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SMALL-SCALE NON-AGRICULTURAL EXPORTS AS A ROUTE TO POVERTY ALLEVIATION¹

by

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1. Background

While a number of developing countries have built their export success on small-farm sectors (Ghanaian cocoa, Colombian coffee, Malaysian rubber and tea, and so on) manufacturing and other non-agricultural items produced on a small scale have in most countries been of distinctly marginal importance. The attractiveness of linking low income producers of artisan items has been recognized by many analysts and policy-makers but with few exceptions the impact on employment and hence on the incomes of poorer people has been minuscule. The experience of Japan and the pivotal role of the trading houses which linked small producers to the international market highlights the nature of the problem: while small producers may fairly often be able to turn out items with important international demand, they are not in a position to export them directly because of the economies of scale at the level of commercialization. Large producers can, at least under some circumstances, jump the threshold into world markets, but unfortunately for their poverty-alleviating potential, they tend to be much less labour intensive--especially low-skilled labour intensive--than do small producers. Thus the challenge which has long confronted developing countries is that of combining export activities with high levels of employment creation. This challenge has been made both greater and more important over the last decade or so by two trends: first, most countries have become more integrated into the world economy, both because of exogenous trends toward lower costs of transport, better information flows, etc., and through policy choice of more open systems. Second, this opening-up process has coincided rather systematically with worsening income distribution. Since the distribution of primary (pre-tax and transfer) incomes in any country is a joint outcome of the average level of per capita income and its distribution, when distribution worsens more growth of per capita income is required to have the same poverty-alleviating effect. The fastest road to poverty alleviation is growth with equity.

Much of the developing world thus faces the challenge of achieving growth, employment creation and equity in the context of increasing integration with the world economy. While many analysts feel that such integration will foster better growth performances in the LDCs, the views on employment creation and the related income distribution outcomes are in general less optimistic, with the balance shifting towards pessimism as the evidence comes in
from liberalization experiences around the world. The transition towards market economies in the Eastern European countries has perhaps not surprisingly led to rapidly widening income gaps. More directly relevant, such increases in inequality have been frequent around the world in both industrialized and developing countries, suggesting that any optimistic expectations on the distribution front should be discarded and that a neutral outcome should be cause for satisfaction. The important question now is whether the impact in any given country will be negative and large. Hence the importance of assessing the possible dimensions of this threat and the ways it might be avoided or attenuated. In this context the potential of small-scale enterprise (SSE) in the creation of productive employment and in avoiding increasing income inequality is a matter of great importance. There are good grounds for believing that, when it can be linked to the export process, this sector can contribute importantly to fast growth both of exports and of GDP and that, because of its labour intensity, this process would be inherently employment creating and inequality reducing.

On the former count, the record of several East Asian countries is central. In Japan, Taiwan and Hong Kong small and medium industry (SMI) has been conventionally viewed as important to the success of the export push; it either exports a significant share of its output directly or helps to keep the cost levels of larger exporting firms competitive by subcontracting with them. It is generally believed that subcontracting is less important elsewhere.

1 Predictions of the distributional impact of market-oriented reform packages, in which trade liberalization is an important component, have varied widely; the popular view that freer markets generally increase inequality has been countered by the idea that trade liberalization in particular should have the opposite effect, based on the simple Hecksher-Ohlin theory that the freeing of trade should shift factor demand in favour of unskilled labour and of agriculture and thereby improve the distribution of income (e.g. Krueger, 1990).

2 Within Latin America, for example, dramatic increases in inequality occurred in Chile, Argentina, and perhaps also Uruguay and Mexico concurrent with market-oriented policy packages which included trade liberalization as a central feature (Berry, 1995).

3 The term small scale enterprise is used here to encompass all enterprises which are not large, i.e. those with less than say 200 workers. Distinctions within this range are made when relevant.

4 In considering the potential role of SSE in exports and in poverty alleviation, it is important to distinguish among types of SSE. Size is one consideration, ranging from microenterprise to medium sized firms. Degree of integration into the economy is another, as are level of technology and the nature and degree of linkages with larger firms.
in the Third World and that, correspondingly, the complementarity between large industry (LI) and SMI is less than in that part of the world. The challenge of successful restructuring of manufacturing in many LDCs, to make it both more efficient in economizing on scarce resources and in using abundant ones and hence better able to compete internationally, suggests the importance of using the contribution of SMI in the low cost production of labour intensive items or components. Most important is the evidence from several countries that a manufacturing sector in which relatively small firms play a major role can simultaneously perform well on the criteria of growth, employment generation and income equality, and export success. Taiwan is the classic case. With its small farms and relatively small manufacturing establishments (especially at the earlier stages of its rapid growth period), it achieved exceedingly fast economic growth, even faster export growth, and the most equitable distribution of income among all the non-socialist developing countries (Kuo et al, 1981; Scitovsky, 1985). Since its industrial structure began to move away from the large firms on which initial export success was built to a mix involving many more SMI, Korea has emerged as another example. Brazil provides an interesting counterpoint. Though it too has grown rapidly over the Post-war period, income inequality has been and remains extreme. Brazil's exports are disproportionately produced by large firms which do so in relatively capital intensive ways (Berry, 1992, 63).

The importance of successful incorporation of SSE in the export activities of LDCs thus derives both from the direct positive evidence of its employment generating capacity and from the accumulating evidence that the currently popular policy reform package has been in many cases associated with sharp increases in income inequality, which signal the lack of adequate creation of reasonably productive jobs. The large firms which in most countries dominate exports of manufactured and mineral products, and sometimes of agriculture as well, are now in a bout of downsizing of their labour forces in order to raise productivity and efficiency. This process, together with layoffs of public sector workers, may be one of the factors underlying the process of income concentration noted above. Even SMI are caught up perforce in the search for efficiency and cost reduction, so that their own employment generating capacity may be less than might be hoped for.

In any case, for a number of LDCs the effective insertion of SSE into the international trade process may well be the only game in town in terms of providing growth without loss of equality.

The last couple of decades have, fortunately, seen a belated recognition of the role and possible contribution to development of smaller enterprise, whether of microenterprise or of small or

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5 In a more limited sense, countries like Colombia (during the 1970s) have given evidence of the potential of SMI to grow very fast and created significant amounts of employment (Cortes et al, 1987, 69).
medium, usually modern, non-family enterprises, and whether in the agricultural or non-agricultural sectors. This re-thinking of the role of small enterprise has occurred in developed as well as developing countries. In most industrial countries the majority of new employment has been generated in smaller firms, many of whom are successful exporters. There is much talk of the decline of the long production run in favour of production flexibility. Several socialist countries (e.g. Hungary, Yugoslavia) are looking to small private firms as a source of both dynamism and exports.

Despite such country experience, and the more general positive assessments of the small-scale sector, its potential contribution to growth in LDCs is hard to pin down quantitatively, and the role of policies designed to support it is also even more so, since few countries have made a very serious effort to foster SSE growth, and few studies document carefully the results of such attempts. The former uncertainty results from the fact that it has not yet been possible to bring ex post evidence, cross country or other, to bear successfully on the question of how much substitutability there is between smaller and larger enterprise or on such possible impediments to rapid small-scale growth as an inelastic supply of the relevant entrepreneurial skills. Accordingly it is not possible to look at a country's industrial structure and estimate with reasonable accuracy how much greater the small-scale sector could become without running into diminishing returns.

In spite of such ambiguity, there are several grounds for optimism with respect to the potential for SSE growth and insertion into international markets. The recent conclusion of the Uruguay round of negotiations under the GATT, culminating in the lowering of tariffs and the creation of the World Trade Organization is one probably positive element. It creates the structure for a more "rules based" management of trade, in particular depriving the United States of some of its capacity for unilateral behaviour in this area. This should in principle be of special benefit to the smaller, trade-dependent LDCs which have little if any bargaining power in these matters, and certainly to smaller firms which cannot run the risk of falling afoul of arbitrary behaviour by importing countries. At the same time, it should not be ignored that freer trade at the world level may have negative impacts on some groups of LDCs. In the first place, they are in varying degrees giving up the policy option of infant industry protection, the core concept of the import substituting strategies which have been in place for most of the Post-War period. Although undoubtedly implemented with considerable error and incompetence in many cases, it remains to be judged whether that policy option has been and would continue to be of value for certain types of LDCs.6 It also remains to be seen

6 In Latin America, which taken as a whole grew rather rapidly over the ISI phase for the end of the War until the 1980s, there has as yet been no persuasive overall assessment of the pros and cons of the ISI strategy. Growth was relatively good, and although many observers felt that this strategy was in part responsible for
how the industrial countries will ultimately respond to the new level of attack by imports on such vulnerable industries as textiles and clothing. If they find ways of pursuing protectionism in spite of the new rules of the game, or if they accelerate labour saving technological change in such industries, the potential gains as currently perceived by the LDCs will turn out to be less in fact than in prospect. It is possible that the new structure will favour a few efficient, aggressive marketers among the LDCs much more than others, following the already apparent tendency for a few "NICs" to dominate LDC exports of manufactured products. The existing quota arrangement under the multi fibre agreement (MFA) has probably had the effect of "protecting" the first export activities of smaller exporters and thus sharing the gains from exports of clothing and textiles among the LDCs, since countries still too small to "pose a threat" operate without quotas. Indonesia owes a good deal of its growth in garments exporting to the quotas imposed on the bigger exporters in East Asia; it might have taken considerably longer to break into the world market without that help. Though one must bear these caveats in mind, overall it seems reasonable to presume that the Uruguay round has created a more positive context for that majority of the Third World's population which lives in the populous countries like China, India, Indonesia, and Bangladesh. It is possible that its net impact will be negative for Africa and some countries elsewhere.

