region, interviews with entrepreneurs in the informal sector indicate that costly licensing and paperwork requirements especially at the municipal level, are why relatively few small companies register formally. While specific regulations governing the establishment of an enterprise vary from country to country, they usually include most of the following:

Formality is substantially discouraged by the cumulative effect of the regulatory requirements of different public agencies.

- Incorporation of the business as a legal entity.
- Inclusion in the Business Registry at the national, regional, or municipal level.
- Registration with the national tax authority.
- Registration of employees in pension, health, and other national social security schemes.
- Acquisition of operating licenses and permits at the municipal level.

Interviews with entrepreneurs in the informal sector indicate that costly licensing and paperwork requirements, especially at the municipal level, are why relatively few small companies register formally.

- Approval of health officials upon inspection (especially for sales of food) at the national and municipal levels.

- Safety approval from local fire officials.

The processes are especially difficult and costly in Latin America and the Caribbean because each requirement usually involves multiple steps and numerous visits to various regulatory authorities. Frequently, the completion of one step is linked to the fulfillment of others so that prospective entrepreneurs have to backtrack between different agencies and regulatory bodies.

The processes are especially difficult and costly in Latin America and the Caribbean because each requirement usually involves multiple steps and numerous visits to various regulatory authorities. Frequently, the completion of one step is linked to the fulfillment of others so that prospective entrepreneurs have to backtrack between different agencies and regulatory bodies. Besides the financial costs cited above, the sheer effort required to navigate the bureaucratic maze along with the opportunity cost of the time involved provides a large hurdle to business formality – it is hard not to wonder at the energy of those who complete the process successfully. Of course, the usual manner of proceeding is to hire one of the ubiquitous "fixers"[1] that are a feature of business life in Latin America. They are, however, costly, and can add some US$800 - US$2000 to the cost of starting a formal business. Together these charges constitute a severely regressive tax on business startup, making it extremely difficult for poorer members of the community to enter into the formal sector thereby contributing to the perpetuation of the unequal distribution of income that characterizes so many countries in the region.

The Role of the MIF in Startup Regulatory Reform

Box 2: Business Registration Reform

Efforts to improve business registration procedures fall into 3 broad categories: consolidating all the procedures into one location, the "one-stop shop" approach; consolidating registration and application procedures into a few locations; and eliminating and reforming redundant and overly complicated registration regulations. Some combination of the first and third procedures is optimal. Both simplifying the process and reducing the number of steps required make it easier and reduces the cost of starting a new business. Often, the process of consolidating the procedures leads to pressure for the reform of the registration process – redundancies and superfluous steps become glaringly evident.

The MIF has begun to support the establishment of consolidated registration centers – one stop shops. In October 2000, a project to set up a one stop shop in Bogotá, Columbia was approved and several other project applications are in the pipeline.

An internal working group [MIF 1999], identified small business registration and one stop shops as a core activity for future MIF operations. In the past it has provided some indirect assistance through its business advisory centers which do help small businesses get started. The most successful of these, located in Rafaela in Argentina, has been active in this regard. However, the centers are essentially helping small business get around the problems and costs of registration rather than tackling the issue head on. The new direction should add impetus to attempts to reform business registration in Latin America.

Together these charges constitute a severely regressive tax on business startup, making it extremely difficult for poorer members of the community to enter into the formal sector thereby contributing to the perpetuation of the unequal distribution of income that characterizes so many countries in the region.

Labor Regulation

Once the necessary permits have been acquired, small business startups face the problems of hiring workers. Although labor regulations are an ongoing cost, they constitute a significant barrier to entry to small business because they strongly affect the ex-ante calculations regarding business profitability. If labor regulations are overly onerous they will discourage new business start-ups.

Small business owners are confronted with a maze of labor regulation. These regulations can be divided into three categories — mandatory non-wage benefits; job security guarantees; and minimum wage legislation.

If labor regulations are overly onerous they will discourage new business start-ups.Small business owners are confronted with a maze of labor regulation.

- *Mandatory non-wage compensation* include mandated vacation bonuses, housing and transportation bonuses, food vouchers, family wage allowances, extended paid maternity leave, employer insurance contributions and compulsory end of year vacations. The additional accounting and registration requirements place a substantial burden on small businesses[2] .

- Job security guarantees usually take the form of a severance pay requirement which makes dismissal of workers difficult and costly. They place an extra burden on the ability of small business owners to adjust during economic downturns as well as serving as a disincentive to hiring workers. In many countries in Latin America and the Caribbean, just cause for dismissal is limited to absenteeism, theft, sabotage, and insubordination; poor performance is seldom a basis for dismissal with cause. Since employees dismissed without cause are often entitled to full severance payments, badly performing workers place a large cost on any business which in turn encourages companies to invest in capital equipment rather than labor. In this way job security guarantees raise the cost of doing business and discourage many small entrepreneurs from hiring workers.

Minimum wage legislation probably does not substantially affect the hiring practices of small businesses because in most countries the minimum wage is below the market wage.

In many countries in Latin America and the Caribbean, just cause for dismissal is limited to absenteeism, theft, sabotage, and insubordination; poor performance is seldom a basis for dismissal with cause.

The Role of the MIF in Labor Market Reform

Reforming labor legislation and regulations is a process fraught with political minefields. The MIF has approached the issue indirectly rather than confronting it head-on, a strategy that is appropriate given the complexity of the issues and the size of the grants that it can make. Two interesting MIF initiatives in labor market reform illustrate its efforts in this area.

The largest and most ambitious program has been a regional labor market modernization effort which focused on Central America. The objective of the program was to attempt to modernize regulations and institutions concerned with policy formulation and implementation. It specific objectives were:

- To attempt to generate some consensus that could lead to an agreement on labor reform.
- To improve the labor ministry's information systems.

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Box 3: Promoting Dialogue in Uruguay

In Uruguay, the MIF project aims to promote the modernization of the labor relations system. This program has a number of innovative features. It assisted in developing an indicator which measures the level of labor conflict which is used and publicized by the Ministry of Labor. It promotes a representative but informal discussion group which meets on a regular basis to identify issues and problems connected with labor. A review of this project concluded that "the project contributed to the development in Uruguay of a new approach to human resources management and negotiation among various parties in labor market. The results were not just theoretical, but practical — an approach that can be applied to each problem and each enterprise." [QED Group, 2000]The result was a better and clearer understanding of labor market issues as well as an ongoing dialogue between the different parties involved which reduced the typically adversarial attitudes that characterized labor relations in Uruguay. It is this type of project that takes advantage of the MIF's capacity to experiment and to innovate.

- To harmonize labor standards.

- To promote better operation of the labor market and enhance dialogue and interaction between employers, unions and governments.

At this point it is too early to assess whether this program will be successful. Because of coordination difficulties, startup and execution has been substantially slower than anticipated although the project is now underway and all components are being executed.

