

Improving Supply Responses in ACP Countries

Private Sector Development with Particular Reference to SMEs

Summary

Governments and the EU need to demonstrate visible commitment to private sector development. ACP governments must be steadfast in their commitment and not capitulate when faced with inevitable adverse exogenous shocks. To create a workable partnership a minimum set of governing rules and procedures, that are acceptable to all parties, will need to be developed, and adhered to by all parties.

At present the CDI is responsible, within the EU, for assisting ACP countries with industrial development. It has produced a sound plan for private sector development. Its effectiveness is currently hampered by having to operate, at times, under cumbersome, centralised, bureaucratic procedures. Ways of reducing these need to be investigated. Potentially there is much to be gained by ensuring other organisations are also included, and by increasing and targeting funds towards projects particularly in areas such as financial sector development and institutional support for SMEs.

More research is required into the development of environments conducive to business growth. For example, there is a need to link the shortcomings in infrastructure with the ability to produce and market goods at internationally competitive prices, match skills with needs, and balance general and vocational training. ACP policymakers require more information. In order to obtain this, links between public and private sectors need to be strengthened.

Private sector led growth requires the development of a sound financial sector. In many ACP countries financial sectors are plagued with market failures. Increased dialogue is needed to find appropriate solutions. Foreign direct investment, technology and know-how agreements are

important for the creation of an indigenous research capacity. Centre-satellite systems are a means of diffusing skills, knowledge and technology, and creating employment opportunities. More research into their potential in ACP countries may prove useful.

There is much to be gained from the development of micro, small and medium-sized enterprises. Under the correct conditions they have the potential to act as an engine of growth for a manufacturing section. A co-ordinated policy for their development is required to ensure their sustained proliferation. The challenge of any post Lomé arrangement is to ensure that:

- (i) SME development must be given priority (European Commission 1996a);
- (ii) legal and regulatory frameworks need to be upgraded to meet the requirements of SMEs; and
- (iii) an efficient support system is required for ongoing, large-scale, small firm development. This includes the provision of a large range of private and public of institutions and agencies and the development of financial, supply and export channels in research institutes, and training programmes.

5.1 Introduction

The 1996 Green Paper highlights the need to stimulate economic growth in ACP countries through competitiveness and private sector development. The importance of the private sector has been heightened by the accelerating pace of globalisation. To operate in global markets, private sector companies must be

competitive in all spheres of business operations, particularly in areas of productivity, quality and the ability in order to identify and meet market requirements. However, as has been stressed throughout this report, the ACP countries are a diverse group not only in terms of economic and industrial development and geographic location, but also in terms of cultures and socio-economic environments. Whereas globalisation offers opportunities to some, it represents major challenges for others. Policies will be required to be both country- and sector-specific, and allow for gradual upgrading of both over time.

5.2 Industrial Co-operation

The current Lomé agreement attempts to address the problems facing ACP countries in their attempts to industrialise by encouraging industrial co-operation between the EU and ACP countries. Article 78 states the objectives of industrial co-operation:

‘Industrial co-operation, as a key instrument for industrial development, shall have as its objectives:

- (a) the creation of the basis of and framework for effective co-operation between the Community and the ACP states in the fields of manufacturing and processing, mineral resources development, energy resources development, transport and communications;
- (b) the promotion of conditions conducive to industrial enterprise development, and local and external investment;
- (c) the improvement of capacity utilisation and rehabilitation of existing industrial undertakings which are potentially viable, in order to restore the productive capacities of ACP economies;
- (d) fostering the creation of and the participation in enterprises by ACP nationals, especially those of a small and medium-size nature that produce and/or use

local inputs; the promotion of new and the strengthening of existing enterprises;

- (e) support for the establishment of new industries to supply the local market in a cost-effective manner and ensure the growth of the non-traditional export sector in order to increase foreign exchange earnings, provide employment opportunities and an increase in real incomes;
- (f) promoting increasingly close relations in the industrial field between the Community and the ACP states, and in particular further encouraging the speedy establishment of ACP-EEC industrial joint ventures;
- (g) promoting business associations in ACP states as well as other institutions for industrial enterprise and business development.’ (Lomé IV Convention)

In order to achieve these objectives, Articles 79-86 pledge EU assistance to ACP states in terms of :

- ❖ improving their institutional frameworks, financial institutions, industry-related infrastructures, and training;
- ❖ establishing key industries, joint ventures, SMEs and their support networks;
- ❖ the exchange of information, research, scientific and technological development;
- ❖ marketing products and stimulating trade.