Also relevant to the future role of SSE exporters are the widely discussed "flexible specialization" and "industrial districts" phenomena and their implications for SSE export competitiveness (Pyke and Sengenberger, 1992; Best, 1990). Industrial districts—composed mainly of small and medium firms among which there is both competition and cooperation, all set in a sociocultural context which facilitates trust and active self-help organization—have attracted much recent attention, especially in Europe because of their apparent success in achieving international competitiveness with high employment and acceptable wages. This discussion is part of the wider debate on the relative decline of fordism and the growth of activities based on less rigid and more adaptable structures, often referred to as flexible specialization (Piore and Sabel, 1984). Though the debate has been mainly in the context of the developed countries, examples of "clusters" have been identified in LDCs and their relevance is now the subject of discussion. In clusters like Tiruppur in south India and in the Sinos valley in southern Brazil, in both of which employment has risen dramatically over a decade or two, the source of income increases for relatively poor families came form that increase rather than one in wages, though a gradual wage increase did occur in Tiruppur (Swaminathan, 1995; Cawthorne, 1995; Schmitz, 1995).

the severe income inequalities, that view is no longer persuasive, since the freer trade policies adopted in the region have coincided with increasing inequality.
For such SSE export activity to lead to wages closer to the European level, skills would have to be greater. Happily another favourable trend in most LDCs involves the level of human capital available for SSE export success. Many traditional SSE have been and are still operated by people with little formal education; most of the knowledge and skills they apply to their businesses are passed on to them by others or learned on the job. Modern SSE, and certainly most of those which could hope for export success, require more human capital, greater and different management skills. The level of education and training has advanced rapidly in most developing countries, and makes it much more plausible than it would have been a couple of decades ago to count on a large supply of people with the capacity to be effective modern SSE entrepreneurs. The unusual supply of such entrepreneurs has been credited as an important factor in the great success of the SME sector in Taiwan (Levy, 1988).

Interacting positively with the supply of modern entrepreneurship for SSE is the information revolution which provides wider access to technological information and to markets. Together with the fact that technological change has been raising the payoff to flexibility and lowering that to economies of scale and perhaps also to economies of scope, this trend opens new opportunities for those SSE which can take them up.

On the down side a number of possible impediments to the healthy overall development of SSE and to its emergence as an important source of exports may limit its contribution to poverty alleviation. One is the economic liberalization implemented in many countries in a setting of recent economic crisis. Optimistic observers have argued that a decrease in the level of government intervention will be of special benefit to non-agricultural SSE because much past intervention has been designed to help large enterprise (LE) and has put SSE at a competitive disadvantage, and because the nuisance effects of the more purposeless intervention (red tape and the associated bribes, etc.) fall most heavily on SSE. At the other extreme, some worried policy-makers believe that liberalization has or will hit their SSE sectors hard, with great cost to employment and to the incomes of the less affluent? This view is, not surprisingly, shared by many, though not by all, representatives of the SSE sector. There is no doubt that trade and financial market reforms will help some SSE but it would be naive to assume, without empirical evidence, that SSE performance and contribution will on balance be helped independently of how reforms are carried out, what complementary support is provided to SSE, etc. Many students of SSE believe that private financial markets in most LDCs will not (perhaps cannot) function efficiently enough to make credit accessible to much of that sector, in which case the options may be public sector bank credit or no credit at all, a serious matter given the sort of retooling which may be required by

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7 A recent study by the World Bank (1994) throws some light on this question.
trade liberalization. The need for rapid technological upgrading in some SSE industries is also a major challenge.

An important determinant of the impact of liberalization on any SSE group is likely to be the character of its "insertion" in the economy, that is, its relation to the power blocks and the economic fulcrum of the system. SSE which are complementary with LE have a natural support/defense system to help them confront problems which may come up, since their performance matters to the complementary LE. Most commonly, such complementarity takes the form of subcontracting, a condition in which a majority of the manufacturing SSE in Japan and some other countries of East Asia find themselves. SME which compete directly with LE are much less favourably positioned, since they do not have the direct and indirect support which LE can provide, they have a difficult time competing with LE for public support services, and on occasion they may be the direct victims of pressure and unfair practices from LE. Many SSE which are neither strongly complementary nor strongly competitive are niche-occupiers and quite a few produce non-tradable goods or services; most direct exports come from LE and tariff systems are usually set up to protect the relatively capital intensive industries in which LE also establishes itself.

The impact of liberalization and related policy changes depends on both static effects, relating mainly to the relative efficiency (total factor productivity) of SSE, and on dynamic effects—on savings patterns, the development of entrepreneurial capacity, and technological change. In the wake of policy change there is also the special "transition" question—how the act of major policy change itself affects the course of events and what special challenges must be overcome if SSE is to emerge from the transition period with its basic strengths intact. In many Latin and African countries there is (or has been) a special transition period challenge; the shift to more liberalized regimes coincides with the attempt to break out of periods of sustained economic stagnation and the related social stresses and strains. They start from a base in which change is not lubricated and facilitated by the fruits of past growth, and in particular where any firm whose present and immediate prospects are closely tied to its recent growth and profit performance, the normal condition of SSE, is unlikely to be able to ride out many shocks.8 A common result of

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8 A major problem in our understanding of the SSE sector is the lack of information on the efficiency of the entry and exit process. It is not clear how socially efficient or inefficient are its high rates of exit and entry; for example, the extent to which exit is primarily of firms with low potential to be socially efficient has been little studied and even less understood. A recent study by Liu (1991) in the context of the case of Chile provides some information but did not probe the issue at enough depth to clarify the social efficiency question very much.
the reduction of controls on capital flows has been exchange rate instability and overvaluation, with serious effects on those trade-oriented firms not in a position to wait it out.

SSE frequently have an efficiency advantage based on their capacity to use relatively labor intensive techniques. Import liberalization might be expected to help import-substituting SSE against the inefficient and previously protected large firms, though both may lose to imports (directly) and to exporting activities (indirectly). A more export-friendly situation might seem more likely to help LE since most of the major exporters of manufactured goods and mining products are large firms, though if the administrative and other obstacles to SSE exports could be lowered as the inducements to exports are raised this might not be the case. In fact, it is common for prominent manufactured exporters to be the same firms that dominated the import-substitution landscape, as noted in Colombia by Diaz-Alejandro [1983, 269] in Costa Rica by Gindling and Berry [1994], and in many other countries. Information is a major factor here; there are powerful economies of scale in gathering it and it has a partially public good character.

Our defective understanding of transitions, and of economic dynamics in general, constitutes a major obstacle to accurate prediction of the implications of trade and financial liberalization for size structure and for the realization of the potential of SSE. Understanding dynamics is of obvious relevance to the appropriate sequencing of policy change, the speed of such change, and the design of special support which may be needed to help shepherd firms or sectors safely through difficult periods.

Views vary as to how well SSE handle the stress of major policy change of the sort under discussion here. SSE is frequently described as more agile and flexible than LE. This source of competitiveness is often attributed to a simpler managerial structure (less layers, entrepreneurs more accustomed to being quick and decisive, etc.) and to less institutional constraints from the labour market (easier to fire workers or cut wages in times of crisis). But being smaller and less diversified than LE also implies less resources to help the firm weather a difficult period, and some of the market niches they inhabit are unstable, so many SSE would not survive long without such agility. In the "natural selection of the fittest" SSE competitors, flexibility is under some conditions a major determinant of success, but the fact that surviving SSE tend to be flexible does not mean that all otherwise efficient SSE are naturally agile. When the "shock" in question is the reduction of trade barriers, a major aspect of the adjustment process for many firms is the reconversion of plant towards the technology required to compete with imports in quality, advertising capacity, etc. It may require a quick infusion of new capital. LE is better placed to handle these challenges since its credit access is good and since government, in its now less frequent interventions in the market, is almost certain to try to protect the large, beleaguered firms. SSE typically expands its capital mainly on the basis of past profits, which will be
unavailable due to the change of regime, not to mention the crisis which has in any case cut off this source of expansion for most SSE in many countries over the last decade or more. On the technological front, although SSE often has impressive capacity to change over time, much of what one sees falls in the category of the gradual; it may be more difficult for such firms to jump to a totally different system, where the surrounding decisions would have to be based more on sophisticated engineering and managerial judgments than on the entrepreneur's own experience and skills.