A second program in Uruguay, although less ambitious, builds on the ability of MIF programs to provide information and build consensus regarding labor issues. It promotes dialogue between the employers, workers and unions. In addition, the program developed a generally accepted objective indicator of labor market relations which is regularly published. (Box 3). The simple act of publishing the data greatly increases the transparency of the process by giving the public an easily understandable measure of labor market relations and provides all sides involved in labor market negotiations with incentives to cooperate and refrain from unreasonable behavior.

A useful area for MIF operations would be to document the costs of startup and the various licensing and other regulatory hurdles that small businesses that are being formalized must go through in order to become formal. This information is needed for every country in which the MIF operates and collecting such data would be an invaluable service to small businesses and to policymakers in the region.

Documenting the Costs of Startup

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Chapter Endnotes

1 Variously known as despachantes or tramitadores, they are individuals who help people navigate the web of complex regulations in their countries. In Brazil, despachantes are acknowleged as a profession and must write exams to be admitted.

2 Holden and Shepherd [1992] documented 15 separate labor taxes that businesses in Brazil had to submit on a monthly basis. All had different bases on which the taxes were calculated. Even if one takes the view that higher non wage benefits are offset by lower monetary wages, the administrative cost of implementing the various mandated benefits and administering taxes places a substantial burden on small business.

There are many explanations regarding why small businesses are not flourishing in Latin America and even more suggestions on how to help them overcome the obstacles that are said to stand in their way.

There are many explanations regarding why small businesses are not flourishing in Latin America and even more suggestions on how to help them overcome the obstacles that are said to stand in their way. Since small business people frequently complain about the cost and availability of finance, schemes to provide small business financing abound and have been tried for many years. Observers see small businesses not adopting modern manufacturing processes and therefore prescribe subsidies for capital equipment purchases. Small business owners are seen to lag in the adoption of technology so technology assistance is provided. Small businesses frequently lack technical expertise; technical help schemes are developed. The list is long and the assistance schemes are numerous. Yet it is difficult to avoid concluding that many such programs are based on an ad hoc approach to small business assistance. They do not evolve from an approach which helps to identify which interventions are necessary.

This chapter looks at some of the issues involved in small business expansion from the perspective of the framework developed in earlier chapters. It identifies where interventions are warranted and where they have lower chances of success than is desirable. It will look at some of the areas where the MIF has implemented small business assistance schemes and identify possible areas of concentration in the future.

Small Business Finance

The financing of small business is a topic that has received a great deal of attention from policymakers.

The financing of small business is a topic that has received a great deal of attention from policymakers. Assistance schemes have been implemented ranging from subsidized loans to loan guarantees to help in purchasing capital equipment. Unfortunately the success of most attempts has been meager at best, although this has not discouraged advocates from proposing further measures. Before examining MIF operations in this area, identifying the various stages of small business growth and financing needs, provides a framework for analysis.

Stages of Financing for Small Businesses

Information on small business finance is virtually nonexistent in Latin America. However, research on small businesses in the U.S. provides valuable insights which have implications for improving the approach to financing small businesses in Latin America. Recent evidence from a large sample of U.S. companies [Berger and Udall, 1998] shows that the financial structure of growing businesses goes through several stages. In the start-up stage, financing comes primarily from owners' equity, and loans from family and friends. If the firm survives and starts to grow, additional equity finance becomes available in the form of venture capital, debt financing from commercial banks and trade credit from suppliers.

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The data from the US study indicate two particularly important characteristics of the early phases of small business finance. First, in the start-up stage, the personal finances of the business owner and the business are virtually indistinguishable. The ability of the entrepreneur to pledge personal assets to support the financial structure of his or her business is of critical importance. Second, once the firm has survived the start-up phase, bank financing becomes available and plays an important role in allowing further expansion. As the company then grows further, the third stage of financing comes from external equity investments, which play a small but essential part in financing successful high-growth companies. Finance for this stage can come from two sources; equity funds which invest in promising businesses; and from "angel" investors, who are individuals that risk their capital in exchange for equity in the company and the possibility of large rewards. The final phase of the transition from a small business to a larger successful company is some sort of IPO or buyout by a much larger firm. In the U.S. institutions have evolved which facilitate each phase of financing. This progression has yet to happen in Latin America.

In the U.S. institutions have evolved which facilitate each phase of financing. This progression has yet to happen in Latin America.

Nevertheless, the pattern of financial advancement described above provides important guidelines regarding policies to assist the financing of small enterprises in the region. Small companies in Latin America and the Caribbean need help beyond the direct provision of financing. Earlier sections documented just how onerous these burdens can be to entrepreneurs trying to start new small businesses.

....(S)mall companies in Latin America and the Caribbean need help beyond the direct provision of financing

Simplifying regulations regarding business start-ups aids the establishment of small firms. Secure rights for fixed property provide assets for entrepreneurs to raise start-up capital. A good secured transactions framework allows companies to pledge movable assets. A well functioning legal framework provides for the enforcement of financial contracts. These underlying issues need to be in place and therefore addressed as part of an overall strategy for assisting small businesses with obtaining finance. For the multilateral financial institutions or other aid agencies to provide loan funds or equity finance for small businesses directly without addressing the underlying institutional weaknesses could even discourage broader private sector participation.

Small business finance has idiosyncrasies that do not exist in the financial structures of larger companies.

The two key characteristics of an environment which allows newly established businesses to obtain finance – the ability of the owner to pledge personal property and the ability of firms to pledge business assets – are non-existent in most countries in the region.

The MIF has directly supported 11 microfinance projects in the region since 1993 and in total has been involved in nearly 50 projects to promote sound, efficient micro-financing practices.

Small business finance has idiosyncrasies that do not exist in the financial structures of larger companies. Access to funding, as well as the cost of credit appears to be a substantial constraint for this size of firm, largely because of the cost and the difficulty in obtaining reliable information on potential investees. Small firms' contracts are generally private and not widely reported. Small firms do not issue traded securities and many are not even audited so that it is hard for small business owners to credibly convey the quality of their businesses. Financial institutions are therefore wary of the moral hazard and asymmetric information problems involved in small business financing.

MIF's Role in Small Business Financing:

The MIF has not directly addressed issues of small business startup financing – indeed the theme of this section is that in economies with well developed financial systems, such financing usually comes from mobilizing savings of the entrepreneurs themselves, whether in the form of liquid assets or in the form of loans against property. However, in Latin America and the Caribbean, this is generally not possible, especially for the less prosperous. Most poorer people do not have secure registered titles to their property. The two key characteristics of an environment which allows new established businesses to obtain finance – the ability of the owner to pledge personal property and the ability of firms to pledge business assets – are non-existent in most countries in the region. While encouraging some reforms in this area could be a fruitful avenue for the MIF to pursue, in the past it has primarily focused on microcredit institutions to provide assistance to microenterprises.