In short, the current Lomé undertakes to assist all ACP states in almost all stages of industrial development. However, this umbrella approach has failed to produce the desired partnerships or results in many countries. Given the constraints on funds and other resources the EU is clearly not in a position to provide support in all areas to all ACP countries. Priorities must be agreed on. The EU must decide exactly where best to target assistance.

5.3 A Partnership Approach

Governments need to develop workable partnerships with the private sector, civil society in general and CDI representatives. By augmenting their knowledge and developing skills of delegation of decisions to the private sector, governments can enhance private sector development. At the same time private sector representatives must realise their responsibility to keep the government informed of their actions. A-symmetric information leads to incorrect decisions and mistrust between partners.

Given the typical differences in the approach of the private and public sectors towards business practice, the development of the channels necessary for information flows cannot be left to chance. A minimum set of governing procedures and responsibilities of the various parties needs to be formulated. Such a set of guidelines must be jointly developed and agreed, clearly stated and easily understood. What is not required is more bureaucracy and the slowing down of decision making processes.

At the present time, under the existing arrangements of Article 98, organisations like the CDI are required to ask recipient governments for permission to undertake any study or project regardless of size or cost. This is done via government channels without private sector involvement. Major problems can be encountered if the short term priorities of government are critically constrained by lack of finances. Under such circumstances it is difficult for government officials to give high priority to the allocation of funds to the private sector for ostensibly long-term projects. The introduction of a simple set of rules could act to free-up the system. For example if the CDI were required to seek permission in principle for a type of project for the development of a particular region or industry but that, once obtained, approval at each stage was left to the private sector, then decisions could be made and acted on more swiftly and there would be no conflict of interest. The private sector and CDI would need to keep officials up to date with new developments via the information channels.

Any major shift in emphasis would be a matter of government involvement.

There are also other areas of potential difficulties. The allocation of funds and success of initiatives depends on a number of authorities and/or people. For example 'coal face' knowledge and skills, market expertise, development skills, funding control, and awareness of specific countries' needs and funding priorities tend to reside within different parts of the chain of potential beneficiaries – the CDI, EIB or similar bodies, experts and consultants, and the ACP governments. It is clear from the above that each group is likely to have its own priorities and, in addition, will not have or be fully aware of the skills and expertise of the other parties.

If the various cross-party steering groups each had all the expertise and authority necessary to identify, specify, fund and subsequently monitor and manage an initiative from start to finish, many of the conflicts would disappear. In this way all involved parties would agree the terms and share accountability for their group's initiatives. In addition, the communications referred to above as being so important would be greatly simplified as individuals from all factions would be represented and would be better able to implement the communication guidelines and feed the communication channels.

5.4 Visibility and Commitment

Industrial and private sector development are ostensibly long and medium term agenda items. Whilst not advocating rigid long term development plans it is important that governments do engage in planning, are steadfast in their commitment to the private sector and that the correct signals are given to the business communities, both nationally and internationally, and to civil society in general. A visual commitment to change and planning, and to private sector development signals the potential for investment first nationally and, ultimately, from international companies. The path of industrialisation is not always smooth – endogenous and exogenous shocks can result in major setbacks. If

governments do not show steadfast commitment to the private sector, but capitulate at the first major obstacle, the process will come to an untimely halt. The same analysis may be applied to the Commission and other international agencies. If the Commission and member states are earnest in their desire for partnership and private sector development in ACP countries, they must demonstrate and signal their commitment so that others can see, and act on it. Individual member states must publicly promote the ACP countries as potential markets for investment, and as suppliers. They must also encourage joint ventures with ACP countries.

5.5 The Centre for the Development of Industry (CDI)

Past constraints on industrial co-operation

The EU has three main organisations which are responsible for co-operation and industrial assistance – the Commission, the Centre for Development of Industry (CDI) and the European Investment Bank. These organisations, though fully aware of the need for ongoing and dynamic change in a global world, have been severely constrained by the nature of the existing Lomé arrangement. As an example of this The Committee on Industrial Co-operation, under Article 87c, has the authority to organise ‘on the request of the Community or ACP states’ a review of industrial policy when conditions dictate. In reality industrial policies must be flexible and continuously reviewed. Procedures are currently too bureaucratic, cumbersome and centralised to be sufficiently fleet of foot to execute instructions within a dynamic commercial environment. These issues must be addressed to enable the CDI to continue to improve its effectiveness.