Government policy with respect to SSE has in most countries been unimpressive, a fact which derives in the first instance from the lack of priority given to the sector in government thinking and policy. This in turn reflects the limited political voice SSE has in most countries and the lack of appreciation of its actual or potential role on the part of most decision-makers. When governments do become interested, they usually lack both the information and the understanding on how to proceed. Virtually no countries have an up-to-date-body of information on the SSE sector, its recent evolution, its problems etc.

In some countries another possibly limiting factor for the healthy growth of SSE is the lack of a small-farm based agriculture of the sort which gave impetus to the initially largely rural industrialization process in Taiwan. Most countries of Latin America remain characterized by a bi-modal land distribution in which large farms control most of the land, while there is concern that a number of countries in Sub-Saharan Africa, as they evolve away from more communal forms of land control, may be moving towards ownership patterns somewhat like the inegalitarian ones of Latin America. Under such circumstances the sort of evolution which took place in Taiwan may not be a real possibility. It also seems unlikely that there will be many agrarian reforms to improve the distribution of land in the coming years, such ventures in intervention being less in vogue than before. The technical arguments in favour of small farms are fairly straightforward, with most analysts believing that the small (family) farm is the most efficient way to organize agriculture (Berry and Cline, 1979; Prosterman and Riedinger, 1987; Dorner, 1992). Its central role in the evolution of both North American and Japanese agriculture is well known, as is the strong performance of the sector in Korea and (especially) Taiwan following the land reforms imposed after the second World War (Kuo, et al, 1981); those reforms left the countries with nothing but small family farms and hence left the governments without the option of favouring/relying on larger farms even if it had been so inclined. Though many policy makers still believe that economies of scale are widespread and important, or at least that large farms are necessary to achieve objectives like a strong export performance or a high level of marketed surplus to the urban areas, such views mainly reflect a lack of familiarity with the evidence from developing countries. Where agriculture is not based on the small-farm model, it may be that the potential of SSE to contribute to growth, employment and equity will be
seriously reduced. Too little research has focused on this theme to provide any clear answers at this time.

The degree to which growth of labour intensive exports will be an important source of employment generation in LDCs, closely related to the possible direct and indirect role of SSE, depends on the rate of labour saving technological progress in the relevant industries. The distributional outcomes of recent trade liberalization suggest that for many LDCs, including most Latin countries, this model is less pertinent than before. In the populous countries of Asia, however, it should provide considerable promise for some time to come.

In summary, it seems clear that SSE may be effectively tied into the export activity in a country which has very well-functioning markets, a broad base of entrepreneurial skills, and good information flows, but since meeting all of these conditions is difficult, that outcome is not very likely to emerge on its own unless there is a strong tradition of subcontracting. A best guess would be that, even if its basic production capacity and characteristics give it significant export capability, SSE would only be able to fulfil its export potential gradually and partially, unless it had unusually good financial and other support.

2. The Poverty Impact of Expanding SSE Exports

There is no reason to doubt that growth of SSE in general and of SSE exports in particular will be poverty-alleviating, since the sector generates a high demand for labour, much of it lower-skilled, and in some cases produces wage goods and cheaper versions of items which the middle and upper classes buy from larger producers or import. Given that many of the people who work in SSE earn low wages or incomes and that many are women and children, questions have been raised as to whether the many SSE establishments are guilty of labour exploitation. As discussed in Section 5 below, this is a legitimate question, but the appropriate response appears to be the implementation of generally desirable limitations on working conditions, hours, and who should work rather than any SSE-specific restrictions. Thus the main question with respect to the poverty alleviating effect of expanding SSE exports is its size: does this subsector have the potential to be the main motor of poverty reduction in many LDCs, and if so under what conditions?

The Quantitative Potential of SSE Exports

A quick reading of post world War II experience in developing countries suggests that direct and indirect exports of SSEs can under certain circumstances contribute a very great deal to poverty alleviation—perhaps even be the main single factor underlying it,

9 Authors like Keesing and Lall (1992) have emphasized the serious information-related impediments and other problems which confront the aspiring SMI exporter.
while in other situations they contribute virtually nothing because they are insignificant in amount. Such an apparent range of outcomes suggests the need for a careful look at when the sector really matters and when it does not.

The norm in LDCs has been for the direct export of manufacturing goods to be undertaken disproportionately by large firms. In Brazil, for example, as of the 1970s the share of manufactured exports coming from plants of under 100 workers was only about 6% (Silber, 1987, Table 1-3). But Taiwan, Hong Kong and a perhaps few other countries have been exceptions to this pattern. In some countries there is aggregate evidence that the share of exports coming directly from SSE has increased, as with Colombia in the 1980s (Berry and Escandon, 1994). The experience of Tiruppur and the Sinos valley indicate the potential of SSEs when organized in clusters. SSE's total involvement is usually greater than its direct participation in the process since it often engages in subcontracting for large manufacturing or trading establishments who handle the marketing, but since aggregate figures are seldom available on the extent of such linkages, such indirect involvement is hard to gauge. It does appear that the role of subcontractors in LDC manufacturing exports is considerably greater that has been widely recognized, albeit not as high as in countries like Japan and Taiwan. And there is reason to hope that the competitive pressure put on large-scale firms established under ISI regimes will encourage them to search for all possible ways to lower costs, including subcontracting. This process seems to have occurred in Korea from the mid-1970s and, as noted below, has had a major impact on the size structure of Korean manufacturing, formerly noted for the domination by large firms. A repeat of this outcome could spell a much more important role for SSE in the export activities of many LDCs.

The contrast between Taiwan and Korea highlights the fact that manufactured-export-led growth can be pursued successfully with reliance mainly on quite large firms (the Korean route) or with relatively small ones (Taiwan). Both export and GDP growth rates have been nearly identical in the two cases, while the income distribution experience record showed a marked contrast in Taiwan's favour until recently (Fei, Ranis and Kuo, 1979; Scitovsky, 1985; Koo, 1984; Hong, 1981). Under the Korean approach the focus is on high volume, high productivity manufacture of standardized products, whereas the smaller Taiwanese firms emphasize flexibility and rapid response in market niches for non-standardized products. Levy (1988, 3-4) interprets the two countries' different approaches to the international market as a reflection of a different firm size structure within manufacturing, due in turn to Korea's lower stage of development when the two began their post-war drives to industrialization, the resulting greater degree of market failure in Korea, and the Korean response of internalising the relevant transactions within large-scale enterprises (including large scale trading companies). At present it would appear that in a number of industries product and technology change is placing a premium on supplier flexibility, a fact which could augur well for smaller,
How much the prevalence of large firms in Korea contributed to the greater inequality of income distribution relative to Taiwan is hard to guess, but an analysis by Nugent (1989) is certainly consistent with there being a causal connection. The lower wages and other advantages of small and medium-sized subcontractors which figured prominently in the Japanese experience may have been accentuated for large Korean exporters by the pressure to lower costs resulting from the appreciation of the yen in the mid-1970s. This may account for part of the rapid recent expansion in their number (Levy, 1988, 4). In the Taiwanese case, the existence of a strong network of small, flexible firms with which exporters can subcontract allows the exporters themselves to be smaller and to set up with limited capital, thus probably lowering the capital/labour ratio through two separate routes. The system also provides the overall flexibility for which the Taiwanese export sector has become noted. The effective network of small firms in Taiwan, based on the combination of well developed entrepreneurial skills, and smoothly functioning markets, has permitted considerable gains based on innovation and specialization in R&D (Levy, 1988, 15). A contrast also developed in the trading system by which the Taiwanese and Korean manufactures are moved onto the world market. Very large firms like those in Korea typically handle their own marketing (directly or through large trading companies) whereas the smaller scale middleman comes into his own when smaller firms produce the exports or buy the imports, as in Taiwan.

One element in the Taiwan and Hong Kong formulae for export success by small firms could be unimpeded access to imports. Keesing and Lall (1992, 181) note that the four most dramatic Asian export success stories are "the only developing economics offering quick, easy duty-free access to imported inputs in any location. Normally access to imported inputs and capital equipment is subjected to bureaucratic processes and barriers for all firms, but in a way biased against the small firms. In several cases small and medium-sized firms have performed particularly well just after

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10 While acknowledging that the "hypothesized relationship between a structural indicator pertaining to one particular sector (i.e. size shares in manufacturing) and the overall distribution of income would not be expected to be very strong" Nugent (1989, 10), he found it interesting that all of the measures of income inequality available for Korea shared "a peaking of income inequality among both all households and non-agricultural or urban households precisely in the years 1976 or 1977, the very years in which the shares of LE's in manufacturing employment and value added were also at their zenith," (p. 11).