Microfinance:

The MIF has directly supported 11 microfinance projects in the region since 1993 and in total has been involved in nearly 50 projects to promote sound, efficient micro-financing practices. This microcredit program has been both innovative and successful. "Undisputedly, the results are remarkable indeed" [Von Stauffenberg, 1999, p3]. It has had a history of identifying microcredit institutions which have the potential for success and providing them with support to ensure that their potential is fulfilled. So good has the MIF been at this that it can justly claim to have shaped microfinance in the region. "The MIF's success in microfinance reaches beyond its direct investments in intermediaries. Profund, the first investment fund aimed exclusively at micro finance, already has played a role in shaping the industry" [Von Stauffenberg, 1999, p3]. The microfinance initiative has clearly been a pioneering intervention into the financial markets of

Latin America and the Caribbean at the microcredit level and has undoubtedly helped informal entrepreneurs obtain loans at a time when microcredit was viewed as unacceptably risky. In several countries, commercial for-profit financial institutions have begun lending to informal entrepreneurs which implies that the mandate for MIF projects to attain sustainability has been achieved. This is a very considerable achievement.

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Lessons Learned:

The MIF microfinance program has been pioneering and visionary. It has paved the way for many other institutions to enter the microcredit field. The MIF has not so far been active in examining and promoting conditions that would assist firms that would like to cross the divide between microcredit and small business credit. With the possible exception of Profund, microcredit institutions perceive their responsibility ending once a (fairly low) loan size ceiling has been reached[1] . Since banks are still unprepared to lend to small businesses in most countries in the region and graduates of microcredit institutions are still far too small to be eligible for equity financing, small businesses are marooned in a no-man's-land where they are too large to be financed by microcredit institutions and where further expansion can only be financed from internally generated funds. In the future, the MIF should focus on how to provide an upward path for successful micro entrepreneurs into the small business world.

Early Stage Small Business Financing:

Financing which enables small businesses to flourish in the early stages of their existence is not something that should be provided directly. If financial systems are functioning effectively, most capital for business start up should come from owner's equity. For initial growth, financing should be provided by banks. In the region, such funding is not available because of institutional shortcomings

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Differences Between Secured And Unsecured Lending:

To see why this serious deficiency in Latin American financial systems exists, first consider the difference between secured and unsecured lending. Any loan implies a promise to repay in the future. Even if lending is secured—is backed by the ability of the lender to seize and liquidate assets of the business in the event of default—the amount of information necessary to make and support a loan is substantial. First, the lender needs detailed knowledge about the business and about the borrower. Second, the loan has to be constructed in a way that takes account of the business's needs but is not too large to put a strain on the likely cash flow. Third, the business has to be monitored on a continuous basis, both to assess the need for future funds and to ensure that it is doing well enough to repay the loan. Reliable financial reporting, certified by quality auditors, is a tool that many banks use to monitor loans. These measures are necessary for any prudent lender, in both the industrial countries and the developing world.

If a business fails, an unsecured lender has no recourse other than to wait while the bankruptcy courts dispose of the assets of the business, a process that in most developing countries takes years rather than months.

Bankruptcy proceedings in Latin America typically take many years because most countries in the region attempt to protect small business owners from their creditors. However, these measures are counterproductive.

Lengthy bankruptcy proceedings raise risks for lenders because the values of any assets that have been used to secure the loan often deteriorate rapidly; machinery becomes obsolete; inventory disappears.

Relationships between borrowers and unsecured lenders are fraught with moral hazard issues.

Bankruptcy Policies:

Bankruptcy proceedings in Latin America typically take many years[2] because most countries in the region attempt to protect small business owners from their creditors. However, these measures are counterproductive. Bankruptcy is a process in which assets that have been inefficiently used (because the activities in which they were employed do not yield sufficient rates of return or because the owners of the assets are incompetent) are redeployed to more efficient uses. The higher the transactions costs of redeployment (the cost and time of bankruptcy proceedings), the less efficient is the resource transfer. In many countries, bankruptcies typically recover only a small fraction of the value of the assets of the bankrupt business. Lengthy bankruptcy proceedings raise risks for lenders because the values of any assets that have been used to secure the loan often deteriorate rapidly; machinery becomes obsolete; inventory disappears; debtors vanish. Because risk is higher for lenders, the risk premium that all borrowers are charged is also higher. Misguided attempts to protect the weak through lengthy bankruptcy proceedings penalize the efficient.

How Credit is Obtained[3]

Relationships between borrowers and unsecured lenders are fraught with moral hazard issues. “Moral hazard problems may arise in any situation in which someone …is tempted to take an inefficient action or to provide distorted information because the interests of the parties are not the same and because the report cannot be easily checked or the action accurately monitored.” [Milgrom and Roberts 1992]. For moral hazard to be present, three conditions must be met. First, the parties undertaking the transaction must have divergent interests. Second, there must be opportunities for transacting that lead to a situation where the divergent interests come into play. And third, there must be asymmetric information—one of the parties must have better access to the facts of the situation than the other.

In most developed countries, institutions have evolved to reduce the risks that arise from these factors in the process of lending. Borrowers and lenders have asymmetric information about loans—it is impossible for a lender to know the business as well as the borrower.[4] The borrower therefore has a much better idea than the lender as to whether the loan can actually be repaid. In circumstances where there is no cost to the borrower of defaulting, the likelihood of default rises. Although lenders could charge higher interest rates to compensate for the risk, problems of adverse selection then occur. Since higher interest rates require a higher rate of return, which is associated with more risk, there would be a tendency for businesses run by risk takers to predominate among the borrowers. The risk structure of the banks' loan portfolio would be biased towards high-risk borrowers. Since banks generally behave in a rational manner and the most secure way to collateralize loans in Latin America is through real estate, they are reluctant to lend to businesses whose owners do not have clear title to large real estate holdings. Businesses that would have access to finance in the industrial countries are unable to find financing in Latin America, as well as in much of the rest of the developing world.

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Bank Regulation Issues

Further issues arise because of the need to ensure that the banking system remains solvent. Most bank regulators require that small businesses supply the banks with audited financial statements and with collateral (usually real estate) that covers any bank loans.[5] While this is clearly a vital issue for financial markets, the implications for small business of different bank regulatory practices are rarely considered. In many countries in the region, bank regulations require small business loans to be written off as soon as they are granted. This requirement arises because of the regulations governing company financial data and because of the requirement that loans be covered by pledges of assets. Many countries (often with the approval of the IMF) insist that companies use "Big 6" or equivalent accounting firms and that loans be fully secured. Both conditions are out of the reach of small firms. Unless the owner has substantial real estate holdings, the loan cannot be secured - collateral cannot be given because the movable property framework is inadequate in every country in the region. The expense of using a large internationally recognized accounting firm is completely beyond the financial capacity of small businesses. In this area, the MIF has initiated an especially innovative and interesting project in Nicaragua which aims to improve the standards of smaller accounting firms in order to improve the quality of information supplied to lending institutions as well as to reduce the cost to business owners of having audits of their firms.