Also, in the early years of the IVth Lomé Convention, industrial co-operation between the Commission, the CDI and the EIB was not always what it could be. As part of ‘The Halfway Revisions’ the new Article 89 stipulated that co-operation between these institutions be intensified. Since 1995 there has been definite progress and the CDI and EIB are more active in industrial forums

and planning (European Commission, 1995).

Project funding

Before looking at some of the important aspects of the CDI’s current and future roles it is useful to look at past fundings.

In 1994 the number of ACP beneficiaries of CDI assistance was 545, and the total number of projects handled was 192. This represented a 24% increase over the previous year and approximately one third of total admissible applications. All accepted projects were subject to pre-selection criteria by the antennae and the CDI.

The geographic and sectoral spread of these projects are shown below.

Geographic Location	1994%	1993%
East Africa	25	18
Southern Africa	22	20
West Africa	22	24
Central Africa	7	14
The Caribbean & the Pacific	24	24
Sectoral Breakdown in 1994		
Agro-industry	35	
Building material	32	
Clothing	15	
Others	18	

In 1994, the agro-industry accounted for 41% of the budget. Overall 34% of CDI interventions were aimed at new enterprises and pilot projects, 35% at expanding and diversifying existing enterprises and 31% at rehabilitating or consolidating existing projects. Interventions fell into two categories: technical interventions on the floor (56%), and those which could be classified as feasibility studies, diagnoses and expert and commercial assistance (44%). During the same year 31.3% of the projects supported by CDI were small 18 business projects, whilst 68.7% were medium-sized. Approximately 50% of assisted enterprises were joint ventures (oppcit).

Sector and key industry development

The 1994 figures demonstrate the importance of the agro-industry and the focus on project, rather

than sector, assistance in the CDI policy framework. This is not surprising as one of the first stages of developing a manufacturing base is to diversify into processed agricultural commodities, thus utilising prevalent basic skills and techniques. However, it is also important that the least-developed countries develop new, labour-intensive manufactures which are suitable for export, and that the more developed ones upgrade, deepen and widen their industrial bases by establishing more technologically-dependent industries. To do this, it is necessary to adopt a more sector-based approach to complement project-based assistance. Whilst projects need to be selected on the basis of their potential for success and profitability, it is also important to select projects which have the potential to generate a long term multiplier effect, and ones which can be viewed as key industries which have the potential to spawn further industrial development. In this way, long-term goals may be sought while meeting short-term imperatives, as recognised in more recent CDI plans.

Such key industries have historically been established by the public sector and divested over time as industrialisation proceeds. However, where the public sector is under-equipped to take on such a role, joint ventures with foreign firms or with the public sector can also be used to establish such industries. Focus on private sector development should not result in the exclusion of the public sector, nor should the public sector monopolise industries which are more suitable for private sector development. Investment by foreign firms can, under the correct conditions, provide the necessary technology, know how, management and marketing skills which are such key components in any individual firm's success. The benefits from joint ventures are amplified when the resultant organisation can become part of a centre-satellite programme⁵. When selecting joint venture projects for funding it is important, therefore, to ascertain the potential of each joint venture enterprise to act as a centre firm from which downstream medium-sized and small satellite firms can develop.

Such development has been demonstrated in Taiwan ROC, to lead to strong backward and forward linkages and the establishment of business networks. As will be discussed later in this chapter a formalised centre-satellite programme needs a co-ordinating body experienced in private sector development to help start up, train and upgrade small firms in all aspects of business development, and also to set standards and monitor both centre and satellite performance. This ensures the quality of output and, ultimately, exports. In Taiwan this role has been, and still is, performed by the China Productivity Centre which is a privately-owned, government-sponsored organisation. The centre-satellite programme in Taiwan has been a resounding success over the years. It has helped to establish many new industries, and upgrade traditional, labour-intensive ones, launching them into export production. There is a great deal of potential for using a similar programme within the ACP countries, particularly in those countries where the private sector is beginning to become established.

The development of more information and resource-flow channels

The CDI antennae system and the follow-up procedures in the aforementioned mentioned report show that information and resource-flow channels from grass root enterprises to fundholders and policymakers are becoming established, but there is still room for more work in this area. At the present time the CDI has over 60 antennae, together with national and regional correspondents and specialist consultants. The CDI has a wealth of technical experts who are active both in industrial development and the co-operation process, but their resources are stretched. There is a need to evaluate the possible ways of targeting, expanding CDI budgets and involvement, and the inclusion of other agencies, institutions, groups and individuals to assist the CDI with private sector development.