11 I owe this observation to Kyu-Uck Lee.
devaluations and the easing of controls on imports;\textsuperscript{12} perhaps the same removal of biases which leads to good growth of output for the domestic market could create the potential for good export performance when other conditions (e.g. good marketing networks) are also met. Keesing and Lall (1992, 186-88) also emphasize both the great difficulties and the lack of relevant knowledge of the local entrepreneurs when they first begin exporting to major industrial economy markets and the potentially important role of export promoting organizations when instead of being multi-purpose general service in character (the usual pattern) they concentrate marketing and related assistance on a small number of the more promising export products and within a short (say 3-5 year) time frame. Given the desirability of a directed focus, there is no obvious reason why smaller and (especially) medium-sized producers could not share in the benefits of such assistance more than appears often to be the case now.

**Economic Policy and SSE**

Apart from some typically quite small and marginally important enterprises, SSE is sensitive to various dimensions of general economic policy. Economic and policy stability is important to all firms, and though some SSE may be favoured competitively by instability—in the sense that they are better able to handle it than other firms, on balance much SSE is likely to be vulnerable because of the lack of a strong base of resources on which to draw in difficult economic times, the lack of political voice to help it out and so on.

SSE exporters are, at least in some countries, particularly sensitive to the exchange rate, as reported by surveyed SSE exporters in Colombia (Berry and Escandon, 1994), who indicated that the most important public policy instrument from their point of view was the exchange rate. For firms large enough to have access to official sector credit, the interest rate and in particular its stability can be quite important. Tight monetary policy, when imposed abruptly, is particularly damaging to such firms.

At this time the big "policy" question is how SSE will fare under the package of policy reforms now being implemented in most LDCs, including trade liberalization, privatization, financial reform and labour market reform. Most liberalization experiments have been undertaken so recently that there is little accumulated evidence on how they have affected SSE. One frequently-expressed expectation—that in LDCs the liberalization of imperfectly competitive industries would result in larger plants with higher

\textsuperscript{12} The Philippine devaluation of 1962 was followed by several years of unusually dynamic SMI growth. After Colombia's 1967 adoption of a floating exchange rate led to an expanded supply of foreign exchange and better SMI access to it, that sector underwent a dramatic boom, with high profits and employment growth of 8-10% annually in the 1970s (Cortes, et al., Chaps. 2 and 6).
efficiency (Devarajan and Rodrik, 1989)--has as yet received little empirical support.

Chile is a particularly relevant case because it liberalized rapidly and well back in time (in the 1970s). In the manufacturing sector the liberalization process brought great dislocation; the nadir came in 1975, with output 33% below the previous high in 1972. The reductions in industrial employment that accompanied the 1974-75 recession were not reversed in the recovery of 1976-81, so labour productivity rose fast at this time (Tybout, with Liu, 1989, 4). The powerful "grupos" which emerged and consolidated control over both financial and industrial enterprises during 1976-81 are still in evidence, though they are now considered efficient competitors by most observers, and it is widely held that the discipline of foreign competition has made the sector an efficient one. But changes in the size structure during the liberalization experiment are worrisome. Between the 1979 and 1989 manufacturing censuses employment in plants of 10 or more workers became increasingly concentrated in the larger ones, as employment in plants with 50 workers or more rose by 33% increase and that in plants with 10-49 workers fell by 22%. Meanwhile self-employment rose rapidly, by about 100% between 1982 and 1990 while paid employment was rising by only 37%. Employment was thus increasingly concentrated at the top and at the bottom of the size distribution.

Argentina's liberalization episode of 1976-1982, despite being truncated in the latter year, also provides relevant evidence. Previously, the country had manifested a very inward looking strategy, both with respect to protection and to technological independence. Its plant size structure was probably more oriented towards the small-medium range than might have been predicted given its relatively advanced stage of development (Gelbard, 1990, 12). Manufacturing output fell by about 11% between 1976 and 1982 and employment by 37%, with output per worker thus rising by 40%. There was substantial exit, especially of small and medium plants, and output declines were sharpest in the smaller size categories during the crisis years 1980-82 (Gelbard, 1990, 70). Large plants cut employment, increased capital stock and improved technology. Relative labour productivity of both small (under 10 workers) and medium (11-100 workers) fell markedly. For all categories the horsepower/employment and horsepower/output ratios rose, but far more rapidly among the large plants. Manufactured exports grew at a creditable 9.0% over 1975-85; they were concentrated among a small number of large firms (Gelbard, 1990, 37-40).

In the case of Mexico, an ongoing study by Ruiz finds that the size structure of Mexican manufacturing has not changed noticeably during the crisis of the 1980s and the beginning of the economic reforms towards the end of that decade. It has been widely believed that SSE suffered most heavily during that decade but this does not appear to have manifested itself in the net exit of a disproportionate number of SSE. I do not know whether they did suffer a sharper fall in earnings and profits than larger firms.

Financial market reforms are another important element of the
current policy package. Here the key objective is to make the systems more efficient in capturing and allocating resources, with "market-determined" interest rates (i.e. ones not involving high levels of subsidy to the borrowers) a major and fairly easily implementable aspect, and with improved competition, restriction of unnecessary regulation, and increased privatization as others. Even if one accepts that the nature and performance of the financial system significantly affects a country's development, it is still a complicated matter to know what constitutes a significant improvement, in view of the inherent unattainability of the sort of competitive model most economists have in mind, and hence the necessarily "second-best" character of anything within practical reach. And the empirical evidence in favour of reforms either on the interest rate front or (especially) with respect to the structure of the financial system, remains partial and inconclusive.\(^{13}\) Except for the switch to more market-related interest rates, which has been made in many countries, such reforms are less far along in most countries than are those in the trade area. It is well to have them in mind, however, since finance has long been viewed as a major issue/problem for SSE. Little empirical study has been made of the effects of financial sector reforms. Two parallel studies, focusing on Indonesia and Ecuador respectively (Gultom-Siregar, 1993; Jaramillo et al, 1992) allege to find that after a liberalizing reform the distribution of credit became more equal as between large and smaller manufacturing firms but in both cases, especially that of Ecuador, methodological problems and anomalous results have left the conclusions open to serious question. Clearly it will be some time before we have much solid understanding of the impact of such reforms. Since considerable

\(^{13}\) The support for the sort of reforms being proposed and implemented comes mainly from the theory that competition is good and that market-determined prices are likely to allocate resources better than imposed prices (see, for example, Fry, 1988). The logic is not fully persuasive since, as noted above, financial markets can never closely approximate perfect competition, especially in LDCs. Clearly, therefore, the arguments in favour of the sort of financial market reforms currently in vogue will remain open to question unless and until a reasonable body of empirical evidence has been accumulated in support of them. The evidence to date is fragile, consisting for example of studies which show correlations between the use of market interest rates and economic growth, where many relevant variables have been omitted from the analysis (Fry, 1980, criticized by Giovannini, 1983); studies showing that higher interest rates on financial assets are correlated with higher savings in financial form, usually without checking to see whether other forms of savings have diminished by a comparable amount (Molho, 1986); and so on. It is also noteworthy that such successful countries as Taiwan have, at least by some accounts and criteria, "struggled" under the weight of an ineffective financial system.
deregulation and privatization will nonetheless occur in many countries, a major issue of possible importance to SSE is the need for and value of special, presumably public, financial institutions which direct their efforts to the funding of SSE.

Reform is in the air on the labour market front also, as various interventions and sources of rigidity come under attack. In some countries (e.g. those of Latin America) loss of union power and the weakening of legislated benefits/defenses like limits on firing and large severance payments has been hastened by depressed economic conditions. There is probably less of a consensus on what changes should be made to the functioning of labour markets than there is on some aspects of financial markets and international trade policy, but important changes are being effected in a number of countries. Implications for SSE of simplification of legislation and elimination of provisions viewed as particularly onerous by business or particularly likely to lead to misallocation of resources are not easy to deduce since application of such elements of legislation to SSE is usually partial and variable.

Though none of trade liberalization, financial market reforms or labour market reforms as commonly implemented are at all guaranteed to help SSE--each has the potential to be damaging--there is at the same time no doubt that the most propitious setting for strong SSE performance and growth is one of well functioning markets, like those which are a defining characteristic of the successful "clusters" referred to above. Not only good entrepreneurial skills but also efficient provision of inputs, services and information are necessary to make networks of small firms work effectively. The gaps in these respects remain striking in many countries, and policies to improve both infrastructure and markets are important; the difficulty is that the best ways to improve markets are not necessarily easy either to identify or to implement. One clearly important market is that for used machinery. Facilities to import such machinery are one factor, while other conditions, including fostering of repair skills, may also play a role (Escandon, 1982).