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In many countries in the region, bank regulations require that small business loans have to be written off as soon as they are granted.

Secured Transactions Reform:

The Working Group Report [1999] identified secured transactions reform as a priority for MIF core activities. In particular, it identified secured transactions as a focus for future projects, a priority that reflects the urgent need for such reforms in the region[6] . To date, the MIF has attempted only two secured transactions reform projects, in Trinidad and Tobago and in Haiti. The Haiti reform has been hampered by the political

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Box 4: Accounting Standards in Nicaragua

The program objectives are:

- To strengthen the technical and professional skills of public accountants and private independent auditing firms in Nicaragua so that they may provide their clientele with transparent, reliable and timely accounting and financial information.

- To review and modernize the legal framework governing public accounting.

- Study the amendments to be made to the Commercial Code requiring firms to keep account books according to the generally accepted accounting principles. Publish and promote new standards strengthening the administrative structure and operations of the Accountancy Board to enable it to oversee the profession and develop continuing education programs; auditing firms, and examination of the methods for overseeing and evaluating the internal auditing units of public agencies in Nicaragua.

- This project addresses a problem that exists almost everywhere in Latin America. There is a large gap in accounting standards between large and small accounting firms. Bank regulators have proven reluctant to accept audited accounts from smaller accounting firms because of their concerns regarding standards.

turmoil in the country. The Trinidad and Tobago reform (see box 5) has the potential to effect a transformation of the secured transactions system in the country[7] .

The MIF has the opportunity to take the lead in secured transactions reform in Latin America and the Caribbean. The sums involved are not large – less than $2 million to rewrite, the laws, set up a filing archive, and train lenders and public officals in the use of the system. The potential benefits for financial systems, small business growth and poverty alleviation are very large. However, simply reforming the secured transactions framework will not bring about changes in lending without substantial training for bankers and lawyers in the use of the new system. Training should include learning how to access a registry or filing archive, the steps necessary to perfect collateral and the procedures that must be followed in the event of default.

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Box 5: Secure Transactions Reform in Trinidad

In its review of operations, the Working Group identified widening financing options through secured transactions reform as a priority. The recent secured transactions project, in Trinidad and Tobago, is a promising initiative. It will reform the legal framework to consolidate several existing laws with a single "code" of law that will cover all transactions involving a security interest in movable property. It will ensure that several movable property registries are consolidated into one registry. In addition, it will support the establishment of a privately managed credit bureau. As a first step, the consolidation of the registries is clearly required although at later stages moving to the most modern practices of converting the registry into a filing archive run by the private sector might be a welcome step.

Property Rights in Real Estate

In no country in the region is secure titling and registration available to the poorer sections of the population. Among the many consequences of weak fixed property rights are those which impact on small business formation and growth. The amount of potential wealth locked up in real estate that is held by possessory right by large numbers of the poor in Latin America is enormous; one estimate puts it at many trillions of dollars. "What the poor lack is easy access to the property mechanisms that could legally fix the economic potential of their assets so that they could be used to produce, secure or guarantee greater value in the expanded market" [de Soto, 2000] (p.48). The lack of secure rights to fixed property is one of the greatest failures of the state in the region and has far reaching consequences that affect financial markets, entrepreneurship, investment, and even crime and physical security.

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While the process of wholesale fixed property reform is beyond the capacity of the MIF to finance, experiments in titling and registration schemes are feasible. For example, the property reform in Peru which has resulted in hundreds of thousands of Lima's poorest residents receiving title to their properties, was based on the pioneering methods of Hernando de Soto [de Soto, 1988]. It was initially financed with a relatively small grant from the World Bank to ILD which allowed the process of identifying existing statutes and laws that needed modification to begin. Initial indications are that it has had a far reaching impact both on the wealth of the poor and on financial market development in Peru[8]. This is one area worthy of

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exploration by the MIF. As with movable property, following any such reform, substantial training is needed in order to help all people involved in the process integrate the property system into the financial system so that the benefits can be fully realized

Later Stage Small Business Financing.

Following business growth through startup funding and bank loan funding, rapidly growing small businesses face a need for equity capital. Continued borrowing to finance expansion risks over leveraging capital structures. Equity markets are severely underdeveloped in the region; stock markets are thin, the amount of trading is dominated by a very few large companies and IPOs are rare. As a result, startup capital is not readily available for new ventures. The MIF initiated a number of different types of equity funds to ascertain the degree to which this gap could be filled. Funds supported by the MIF include:

- Community development funds
- Venture capital funds
- Funds that promote the environment
- Technology funds
- Agro-business funds

Over the period since the funds became operational they have attracted more than 40 co-investors including other international organizations, national finance entities, foundations and the private sector.

Following business growth through startup funding and bank loan funding, rapidly growing small businesses face a need for equity capital.

Lessons Learned from Venture Funds

A review of the MIF equity fund program [Holden, 1999, p28] described the MIF's efforts to promote equity investment in small and medium-sized enterprises in Latin America as "a bold effort to jump start financial market development in this area". The review recommended that the MIF step up its efforts to coordinate the equity fund program with broader steps to reform financial markets in the region. To this end, the MIF has decided to slow down assisting new funds and focus on such problems as the lack of exit mechanisms and the more general issues related to small business finance. The focus has shifted towards commercial vehicles and promoting MIF's environmental niche. New fund creation is being confined to the smaller countries. This step appears to be appropriate – even if all MIF's resources were devoted to equity funds, it would still make up a very small fraction of private direct investment in the region. The funds have achieved the important goal of demonstrating that they are feasible. The next step must be to reform the institutions underlying financial markets in order to promote further privately supplied equity financing.

A further issue is the training of fund managers, particularly through the exchange of information. Given that MIF now has interests in a significant number of funds, the amount of experience that is being gained is substantial. This can be utilized in two ways:

First, the interchange of information between the managers themselves can provide invaluable assistance to all fund managers. The MIF has moved to promote this, which is a welcome step and one which should continue.

Second, the experience of the funds could provide a wealth of information to private sector funds. This experience needs to be widely disseminated throughout the region.

Experience with the equity fund program indicates that funds managed by private sector, profit oriented managers appear to be performing, in general, better than those managed by NGOs. Although development institutions have a strong interest in working with NGOs (or civil society) in the development process, funding of NGO managed equity funds does not seem to be a promising avenue for future cooperation

Given the underdeveloped state of capital markets in Latin America, the straight equity approach to investing in small businesses has not proved to be very successful because of the lack of exit mechanisms. Rather, various types of loan instruments appear to be a better vehicle for small business investment. In addition, the experience of the funds reinforces the points made in earlier sections of this report – even companies that have received equity investments from the funds have extreme difficulty in obtaining bank loans.

The overall conclusion from the equity fund program is that it has been a pioneering initiative. Nevertheless, efforts should now be focused on systemic reform issues and on spreading the results of the experience so that purely private sector operators can benefit from MIF's experience. The vehicle for disseminating the lessons learned from the equity fund experience needs to be carefully thought out to maximize the impact of the message.

Second and Third Tier Financial Institutions

A feature of financial markets of the industrial countries, particularly the United States, is the rich array of second and third tier fi-

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Box 6: Equity Funds

The MIF has invested in 20 equity funds in the region. Besides demonstrating that this type of instrument has potential for small business financing in the region, the experience has identified a rich source of information on problems facing small businesses. Fund managers and executives of the companies financed by the funds described problems that they encountered. They spoke eloquently of the problems of overly burdensome regulation and inadequate institutions that raise the costs of transacting and hinder their business operations. These discussions constitutes an extremely rich source of information on the practical measures that could be taken to improve the conditions under which the small business sector operates in Latin America.

In the early stages of establishing the funds, the MIF did not attempted to integrate its support of small business equity funds with its broader mission to help SMEs in Latin America. Insufficient experience was unavailable from the funds themselves and from the companies they supported. However, as experience has accumulated, this has changed. The MIF is now attempting to coordinate its activities in creating small business equity funds with its role in improving the environment in which small businesses operate in the region. This step will enhance the ability of the MIF to fulfill its mandate. By identifying and using this knowledge in pursuing its broader mission, the MIF can improve the environment for small businesses as well as promoting and enhancing the operation of equity funds.

The overall conclusion from the equity fund program is that it has been a pioneering initiative. Nevertheless, efforts should now be focused on systemic reform issues and on spreading the results of the experience so that purely private sector operators can benefit from MIF's experience

nancial institutions that provide different types of financing and liquidity to financial markets. These institutions provide as much as 50 percent of the total credit to the private sector from the financial system. By contrast, private sector financing in Latin America and the Caribbean is dominated by commercial banks – on average banks provide over 90 percent of all credit to the private sector. The types of financial institutions and instruments that are missing in the region include:

....(P)rivate sector financing in Latin America and the Caribbean is dominated by commercial banks – on average banks provide over 90 percent of all credit to the private sector.

- Factoring institutions that use accounts receivable as security for loans
- Leasing Companies and other trade financial institutions that specialize in financing equipment
- Institutions that underwrite and issue asset-backed securi-

ties, thereby increasing the liquidity of the financial system as a whole

- Underwriters that help companies make IPOs

As in many other types of economic activity, specialization pays. A broad array of financial institutions are needed for financial markets in Latin America to serve small business. By knowing the industry that it is financing, lenders can better assess financial and investment plans. The MIF could take the lead in identifying the institutional and legal reforms that are necessary for financial deepening to occur.

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Chapter Endnotes

1 Typically, the ceiling ranges from US$800 to US$2000.

2 In many countries in the region, bankruptcy proceedings can drag on for up to 10 years during which time any assets sit idle and the business owner cannot enter into another business.

3 For a more comprehensive discussion of the information requirements and problems in the making of loans, see H. Fleisig [1996].

4 It is for this reason that many lenders require small and medium sized business borrowers to provide personal guarantees. This presupposes that lenders can easily seize the personal property of the borrower.

5 The value of the real estate in general must substantially exceed banks' exposure to compensate for the inefficient and cumbersome procedures associated with executing on real estate collateral. This requirement substantially raises the owner's risk of failure because there is a wedge between the value of the assets to the owner and the value of assets to the lending institution.

6 At this point, not one country in the region has a well structured operational framework that effectively allows the pledging of movable property as security for loans.

7 A more comprehensive reform (which is not a MIF project) is underway in El Salvador. This project, which could serve as a model for countries where there is widespread support for reform, features a number of innovations which are worthy of close examination. They include; an electronic filing archive; the involvement of the private sector in guaranteeing the accuracy of the archive; the involvement of small business organizations; and extra judiciary proceedings for the seizure of pledged collateral in the event of default.[See Holden, 1999].

8.The impact on those who have acquired registered titles for their properties has been dramatic. The value of a dwelling in one of the poor areas of Lima doubles overnight when it is titled and registered. In addition, this program has greatly contributed to the development of financial markets in Peru. Banks are prepared to use the newly registered titles as security against mortgage loans and many property owners have borrowed to finance their businesses or to invest in land and dwellings.

Chapter 7: Non-Financial Small Business Issues

There is now substantial evidence to support the contention that critical factors in small business success are the skills of the owner as well as the competence of the firm's employees.

There is now substantial evidence to support the contention that critical factors in small business success are the skills of the owner as well as the competence of the firm's employees. As small businesses in Latin America have been confronted increasingly by the realities of global competition, many find that they do not have the trained personnel nor the management skills to cope in the new business environment. There are numerous businesses experiencing problems of this type in many sectors which range from technology to retailing to manufacturing to tourism. The problems of supplying expertise to such a diverse group are substantial. Nevertheless, the MIF has undertaken numerous projects in this area. It has attempted to enhance labor force skills in the region by setting standards and implementing training. "Working in partnership with local groups, projects have emphasized continuous training, skills standards and certification methodologies and promoting access for small and medium business to international quality assurance and environmental standards" [MIF, 2000, p6].

A full review of MIF's projects in this area is well beyond the scope of this report. Rather, highlighting some of the strengths and weaknesses of its interventions will give a picture of what has been achieved and the type of projects that have been successful.

Business Development Centers

The MIF has undertaken over 30 projects relating to small business advisory services.

The MIF has undertaken over 30 projects relating to small business advisory services. As part of this program it supported the establishment of 12 business development centers in the region. These centers provide a range of services which include:

- Help with getting small businesses established
- Advice on selection of personnel
- Training of personnel
- Technical assistance and training
- Accounting and legal services assistance

The centers provide initial services on a subsidized basis with charges gradually increasing as firms gain experience and confidence in the quality of help they are receiving.

The centers provide initial services on a subsidized basis with charges gradually increasing as firms gain experience and confidence in the quality of help they are receiving. MIF support consists of providing funds which cover part of the cost of setting up the centers as well as initial running expenses. Ultimately fees from firms are expected to lead to sustainability.

Experience with the centers has been decidedly mixed and few have approached long term sustainability. Several significant problems have emerged.

- The quality of the services provided by the centers has often fallen short of what might be expected.

- Use of centers by small businesses has been disappointing. One explanation is that firms are often complacent about their operations until confronted by strong competition, by which stage it is too late and they fail.

- The firms themselves have had great difficulty incorporating the training that they received into their day-to-day business operations [Angelelli et al, 2001]. Often they proved to be passive recipients of assistance which has not translated into improved efficiencies or dynamism.