A general policy dilemma warranting special comment involves labour productivity. Since labour intensity is an SSE feature which underlies its potential contribution to poverty alleviation, it is important not to foster policies which will push rapid increase in labour productivity unless these are essential to its retaining competitiveness. But frequently that is indeed the case. Hence a very delicate aspect of effective SSE policy involves identifying when and how fast one would like to see labour productivity in that sector rise. We return to this issue below.

3. The Central Challenge: Linking SSEs to International Markets

Marketing is a bigger challenge for most small enterprises than production, i.e. there are many situations in which the product can or could satisfy buyers but the link to those buyers is not easy to achieve. This is especially for international markets
where barriers of culture, language, business practice and the like must be hurdled, together with the problem posed by the tendency for international transactions to be large-scale, far too big for really small producers to deal with. To the extent that entrepreneurship is involved in the international activities of SSE, it is most likely to emerge at this marketing stage (Scitovsky, 1985).

Given the difficulties impeding direct international marketing by small producers, the normal channels are trade intermediaries and/or vertical or horizontal subcontracting, with the subcontracting done by local producers, local traders, international producers or international traders. These categories tend to shade into each other and various combinations exist, experience varying widely from industry to industry according to the characteristics of the product. When the item is traded directly, the intermediation function can be handled by trading houses, small traders, public institutions, international buyers, or direct contact between the firm and the final buyer. Various associations and institutions can help to arrange the contacts between the actual participants in the deals.

The smaller the firm the less likely it is, ceteris paribus to be in a simple, arms-length relationship with a final international buyer; almost no microenterprises would be expected to handle this function directly, few small firms, but a fair number of medium sized firms. Direct international marketing capacity is also dependent on such correlates of size as age of firm and extent of previous marketing experience in domestic and international markets, as well as the educational levels of the people involved, access to an ethnic network which lowers transactions costs, and availability of information networks which can to some extent substitute for face to face contact and travelling--a normal aspect of international marketing and one which generates important economies of scale which pose a problem for the smaller firm.

The institutional features of the demand side also help to determine which producers may be hooked in which ways into the international market. Where orders must, for whatever reason, be relatively large, either the producer must itself be correspondingly large or an effective aggregation mechanism must exist in order to build up large amounts of the product. Sometimes the aggregation function is performed on the demand side or at the intermediation level. Where orders can be smaller, the task is to make contact with the intermediaries or buyers who handle such orders, since the possible lines of trade will be less clear in such cases.

Small establishments may interact with larger ones as suppliers of complete items, suppliers of components, or providers of special functions or stages of the production process. They may act in groups or individually in their relationships with their partners. The relationship may vary widely from one of great dependence on their partner(s) to one of considerable independence and arms-length character. The share of final product price going to the producer will depend on these features of the structure of
production and commercialization. The contractor, buyer, or intermediary will often take the initiative in the beginning and correspondingly reap the bulk of the benefits (Scitovsky, 1985); an important determinant of the poverty alleviation potential of SSE exports may then be the way in which this structure changes as the small producing firm grows and gains experience, so the process of "graduation" from one sort of relationship to another is of interest. Does initial "exploitation" of small producers tend to continue over time?

Clearly vertical linkages with larger producers, assemblers or traders play the key role in tying many SSE to international markets. When SSEs are already (before the possibility of producing exportables arises) embedded in well-developed private market networks, those linkages might require no special policy attention. But many of the countries in which it is to be hoped that SSE links to international markets expand quickly cannot be so characterized, so entry and retention of international market position pose major challenges. In situations where SSE are actually or potentially complementary to larger firms, fostering that complementarity is the goal. The comparative advantage of SSE is normally considered to lie in the areas of lower labour costs and flexibility, but sometimes in access to cheap capital or workspace. In many manufacturing systems developed under the ISI model, with the level of protection either high "according to need", there has been little pressure to lower costs by subcontracting, so there may be considerable untapped potential in this direction. Under certain circumstances the level of subcontracting can be increased rather quickly, the experience of Korea from the mid-1970s.

Where there is little incentive for LI to seek subcontracting or other forms of collaborative arrangements with smaller firms, the relationship may be competitive and conflictive. Increasingly open markets may be expected to help SSE under such circumstances by taking some of the policy tools normally wielded against them away from governments, business associations etc. But this should not be taken for granted either, pending the actual outcomes. The labour conditions under discussion in the context of NAFTA could easily be used jointly by American industry and large Mexican firms against smaller Mexican firms, for example.

As noted above in the contrast between Taiwan and Korea, countries vary in their approach to the conquest of international markets. It is also important to note the changes associated with the evolution of a country's export activities. Early on, the obstacles great because the country's producers have little recognition in the international market, few foreign buyers visit, agents are inexperienced, and so on. There are many bugs to get out of the system. As export experience accumulates, momentum improves and the transactions costs facing SSE exporters decline and opportunities grow. Much emphasis thus must be placed on achieving that momentum and taking advantage of it to pull SSE into the

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14 Hill (1985) describes the Philippines in these terms.
system.

Issues Around Subcontracting

Although there are always concerns about fairness inside the system, subcontracting is generally looked upon with favour by economists, since it appears (i) to allow the industrial system to become more efficient by distributing functions to the sort of firm best able to undertake them, and (ii) to increase the labour intensity of the industries involved, since the small subcontractors do things in more labour intensive ways than would the contractors they deal with, and (iii) to contribute to the healthy development of certain types of SSE. Some critics view it as an indirect form of labour exploitation, while others believe that it impedes the development of a healthy SSE sector. Proponents can point to the famous density of subcontracting in countries like Japan, Taiwan, and Hong Kong, all noted for fast and relatively egalitarian growth. On balance it appears to be a positive institution both from the point of efficiency-growth and from that of equality, hence one to be encouraged. Viewed that way, the main issue is how to encourage useful subcontracting.

Is there a place for surveillance to assure that labour exploitation not occur in the context of subcontracting relationships? Because most such arrangements develop a degree of continuity, there either is from the start or soon develops a degree of bilateral monopoly, within which there may be a range of prices acceptable to both parties, among which the choice depends on bargaining power etc. Where the relationship is more in the nature of a monopsony one—-one buyer and many sellers, it is inevitable that the outcome will be less favourable to the subcontractors than might be the case if some sort of price fixing equivalent to minimum wage legislation were possible. Such regulation is unlikely to be implemented with the combination of efficiency and thoroughness to make its overall impact positive and is hence better forgotten about. Probably the only way to improve the bargaining power of the subcontractors is to raise their productivity, to increase the number of contractors, and thus change the character of the bargaining relationship. Where the input in the subcontracted activity is only of labour, it is tempting to try to apply minimum wage legislation. But it is for the most part neither practical nor likely to be desirable even if practical.

An aspect of developing effective subcontractors, common to but perhaps more focused than the parallel question applicable to exporting SSE as a whole, is that of achieving standardization, quality control and timely delivery. It is a boon when the contractor takes charge of such issues by selecting, training, and generally contributing to the development a strong cadre of such subcontractors.  

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15 The final and generally positive outcome in Japan certainly did not mean that there was not great criticism of the country's subcontracting system on grounds of exploitation (Kaneda, 1980).
producers. When this is not the case, it is valuable if potential subcontractors have access to other sources of relevant information and training.

TNCs are the main actors in international subcontracting associated with export processing zones and with maquila-type activities near international borders. In both cases backward linkages have tended to be disappointing (Aguilar Barajas, 1995), but not surprising since the logic of both situations is the combining of (cheap) local labour with raw materials and inputs brought by the foreign firms. The physical separation from the rest of the economy has the tendency to raise transactions cost and to reduce the likelihood of coming across a better supplier. Production is usually at a fairly high level, further complicating the involvement of local SSE. In some relatively developed LDCs equal-footing policies have been extended outside the EPZs, however, and there is no reason to believe that with time linkages will not increase; but it would not be reasonable to expect them to become very important in absolute terms.

The Role of Government in Facilitating Access of SSE to International Markets

In situations where vertical linkages do not provide the link to international markets, what policies, if any, may be used to and how much emphasis should they receive? Most governments have shown little knowledge or skill in assisting the international entry of SSE, part of a more general picture of lack of interest in and competence to assist this sector. Hopefully, government capacity in this regard is beginning to improve in many countries, but it would be unrealistic to expect that it will soon reach very high levels in most LDCs. Still, those cases where performance has been strong clearly warrant close study by those where this is not yet the case.