- There now seems to be some evidence [see Angelelli et al, 2001] that business centers closely associated with the public sector do not work, which in retrospect is not surprising given the entrepreneurial energy necessary to make a success of such centers.

Experience with the centers has been decidedly mixed and few have approached long term sustainability.

Box 7: Revamping a Business Assistance Program in El Salvador

The MIF in conjunction with ANEP, a business association in El Salvador, initiated a program to assist small business in El Salvador through training and the provision of technical assistance. In its initial stages the program encountered substantial difficulties because of slow implementation and difficulties finding appropriate consultants. While this experience was not uncommon for small business assistance projects, further developments provide an illustration of how setbacks can be overcome. With the agreement of the MIF, the original three year time period for the project was extended. A new manager was hired who improved the quality of the services and the consultants employed under the scheme. He aggressively marketed the revamped organization to small businesses who responded favorably by extensively utilizing its services. When the project came to an end, with the support of local and foreign partners a new organization was formed employing the same manager and personnel. Its work continues with some minimal MIF funding.

Lessons Learned

There now seems to be some evidence that business centers closely associated with the public sector do not work, which in retrospect is not surprising given the entrepreneurial energy necessary to make a success of such centers.

In the main, the business centers that the MIF have supported have not proved to be especially successful. The business center in Rafaela-Esperanza in Argentina, which is widely regarded as an international model for small business service provision, is a notable exception. Since its founding, it has displayed exceptional energy and initiative. It has undertaken extensive outreach to firms and is known for the quality of the services that it provides. By some measure it is now close to self sufficiency. It appears to have a strong future and is rightfully regarded as a model. The key factor in the success of the Rafaela-Esperanza business center appears to be the energy and initiative of its personnel. The conclusion is that the success of a business center is very hard to predict ex ante when it is in startup or very early stage mode.

Experience to date shows that assisting startup or early stage centers is not a good idea. If help is to be given, it might be better to help a successful center expand into new areas.

MIF has, in the view of the author, correctly decided to limit its future involvement in small business centers. Experience to date shows that assisting startup or early stage centers is not a good idea. If help is to be given, it might be better to help a successful center expand into new areas.

Skills Certification and Training

ISO Standards

The MIF has had a pioneering role in introducing these standards to Latin America and the Caribbean.

The MIF has pioneered the introduction of international skills and standards certification in Latin America and the Caribbean in an effort to upgrade the quality of small business products and to provide international buyers with assurance regarding the quality of the products that they might purchase from small businesses in the region.

The MIF has pioneered the introduction of international skills and standards certification in Latin America and the Caribbean in an effort to upgrade the quality of small business products and to provide international buyers with assurance regarding the quality of the products that they might purchase from small businesses in the region. It has implemented 37 training projects oriented toward meeting private

***Box 8: ISO Standards*.**

The aim of adopting ISO standards is: to facilitate trade, exchange and technology transfer through enhanced product quality and reliability at a reasonable price; improved health, safety and environmental protection, and reduction of waste; greater compatibility and interoperability of goods and services; simplification for improved usability; reduction in the number of models, and thus reduction in costs; increased distribution efficiency, and ease of maintenance sector needs for specific skills and 15 additional projects which have worker skills and certification components. The projects focus on building worker competencies and developing accreditition standards so that employers have confidence in the skills of those that they hire.

The MIF has also begun to focus on product standards and quality through the introduction of International Organization Standards (ISO). The aim is to facilitate trade and technology transfer through:

- Enhanced product quality and reliability at a reasonable price
- Improved health, safety and environmental protection and reduction of waste
- Simplification for better usability
- Increased distribution efficiency and ease of maintenance

Users have more confidence in products and services that conform to International Standards. Assurance of conformity can be provided by manufacturers' declarations, or by audits carried out by independent bodies. In general, the non sector specific MIF programs have revolved around the implementation of standards developed by the International Organization for Standardization. Noteworthy efforts have been made to introduce an awareness and use of ISO standards in a number of countries and several conferences have been held on the uses and advantages of standards. ISO standards have aroused a significant amount of interest among government departments concerned with manufacturing and exports as well as among industry bodies.

However, to date this interest has not translated into adoption by small business. Typical of the attitudes towards ISO standards by small business in the region are those expressed by small business owners in El Salvador. "Not only have El Salvador small business entrepreneurs not embraced international standards, many do not even know about them. In response to a question regarding ISO 9000 norms, 67 percent indicated that they had not even heard of them and only 5 percent have adopted, or are in the process of adopting, such standards. When those who knew of the ISO standards were asked why they had not adopted them, a majority replied either that there was no need or that there was no demand for such standards" [Holden, 2000, p 46].

Beyond further publicizing the benefits of such standards, there is probably little that can be done to extend their use to small businesses in the

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region. The MIF projects to date have shown that there is interest and that introducing these standards is feasible – this is a laudable achievement. However, even if there is interest in the development community for further projects of this type, unless the interest is matched by small business associations in specific countries, it is probably better not to pursue further implementation of technical standards. Nevertheless, the MIF projects have demonstrated that it can be a frontrunner in areas that will undoubtedly increase in importance in the future.

Tourism Training

MIF has implemented 9 projects connected with tourism training...They have all focused on human resource development within the tourism sector to develop formal occupational skill standards and credentialing.

MIF has implemented 9 projects connected with tourism training, of which 2 have been at a regional level (in the Caribbean) with the others being either at the country level or for areas within countries. Most were directed at the tourism industries within the Caribbean basin, but there have been three others, two in Brazil and one in Peru. They have all focused on human resource development within the tourism sector to develop formal occupational skill standards, certification and credentialing. The purpose of these programs was to develop a model that could be used for the Latin American and Caribbean region as a whole.

A review of the group of tourism training projects states that "the projects taken together are revolutionizing the way human resource matters have been handled in the tourism industry in the Caribbean.

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Box 9: A Flagship Job Standards Program in Brazil

In 1998 MIF and the Brazilian Small Business Administration (SEBRAE) awarded a $5 million grant to the Instituto de Hospitalidade (IH) for the purpose of increasing the supply of well trained workers and enhancing the quality and productivity of the tourism sector in Brazil. Although Brazil has extensive tourist attractions, it does not rank among the world's top 40 destinations for tourists.

The program started in Bahia in the North East of the country and by the end of 2000 had registered substantial progress. Specific standards for over 30 occupations were completed and thousands of workers successfully completed the program. For example, tour guides were trained in history and geography as well as in workplace attitudes and customer service. Health standards for restaurants were implemented and hotel personnel trained. Plans are now being developed to broaden the program on a national basis to further promote tourism in Brazil and to extend the standards that have been developed into related industries such as restaurants and foodservice.