Most governments have, at least in a formalistic sense, supported their exporters and potential exporters through the activities of their international network of commercial offices in embassies abroad, but these have generally been of limited usefulness, if that. Personnel are often not well suited to the task, and their familiarity with and contact with potential exporters is little developed. Government export institutions are sometimes useful, though this varies widely from country to country. Some focus excessively on the larger firms, so even though they have competence it does not redound to the benefit of SSE. Others are not able to do much except to finance participation in local and international fairs, a function which however is recognized to be valuable and important to SSE. Others are able to

16 It must be remembered of course, that the various challenges faced by SSE are interrelated, so often the same help will be relevant on the marketing and the production side, for example.
fulfil a wider range of the needs of potential exporters, often in collaboration with industry associations or other groups of firms. Export oriented countries of East Asia appear to be well in the lead in terms of the quantity and quality of support they provide to small and medium exporters. Levy et al, (1994, 39) report that, though in each of Indonesia, Japan, Korea and Colombia, private channels (buyers, traders, similar firms, subcontracting principals, etc) are the most important sources of support for small and medium manufacturing exporters in the areas of marketing and technology, such private mechanisms are not available equally to all smaller exporters so collective support (whether from the state or from business associations, sometimes supported by the state) is often valued disproportionately by less well-endowed though subsequently successful firms. "The record of delivery of collective technical and marketing support is a chequered one, but some promising new approaches appear to be coming to the fore. The most promising interventions are those with a "light touch": their delivery mechanisms generally are decentralized; and their goals are to support, rather than supplant, the private marketplace--...."the overall business and incentive environment is the most important determinant of the effectiveness of marketing and technological support for SMEs. However, the results also caution against complacency, against the presumption that a liberalized market place will be sufficient to secure industrial development." (Levy et al, 1994, 39-40).

4. The Implications of Flexible Specialization

The extent of economies of scope (and perhaps to a lesser degree economies of scale) which it pays to internalize in the firm depend on how effectively markets work; handling most or all stages and details of a production process inside the firm pays when it is easier to coordinate the activities that way. When markets function well, the co-ordination advantage of integrated production is diminished or absent and the potential role of the smaller producer is greater; if some of the twenty activities which might have been handled inside a large firm can be handled effectively by a separate small firm, then such smaller firms become viable. Effective participation in such a coordinated system depends on enough flexibility to allow quick changes of product or activity and rapid scaling up or down of the level of output.

Flexible specialization may involve a large producing firm at the centre of a system of smaller firms. In that case, a number of the types of support (e.g. financial, technological, managerial, access to raw materials, marketing) may be useful to SSE will be best provided by the large firm; in that case subcontracting relationships have a lot to be said for them. In other cases, either because there is no tie to large firms or because what has to be obtained or learned cannot come from them, collaboration and externalities among small firms plays a major role. One setting for such collaboration is that of the "clustering" of such firms, a
much-noted feature of small firm activity in certain industries, and perhaps especially in the case of those which export. Such clustering provides a number of significant advantages, most falling under the general heading of better capacity to organize for collective action and hence to attack common problems more effectively. Typically the advantage of horizontal linkages lies in the flexible specialization that it allows the SSE sector to achieve, i.e. the resource and information sharing and complementarity of activities that often evolve between SSEs in close physical proximity to each other. They provide innovative potential as well as other benefits. Clusters are typically characterized by depth as well as density, with small manufacturers out-sourcing to microenterprises and small-scale service suppliers. Klein (1995) emphasizes trust as the key factor which makes them work up to potential.

Local industry associations, chambers of commerce and local governments provide marketing and sometimes other support. Still, the great majority of clusterings in LDCs do not achieve the combination of innovation, specialization and quality necessary to move into international markets. Historical and other exceptional circumstances have usually had a hand in those cases which are exceptions to this rule. Such clusters have vertical as well as horizontal linkages, which tend to be pivotal to international market participation. The usefulness of collective marketing tends to be greatest for the early export "pioneers" of an industry when endowments are limited. After that vertical linkages become dominant as foreign buyers multiply. But it may be frequent that the marketing system connecting industrial districts to the international market is less developed, effective and specialized than the system of production, a contrast noted by Rabelloni (1995, 35) in the case of two Italian shoe districts. Normally the cluster is in existence as a producing entity before export activities become important, helping to explain the different level of evolution of the two.

How important exporting clusters made up primarily of labour

17 An extensive discussion of flexible specialization and clusters, including both general principles and a description of cases, is presented in the January 1995 issue of World Development, in which a number of citations made here appear.

18 In the interesting case of leather shoe exports from the Sinos valley in Brazil, Schmitz (1995, 14) reports that at first the traders who connected the local producers to the international market were ex-manufacturers from the U.S. They were followed by offices of U.S. retail chains, then by independent agents, first mainly American, then increasingly Brazilian. These agents studied the markets, developed models, inspected product quality, provided technical assistance, and organized the transportation and payment arrangements. They are nonetheless controversial in the valley because of the big gap (four fold) between the firm gate price and the U.S. retail price.
intensive small firms may become remains to be seen. The phenomenon is not yet important in an aggregate sense but the exciting success stories make it something worthy of serious attention and, as appropriate, policy support. Klein (1995, 6) speculates that there may be 10 clusters in the state of Rio Grande do Sul (in which the Sinos valley is located) and 100 in Brazil. He also notes that interested Italians were amazed when a 1992 book reported on no less than 65 clusters in Italy. If his optimism is well-founded, the export potential associated with clusters (whether fully fledged or nascent) may be significant, and the payoff to policies which facilitate their linkage to international markets very high indeed. On another front, policies to facilitate the emergence of well-functioning clusters obviously deserves attention as well. These are likely, as with much effective support policy, to be characterized by the "light touch" and their complementing rather than substituting market processes. One noteworthy benefit of reaching the world market, both for large-small collaboration and for that among small firms lies in the more complementary and less competitive relationship among producers in that more open context. The challenge is to get there.

It is clear that producer associations and special training institutions (often providing short courses) will be among the important actors in clusters. The actual or potential role of local governments has been emphasized in some of the literature (especially that on the Italian experience), and seems to be increasing in a number of developing countries (e.g. Argentina), fostered in part by ongoing decentralization of finances and of responsibilities. It is quite possible that local governments will be more dedicated and successful in providing the sort of support SSE needs, because it is seen as important to the local economy and therefore given higher priority. But a cautionary note is sounded by Schmitz and Musyck (1993) whose literature review unearthed very little in the way of evaluation of services supplied from the users' point of view. Rabelloni (1995, 36) reports that local government was of little significance in either of the two Italian footwear districts he analyzed, and suspects that the undeniable importance of institutional support in the growth process of the Italian industrial districts has "fed the myth of an efficient local government". The local entrepreneurial associations were in both cases the main actors in supplying a number of services and in the promotion of initiatives to support the sector. Their role is equally emphasized by Schmitz (1995) in the Sinos valley case from Brazil.

5. Honing in on the Poverty-Alleviating Impact of SSE Expansion

Though it is not possible given the present dearth of information to say a great deal of a quantitative nature about the actual and potential role of small scale exporters (direct and indirect) in poverty alleviation, the issue is of great moment both because, on the positive side, it may be one of the most promising anti-poverty policy instruments and because, on the negative side, if that potential is small there is a high likelihood that the
increasing integration of developing countries into the world economy will be accompanied by deteriorating income distribution, perhaps sharply so.

There are no serious grounds to doubt that SSE's contribution to poverty alleviation would normally be greater, per unit of investment, than that of large enterprise (LE). The income distribution and poverty impact of a sector's (or a firm's) growth depends, inter alia, on (i) the factors it uses, and the supply conditions of those factors and (ii) its relations of complementarity and substitution with other sectors, and (iv) its contribution to raising skill levels (through learning at work, etc. A first indicator of that impact can come from firm-level data on factor use. The attractiveness of SSE on the income distribution count is usually expressed in terms of its high L/K ratio and the presumption that the bulk of income generated therefore goes to labour, and in terms of the relatively low levels of labour remuneration, implying that the labour income goes mainly to lower skilled, poorer workers rather than highly skilled technical or managerial personnel.19 To know how much the incomes of various types of labour (or of small scale capital where its returns are relevant for the poverty question) change as the demand for them is increased by an expanding SSE sector, it is also necessary to understand the supply conditions of these types of labour. Two features of that labour market are pivotal: the slope of the supply curve and the extent to which supply price (more precisely the wage paid) reflects the social opportunity cost of the labour. Several benchmark cases or situations may be distinguished, according to the degree of poverty-impact (here associated with the income increase for poor families).

1. Neoclassical labour market with horizontal unskilled labour supply curve SS' and social opportunity cost (SOC) of labour equal to its supply price. Result: no poverty impact. If the growth of SSE shifts the non-agricultural demand for unskilled labour to the right, from D0 to D1 as shown in Figure 1, the sector's employment increases from L0 to L1 at the expense of that in agriculture but without raising wages or (therefore) incomes. In fact the supply curve is unlikely to be perfectly flat, but if it is nearly so the income gains will be small. Such a case is most likely when agriculture greatly dominates

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19 The Colombian data illustrate what is probably a fairly typical difference in the composition of labour incomes across firm size. Manufacturing data for 1976 (see Cortes et al., 1987, 71, 72, 62) indicate that the capital/output ratio did not vary greatly with size (number of workers) and the paid labour share of gross value added was only a little higher—34% to 30%—for small plants (5–49 workers) than for large one (100 workers or more), the average remuneration was less than half as great with the result that a unit of capital generated about 2.4 times as many jobs and put much more money in the pockets of lower income workers—how much more depending on where one draws the line.
the rest of the economy.