The commitment of industry and the progress that has already been made is an excellent foundation on which to move forward" [ARA Consulting Group, 1999]. The judgment was based primarily on an assessment of the projects in the Caribbean. Although the report was in general positive about the progress that had been made in tourism training, it emphasized a number of procedural caveats in terms of the goals of the project, the complexity of design and the commitment of counterpart agencies. In the period since the report was written, however, progress on the various projects has varied widely. The projects in the Caribbean have experienced further delays (which were alluded to in the ARA report) while the project in North East Brazil has proved to be a model on which further projects could be based.

Project design should not be overly ambitious nor should it require cooperation between too many groups.

Lessons Learned

While the aim of this assessment is *not* to focus on process, there appears to be clear evidence that there are several procedural criteria that are of great importance in designing technical training programs:

- Project design should not be overly ambitious nor should it require cooperation between too many groups.

- The counterpart agency should be well funded and highly motivated and preferably from the private sector.

- The degree of professionalism of the counterpart agency is particularly important and the influence of the central government should not be strong.

Alternative Dispute Resolution

Alternative Dispute Resolution (ADR) is any process that resolves a conflict or dispute using processes other than litigation. ADR includes arbitration, mediation, and conciliation. Dispute resolution may be a small part of reform in terms of the judicial system as a whole but it could prove to be a crucial issue for SMEs that need to find a secure and affordable method of resolving commercial disputes.

The MIF has pioneered the introduction of ADR procedures in Latin America. The MIF has supported 18 dispute resolution projects most of which have emphasized training and information dissemination.

The MIF has pioneered the introduction of ADR procedures in Latin America through the support of 18 dispute resolution projects, most of which have emphasized training and information dissemination. It has supported existing ADR centers, assisted in the creation of new centers, trained officials so that they provide this service as efficiently as possible, and educated the public—and the business sector in particular—on the advantages of ADR and how to best use the system. The primary goal of these efforts has been to provide the private sector with a less costly and less time-consuming

Box 10: Alternative Dispute Resolution

Arbitration is a process similar to the court system but it is generally quicker, less formal and conducted in private. A neutral third party—the arbitrator—is hired by the parties and is empowered to resolve a dispute by making an award. The rules of evidence are relaxed and there is little pre-hearing discovery. The arbitrator will hear evidence and submissions on behalf of each party and then decide on the appropriate outcome. Arbitrated awards are normally binding unless the parties have elected a form of advisory arbitration. The ruling can often only be appealed on a narrow range of grounds—such as fraud or the refusal to hear evidence material to the dispute. Awards are enforced by the Courts. *Mediation* was designed as an alternative to arbitration or litigation. A neutral third party—the mediator—helps the disputants to negotiate their own resolution to the situation. There are different approaches to mediation taken by different mediators but the process in essence is one in which the mediator helps the parties negotiate. The mediator does not have the power to impose a settlement to which either party objects. This is a process in which the parties retain control over the shape of an acceptable outcome. It is an especially appropriate process where those involved in a dispute need to relate to each other or conduct business in the future. *Conciliation* is a process whereby conflicts between parties are resolved without formal dispute resolution processes. The neutral party gathers information regarding the issues in dispute and makes it available to both sides. The conciliator also deals with any procedural matters. If a case cannot be resolved via conciliation, the conciliator explores what remains to be done prior to futher legal proceedings. The importance of arbitration procedures is highlighted by the prominent role that they have in NAFTA contracts.

way to resolve disputes and to loosen the bottleneck clogging the official judicial system. By encouraging the proliferation of ADR centers, the MIF is helping relieve some of the pressure on the formal judicial system and encouraging SMEs to resolve their disputes through more formal means without incurring substantial legal costs. The more accessible resolution mechanisms are, the less expensive it becomes to contract and to conduct arms-length transactions.

The MIF ADR projects have begun to change the way in which ADRs are regarded in much of the region.

Lessons Learned:

The MIF ADR projects have begun to change the way in which ADRs are regarded in much of the region. In spite of the difficulties in implementing ADR projects, this is a substantial achievement and in many countries the work initiated by the MIF is being continued by local agencies. As ADRs becomes more widely recognized as a useful legal tool, more people will become comfortable with the process and the procedures will be more widely used. There are indications that those who had not chosen ADRs previously are beginning to view them as an alternative to the formal judicial system. Given that many small businesses do not use the court system, they likely benefit most should ADR decisions become truly enforceable. The MIF has demonstrated that ADRs can be effective and local legal bodies are taking the issue forward. On the other hand, there is no substitute for a well-functioning, efficient judicial system and judicial reform must continue.

Chapter 8: Conclusion

Identifying Issues and Priorities for MIF Operations:

There are still vast areas where little is known regarding either what to do or how to set priorities.... small business projects are being designed and implemented with too little information.

The Working Group Review of MIF operations recommended that project design be strengthened. The question that this recommendation provokes is how to go about doing so. MIF has had a policy of not supporting "studies," that is, work that is not strictly project related. Such a policy is understandable in view of the vast outpouring of study reports on various development issues that typically start gathering dust from the day that they are completed. However, the problem is often the result of poorly defined terms of reference and inadequate capacity or will to implement the recommendations. There are still vast areas where little is known regarding either what to do or how to set priorities. Small business projects are being designed and implemented with too little information. If terms of reference are sufficiently tightly defined and implementation action plans are required for any recommendations, "studies" can provide essential information on which to base MIF projects. Indeed, it is hard to see how projects of the type that have been recommended in this review could be properly designed and implemented without such information.

This review identifies small business regulation as one of the areas where future MIF operations should be concentrated.

The knowledge that accumulates within MIF comprises valuable experience obtained through "learning by doing."

Little is known about the costs of regulation on small business, how the costs vary from country to country and how these regulations are distributed between federal, state, and municipal levels of government. Such information is required for virtually every country in the region and in some cases for areas within countries.

This review identifies small business regulation as one of the areas where future MIF operations should be concentrated. Little is known about the costs of regulation on small business, how the costs vary from country to country and how these regulations are distributed between federal, state, and municipal levels of government. Such information is required for virtually every country in the region and in some cases for areas within countries. Furthermore, if properly disseminated, the demonstration effect from such work will be cumulative. As evidence of the cost of regulation mounts, policy makers in countries where such work has yet to be done will start to take notice and ask for assistance. This is only one example of a host of issues that require serious analytical investigation as part of the design and implementation of MIF projects. This issue also complements the recommendation that MIF increase resources and efforts to analyze and disseminate the lessons learned from its projects.

MIF and Project Innovation: What are the Issues?

Part of the MIF mandate is to undertake innovative projects. What this means, however, is open to more than one interpretation. One construal could be that the MIF should undertake one or two projects to determine if they are feasible then pass on similar additional projects to other aid institutions. However, such a strategy would result in very substantial inefficiencies. The process of learning how to design and implement a particular type of project involves trial and error in the process of arriving at good design and execution. The knowledge that accumulates within MIF comprises valuable experience obtained through "learning by doing." Although project evaluation and lessons learned analysis along the lines described in the previous section will help, for full knowledge to be transferred to other projects outside the MIF, the people involved would have to assist. In this case it would be more efficient to keep the project within the MIF.