2. Surplus labour model, with horizontal unskilled labour supply curve SS', but social opportunity cost of labour, below its supply price (Figure 2). Result: positive poverty impact of an increase in demand for the labour can range from small to large depending on the opportunity cost of labour. With a SOC of labour curve CC' the income gain to workers would be the area ABFE. In the extreme case where the labour hired by SSE comes from an unemployed pool or from disguised underemployment, the CC' curve coincides with the horizontal axis and the whole of the increase in the wage bill is net gain to the workers and their presumably poor families (i.e. area ABL1L0).20

3. Upward sloping supply curve, with or without a wage-opportunity cost gap (Figure 3). Result: positive poverty impact depending on the slope of the supply curve and the size of any gap between supply price and SOC of labour. If the supply curve slopes up sharply, net employment creation in the labour category under discussion cannot be large; if SSE expansion leads to the employment of 100 new workers, perhaps 80 are drawn away from some other activity. But this fact does not imply a lower poverty effect than in case 2 above, since the upward pressure on wages can help all workers in the category.21 In the neoclassical case where the wage is equal to the private and social opportunity cost of the labour, the gain to workers would be \( W_1BAW_2 \). If SOC is below the wage, the gains would be correspondingly greater.

The process of development cannot be considered to have succeeded until the upward push on wages dominates all other effects, and raises them to a level consistent with a reasonable standard of living.

It is evident, therefore, that an understanding of the labour market context in which SSE operates is necessary if one is to make some assessment of its poverty-alleviating effects. They are not necessarily related in any simple way to the number of jobs created in expanding firms, nor even to the net employment creation after

\[ W_1BAW_2 \]

20 The outcome is the same in cases where workers are paid at rates above their supply price due to firm preferences; wage legislation is another institutional factor which can lead to a similar result in the sense that a surplus is creating for workers. In such cases, though, the fact that the wage is above the equilibrium level makes it less likely, per se that the workers will be poor.

21 In the neoclassical case where the wage is equal to the private and social opportunity cost of the labour, the gain to workers would be \( W_1BAW_2 \) in Figure 3.
indirect effects on employment elsewhere are also allowed for. The quality of new jobs matters, but most of all what matters is the gap between wages paid and alternative income opportunities.

**Distinguishing the Poverty Impact of Different Categories of SSE**

At one level, it may not matter whether SSE's poverty impact comes primarily via a gap between the SOC and the supply price of labour (the mechanism portrayed in Figure 2) or through an upward push on wages (the mechanism portrayed in Figure 3). For planning purposes and for effective project design, however, it does matter since without the relevant information on the labour market and on how different types of SSE will draw on it, one has little idea of whether the impact is likely to be large or small. In general, smaller, lower productivity firms pay lower wages and often depend on being able to pay low. When wages rise enough, their economic viability ends. The relative merits of support for micro-enterprise, small firms, medium firms and large firms depends on the future of wages and of the social opportunity cost of labour, which as noted above are not the same thing.

The contribution a given type of firm can make to raising the earnings of relatively low skill categories depends on both its labour intensity and its efficiency. Consider an economy whose demand, supply and social opportunity cost curves of homogenous unskilled labour are initially as shown in Figure 4. One set of firms, which might exist in even poorer countries than this one, depend for their success on very cheap labour; their labour demand curve \( (D_a D_a') \) would be relatively elastic but would lie completely below both the labour supply curve SS' and the opportunity cost curve CC', making them untenable in this economy.\(^{22}\) Somewhat less labour intensive technologies would be tenable, i.e. their demand curves would intercept the vertical axis above C or S (whichever is relevant).\(^{23}\) Less and less labour intensive technologies will tend to have steeper (less elastic) labour demand curves.\(^{24}\) Among

\(^{22}\) Though their labour demand enters the overall labour demand curve \( D_0 D_0' \), it does so only at wage levels lower than the market would generate and hence does not affect the quantity-price outcome of the market.

\(^{23}\) Groups of firms using a technology such as to give them a labour demand curve intercepting the CC' curve contribute positively to social welfare if they are privately feasible (profitable). Firms using family labour of the sort to which the diagram refers would fulfil that condition but firms having to hire their labour in would not unless their demand curve intersects SS'.

\(^{24}\) If highly capital intensive technologies are not protected by policy or by factor market imperfections they, like the excessively labour intensive ones, will be uneconomic and their labour demand curves will intersect the vertical axis below S, while showing the steepness characteristic of capital intensity.
those technologies whose demand curves do intersect the SS' (or CC') curve, the more labour intensive ones (like that use by firms with labour demand curve $D_s D_s'$) will contribute more to total labour demand, i.e. will shift the total DD' curve rightward by a greater amount per unit of capital invested. Choice of capital intensive technologies (like that used by firms whose labour demand curve is represented by $D_c D_c'$) at this stage of development can guarantee that the equilibrium wage will remain low for a long time (or permanently if labour supply is rising fast enough). Short term poverty gains are thus likely to be greatest when the technologies supported are the most labour intensive of those which are viable at current labour costs. This fact provides the logic for credit programmes focusing on the most labour intensive (usually the smallest) firms which are interested in borrowing at market rates.

Three caveats should be attached to this rule of thumb. First, firms (or technologies) differ in efficiency as well as in factor intensity. Within the same technology, that of the firms with demand $D_b D_b'$ in Figure 4), one might have a set of firms with the labour demand curves $D_{bi} D_{bi}'$, $D_{bii} D_{bii}'$, and $D_{biii} D_{biii}'$ shown in Figure 5. Assume the efficiency difference is correlated to factor intensity, i.e. all firms have the same K/L ratios, but those with higher labour demand curves have higher O/K and O/L ratios. Firm $D_{bi}$ has the highest L/O ratio but this firm is not viable since its labour demand curve does not intersect SS'. Of the two viable firms, the one with lower efficiency and hence a lower labour demand curve $D_{bii} D_{bii}'$ is likely to be less desirable than the more efficient firm with demand curve $D_{biii} D_{biii}'$; economic logic suggests that the more efficient firm be chosen, in spite of a lower L/O ratio: it provides a better payoff in terms of output per unit of capital, generates more employment at any given wage rate, and will remain viable longer than its less efficient counterparts.

The second caveat is related. When labour demand differs across firms not because of differences in efficiency within a given technology but because of different technologies (Figure 4), 

In fact many such technologies may exist behind the sorts of protection cited.

25 The more efficient firm uses the same technology; for a given input of capital, because of higher factor productivity the marginal product of any given amount of labour will be higher and it will thus demand more labour at any given wage rate. When efficiency is the source of differing demand for labour, the more efficient firm will, assuming elastic demand for its product, have a higher labour demand for all wage rates. This contrasts with the case where firm labour demands differ because of differences in technology; in that case the labour demand curve of the more capital-intensive firm is higher for higher wage rates and lower for the low wages that prevail in a developing country.
D_cD'_c reflects a more capital intensive technology than D_bD'_b, which in turn reflects a more capital intensive technology than D_aD'_a. Firms using the latter technology are, as discussed above, not viable. At the current wage rate, firms using the technology reflected in D_cD'_c would generate more employment per unit of capital invested than would those using the technology reflected in D_cD'_c. But the former may not be the best technology to choose if there are significant fixed costs in an economy's learning how to make a given technology productive and if wages are rising fairly quickly. Such costs may occur at the firm level, as where entrepreneurs and workers take considerable time to become maximally efficient in their use of a given technology and lose efficiency temporarily or permanently when shifted to another, and/or at the institutional level, as where credit institutions require time and investment to learn how to interact efficiently with certain types of firms. Heavy fixed-cost investment is unwise in technologies which will not long remain viable. Thus vigorous support for the most labour intensive technologies now viable should be undertaken only after analysis of the costs involved and the likely viable life. On the other side of this coin, it is important for planners to be looking ahead towards the time when more capital intensive techniques will be necessary and laying the groundwork for effective support to them. In such decisions, an understanding of labour market functioning and change is of obvious importance, since otherwise wage and opportunity cost of labour cannot be predicted successfully.

The third caveat involves the difference between the wages and the social opportunity cost of capital. Benefits accrue to labour and to the economy as a whole as long as technologies are adopted whose marginal labour productivity exceeds the SOC of labour. Thus D_eD'_e in Figure 4 would be a socially desirable technology (barring the relevance of caveat two just discussed) if the CC' curve lies partly below it. In reality some firms have access to labour at its SOC, others at the wage, and others above the wage (e.g. when labour taxes of one sort or another are imposed). Family enterprise presumably costs labour at its SOC, whereas hired labour must be paid the wage. When SS' and CC' do not coincide, policy should support technologies whose labour demand lies above CC' provided the firm's employing those technologies have access to labour at that price, or can be efficiently subsidized for the labour they employ. Since the latter is improbable, the former condition is likely to be the relevant one.

The above discussion oversimplifies in assuming only one type of labour is relevant. In fact, distinctions among low income groups must often be made (e.g. by gender), so the above sort of analysis must be carried out for each type of labour which needs to be distinguished. In those small firms where the capital owner is also poor, capital income should also be taken into account. When comparisons are attempted between firms creating fewer but better paid jobs than other firms, it becomes essential to know what sort of workers are hired in the former. LI is known frequently to score badly because it creates well paid jobs for people whose next
best alternatives are also well paid, i.e. clerical personnel, etc. It also tends to pay high wages to unskilled personnel, and here there is at least the possibility that such individuals are taken from the low income pool and given a big income increase. One wishes to have the full picture on present and "former" incomes of the workers in each type of firm. It may be relevant to distinguish regional labour markets, since the regional dispersion of SSE may permit it to provide distributional benefits through that route.

A major challenge in assessing the general equilibrium impact of the growth of many types of SSE on employment, poverty and income distribution is the need to know with what other types of production their output is complementary or substitutive on the output side and on the demand side. We do not enter this complicated area here.

The Poverty-Consumption of SSE Products Link

The literature on SSEs has suggested that small enterprise contributes to poverty alleviation by producing wage goods at low prices. The argument is made most frequently with respect to microenterprise. The evidence available to date is limited and inconsistent. It is clearly the case that some SSE compete with larger firms on the basis of lower price for lower quality (or lower price with comparable quality but less advertising power) directed towards lower income clientele. In other cases SSE owes its competitiveness to regionally segmented markets and focuses on smaller urban centres; in this way, also, it may sell to a lower income clientele. There appears to be no evidence yet of a general pattern whereby the output of urban SSE is purchased in a very disproportionate way by the poor. Such a presumption is rather strong for rural industry, most of which is micro-enterprise.

6. Policy Proposals

Several important elements of a good policy package to take advantage of the export potential of SSE are unambiguous. Three general objectives form the backdrop to policy: the need to take advantage of the complementarity between SSE and larger firms, through subcontracting and other types of linkage; the need to facilitate direct exports by those SSE in a position to do so; and the need to assure the protection of the poor who work in the SSE sector.

With respect to the first objective, not too much has been learned on how the public sector can help. Frequent initiatives in this area include the compilation of lists of SSE interested in subcontracting, support for industry associations in which SSE can come into contact with and initiate business with larger firms, and pressuring large firms to expand their ties with SSE. If any of

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26 As reported for Colombia by Cortes et al (1987).
these have had significant effects it is probably the last, but success is certainly not assured; it may have made an interesting contribution in Korea, while Indonesia's "foster parent" program to link large and small firms seems to have been essentially irrelevant and eventually shelved (Hill, 1990, 23). Probably the best contribution to improving mutually beneficial links comes from policies to raise SSE performance in general (see blow).

The main focus of policy, in most countries which have given any serious attention to the question of SSE exports, has been in helping firms to export directly. There is widespread agreement that, for a number of industries, support for participation in local and international fairs is one of the best expenditures of public funds. Special financial support for SSE exporters is also recommended by many observers.

Several policy initiatives are of general relevance to the effective performance of SSE, whether potential direct exporters or not. These include:

(i) **Curtailing unnecessary red tape.** Some SSE, through being small enough, remote enough, or hard enough to impose rules on, are protected from public regulations, good and bad. But those with export potential tend not to fall in this group; instead of being free of regulations they may be particularly disadvantaged by them. Many regulations are designed with large firms in mind about are inappropriate to the conditions of SSE. Others are inappropriate to all firms—classic red tape which has no function except to provide jobs for public workers and bribe money to them, but particularly costly to SSE when they involve fixed resource costs to respond to them. In Colombia prior to the recent trade policy reforms, a whole professional specialization had developed around dealing with complicated customs regulations. Some SSE use few imports so these costs did not apply to them. But exporting SSE, which must be especially cost conscious and must often use international inputs in order to meet quality or style requirements, the costs could be high. Such firms may also be more subject to petty bribery than their larger scale counterparts. So simplifying regulations to those which are really necessary, and developing a constructive attitude to the SSE entrepreneur who is trying to deal with them is an important improvement.

(ii) **Provision of relevant information to SSE—on technology, on marketing options, etc.** Given the increasing importance of information to producers of all sizes, and the greater cost of its acquisition to SSE, and the fact that it has a public good character, one of the key functions of the state should be the provision of relevant information to SSE. This need not be, and often should not be, done directly, since too often the public sector cannot carry out such functions efficiently enough, functions which involve flexibility, knowledgeable operatives, and so on. Support to private sector providers of such functions can take various forms. Chile subsidizes a firm's first use of
technical consultants for SSE firms, after which it is presumed that they can judge for themselves what is worthwhile and what is not. Industry associations are often the best placed to provide certain services, and public support for them to do so will be advisable, together with some surveillance to make sure that the support gets through to the intended recipients. Authors like Keesing and Lall (1992) have suggested that where the state provides functions directly, the time frame be limited in order to encourage the attacking of doable tasks and the early monitoring of success in the attainment of the proposed goals. This policy presumably would not apply in those areas where competence depends very much on accumulated experience.

(iii) Providing the professional and information resources to make and implement effective SSE policy. A government, whether national or local, which aspires seriously to assist SSE, should develop a cadre of operatives who know enough about the sector to interact positively and effectively with it. Along with providing the resources for and attaching the appropriate importance to this task to attract well-qualified personnel, a serious information gap must also be confronted. In most developing countries policy-makers as well as SSE-related institutions are seriously disadvantaged by the lack of a body of reasonably accurate and up to date information on what is happening in the SSE sector. While macro-planners have close-to-current information and labour force surveys give evidence on what is happening in the labour market, the business side of what determines many of the labour market outcomes are a black hole in most countries. Information is out of date, partial and often incomplete or inaccurate. The most well-intentioned government could not take the present state of problems of SSE well into account since it lacks the needed up-to-date information. Many elements of a good set of information are obvious, but other elements are less so, calling for some research into what pieces of information are most likely to be useful to policy-makers and others.

(iv) Training. Much training is required to help SSE to become and remain effective producing units. Some involves the managerial talents of the entrepreneurs or others in the decision area, other involves the various types of workers. Although a fair amount of training is undoubtedly carried on within the firms, even the fairly small firm, and should be encouraged by the state in whatever ways it can, in the case of SSE much such training inevitable partakes of the character of a public good. In the latter case it is a public sector responsibility to finance it, though the provision decision depends on the relative efficiency of the state providers, which varies from country to country. It is impossible to generalize on this point; state institutions tend to suffer from one set of deficiencies and private ones from a somewhat different set. But SSE are always at risk if they spend heavily on training only to lose the workers to better paying larger firms.
Worker Protection

Since working conditions are often poor in SSE, worker protection is a potentially important goal. Two problems make effective protection unlikely. First, many workers found in undesirable working conditions are nonetheless better off with the job than without it; normally they would not otherwise have accepted it in the first place. One focus of protection should be those workers who are in some kind of danger that they do not know about (e.g. those working with dangerous chemicals), or who do not make the decision about their own work activities, as frequently is the case with children below a certain age. The second problem is that, even in the case of well-designed regulations, implementation may not be effective: many SSE workers are family workers, making it hard to locate infractions; where marginal offenses (or even non-offenses) occur, the SSE families may be victimized by dishonest bureaucrats seeking bribes, and where real offenses are committed the system may still not "protect" because such dishonesty promotes bribes to avoid the legislation rather than to generate adherence to it. In summary, worker protection involves sufficiently tricky questions of what is really in the best interests of the worker that it would be asking a lot of a regulatory system that it be both well designed and well implemented.

It would appear that virtually all of the steps which would show any real promise to curtail worker exploitation in SSE should be enforced generally rather than for that sector alone: child labour regulations, prohibition against working with dangerous materials or in ways damaging to the health, and so on.

It is inevitable that many SSE be close to the margin of unacceptable working conditions. Given that, it is important that the state work with rather than against the SSE in dealing with working conditions having to do with the locale, the materials and the like. Such an approach takes away the bribe potential mentioned above, increases the likelihood that the SSE will improve conditions since they no longer have the same incentive to cover up, and increases the chances that the regulatory personnel be chosen for their true competence rather than for dishonesty. It is extremely important that such positions be defined as professional ones, involving both a high moral standard and a competence in the issues in question.
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Figure 4

Figure 5