....(E)xperience casts doubt on the notion that after one or two successful demonstrations, the MIF should move onto something else and belies the assumption that projects are easily replicable across countries.

An alternative definition of innovation would be for the MIF to innovate on a country basis rather than on a project type basis. Although this approach might seem to be repetitive, in reality it would be less so than would appear at first glance. Countries have circumstances and institutions that are unique and require subtly different approaches even for the same project. For example, the tourism skills enhancement project that succeeded so well in Brazil, was much less successful in the Caribbean, even though aims and design were fairly similar. Such experience casts doubt on the notion that after one or two successful demonstrations, the MIF should move onto something else and belies the assumption that projects are easily replicable across countries. It makes a strong case for the MIF building up competency in essential areas such as property rights and innovation by implementing projects on a country by country basis across the region.

An alternative definition of innovation would be for the MIF to innovate on a country basis rather than on a project type basis.

Implementation of Reform Projects:

The strategy for projects that are narrowly defined and limited in scope, such as financing assistance centers, should be different from that for projects which aim to reform institutions more broadly. If the former fail, little is lost beyond having participated in an experiment. This in itself adds to knowledge because is possible to learn much from such failure. However, in the case of systemic reform projects, the consequences of failure are much more serious. For example, attempting to reform the secured transactions framework to improve collateral that small businesses can give lenders is substantially more complex than projects that provide, for example, training or export assistance.

The strategy for projects that are narrowly defined and limited in scope, such as financing assistance centers, should be different from that for projects which aim to reform institutions more broadly.....(A)ttempting to reform the secured transactions framework to improve collateral that small businesses can give lenders is substantially more complex than projects that provide, for example, training or export assistance.

The process of institutional reform requires expending extensive political capital, widespread publicity for what is being attempted and soliciting the active support of small business groups, chambers of commerce, banks and other parties who will benefit from the reform. Such efforts raise expectations significantly. If the reform is not successful because of faulty design or implementation, the political capital will have been expended for no gain and the disillusionment with reform can set back further efforts for many years. It is therefore essential that such reforms solicit the review of acknowledged experts in the area that is being reformed. Quality control is essential. If institutional reform projects fail, the result can lead to bitter disillusionment with advice from donors and consultants.

MIF and Small Business Projects in the Future

Its ability to experiment and innovate makes the MIF the ideal institution to take the lead in innovative projects which promote systemic reform that would enable the small business environment to improve radically.

The conclusion of this review of MIF's involvement in assisting small businesses in the Latin America and Caribbean region is that MIF has demonstrated that it has unique potential among development institutions. It has the capacity to fund interesting innovative projects with relatively few bureaucratic requirements and in a relatively short time. Many of the projects that it has funded since it began operations in 1993/94 have demonstrated these characteristics. It has pioneered micro-finance initiatives, labor issues, equity funds, alternative dispute resolution mechanisms, training programs, and business assistance. When examining the range of projects that the MIF has undertaken, the breadth of different areas in which it has undertaken operations is striking. While embarking on projects over a wide range of issues was probably appropriate at the outset of operations, the recommendations of the Working Group to significantly narrow future MIF operations is one that should enhance the effectiveness of future operations.

There has been too little focus on the conditions that enable companies to prosper and, more particularly, on the factors that encourage the establishment and growth of small business.

A theme of this report is that issues facing small businesses in the region are similar to those that face the private sector more generally, but that these problems impact small businesses disproportionately. The report pointed out that informality poses a huge cost in many countries, perpetuating low productivity and poverty. Much of the informality that exists occurs either because of labor market barriers or because the small business sector is not sufficiently dynamic to generate the employment and growth necessary to reduce endemic poverty. Most small firms in the region were established before the most recent round of reforms. The report points out that the expectation that the reforms in themselves would bring prosperity was based on the failure to realize that it is companies that generate employment and growth and which ultimately bring prosperity. There has been too little focus on the conditions that enable companies to prosper and, more particularly, on the factors that encourage the establishment and growth of small business.

A theme of the successful projects mentioned in this review is that they all involved highly motivated, well organized counterparts.

This report strongly recommends that, in the future, the MIF focus on policies which remove barriers to small business startup and growth. Its ability to experiment and innovate make the MIF the ideal institution to take the lead in innovative projects which promote systemic reform that could improve radically the small business environment. The MIF should now focus on core activities, such as improving the regulations and costs associated with starting small businesses, small business registration systems, property rights in fixed and movable property, institutional reform in the financial sector, and further promoting the development of capital markets. Although there are substantial political hurdles to be navigated, many of these areas do not require large sums of money to effect radical change. Pioneering initiatives can be implemented at a comparatively low cost and are ideally suited for MIF support.

While the MIF does not provide continued support to any of the counterpart institutions with which it deals, it should consider adopting a policy of "backing winners."

In implementing projects, the report recommends that the innovation criterion be applied to countries rather than projects themselves. The MIF needs to build up core competence in all these areas – one reason that it has been able to achieve innovation in such areas as equity finance and training is that it possesses talented and experienced personnel who have built up expertise in these topics. Such expertise needs to be extended to areas like secured transactions reform and business registration models.

MIF is the ideal institution to take the lead in innovative projects which promote systemic reform that would improve the small business environment radically. The MIF should now focus on core activities, such as improving the regulations and costs associated with starting small businesses, small business registration systems, property rights in fixed and movable property, institutional reform in the financial sector, and further promoting the development of capital markets.

The report further recommends that in a practical way, the MIF extend its knowledge of the cost of barriers facing small businesses in the region. In particular, the cost and impact of regulation on small business needs to be obtained and used in the design of reform projects. Other obstacles to small business development need to be identified and worked on. While this recommendation might be seen as a move towards financing studies, a practice that to date the MIF has eschewed, such information is essential for identifying the issues and costs that face small businesses in the region. If properly undertaken, it could greatly strengthen MIF's project design.

It is striking that the successful projects mentioned in this review all involved highly motivated, well organized counterparts. While the MIF does not, and should not, provide ongoing support to the counterpart institutions with which it deals, it should consider adopting a policy of "backing winners." Successful institutions with which the MIF can work are still relatively scarce. While eschewing policies that would lead to dependency, ways of extending the scope of successful projects, or exploring new areas with high quality counterpart institutions are worth considering.

In particular, the cost and impact of regulation on small business needs to be obtained and used in the design of reform projects. Other obstacles to small business development need to be identified and worked on.

The uniqueness of the MIF as a development institution makes it the ideal vehicle for further pioneering initiatives. By narrowing its focus to deal with the systemic and institutional barriers faced by small businesses in the region, the MIF has the opportunity to make a substantial contribution to alleviating the poverty still faced by too many people in Latin America and the Caribbean.

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