5 Centre-satellite systems will be discussed in more detail in subsequent paragraphs.

5.6 The Need For Entrepreneurial ACP Governments – Ways in which the CDI and Commission Can Help

One of the key players in the private sector is the entrepreneur, but it is often difficult for government officials and private sector employees to relate to such individuals, or to become more entrepreneurial themselves. However economies like the Asian Tigers have industrialised through a combination of entrepreneurial and authoritarian governments. Article 110 states that 'fostering of ACP entrepreneurship is crucial... 1.(vi)'. In most ACP countries entrepreneurial skills within government and the public sector are very scarce. This has the potential to produce problems which could resonate throughout the industrial and export sectors.

Firstly, if entrepreneurs and government officials do not hear the same tune there will be no harmonisation of policies and actions. This problem is exacerbated if entrepreneurs are not involved at the policy planning stage.

Secondly, a related problem may emerge at a more decentralised level. Regional or local officials may misinterpret the essence of rules and procedures for the private sector or, even more catastrophically, they may believe, given their mindsets, that a policy is not appropriate and deliberately block or slow its implementation at grass root levels. This calls for:

- ❖ documentation to be clear and simply presented with the minimum potential for misinterpretation;
- ❖ dialogue between the private and public sector and the CDI at all levels;
- ❖ the use, where at all possible, of officials who have at least a working knowledge of the private sector; and
- ❖ some basic training of government officials in the mechanisms underlying successful business practice.

Thirdly, if governments themselves are not entrepreneurial they will not respond to market

signals, resources will not be channelled appropriately, and opportunities will be lost.

However, governments cannot become entrepreneurial overnight. There is a clear role here for the EU to provide some assistance. The CDI, with their comparative advantage in business practice, are in an ideal position to (i) help governments understand the importance of being entrepreneurial (ii), provide support for them to become so. However the scope for CDI involvement is limited by its budget, and other organisations could also play important roles.

Until now the CDI's role had focused primarily on stimulating and maintaining growth in the private sector, but it could be expanded to include more initiatives to improve public sector awareness of business. Alternatively other organisations could provide such a role. This approach would only work if both parties recognise the added advantages of co-operation and openness. Ultimately they would be better placed to understand each other's priorities, positions, and constraints, and to develop complementary skills and procedures.

5.7 Creating an Economic Environment Conducive to Private Sector Growth

The ongoing proliferation of private enterprises depends on the creation of an environment which will encourage entrepreneurs to engage in market making activities. As has been previously mentioned, the first and most fundamental prerequisites for this are good governance, rule of law, a stable economy, and the existence of a sound macro policy framework. Similarly, institutional arrangements, infrastructure, and education policies must keep pace with industrialisation.

Infrastructure support

As a recent survey (Stern and Gugerty 1986) points out, it is easy to list the shortcomings in the supporting structure of the Sub-Saharan African countries – a weak legal system, poor telecommunications, lack of roads and well maintained ports, lack of appropriate human capital, a failure to

develop a variety of export support services. However, there is little research linking these shortcomings to the ability to produce and market goods at internationally-competitive prices, yet without this information it is not possible to rank the relative importance of these factors and design appropriate policies. A further difficulty in the context of physical infrastructure is an absence of information on the extent to which the poor infrastructure is due to under investment in capacity, compared to the lack of maintenance of the existing capacity. The need for information and research to determine the priorities for building infrastructure is underlined by the observation that most successful developing countries (and for that matter many industrialised countries) have many serious gaps in their infrastructures. It is therefore crucial to identify those deficiencies that really matter for achieving the objectives that the ACP have established for their economies. Close collaboration between public and private sectors has proved to be an essential element in providing information on which these priorities can be established. In the context of EU-ACP development co-operation, this requires an institutional mechanism enabling the private sector to participate much more actively in the policy dialogue and in the development of the NIPs. An increase in direct private sector participation in infrastructure projects is also probably essential in most ACP countries, because public resources are inadequate to meet the huge task of investment and upgrading. The methods by which this can be achieved will vary between countries, but in all cases will involve changes in the legal and regulatory framework to induce greater private sector participation by local and foreign companies. EU countries have developed a considerable expertise in this field and have been particularly active in providing advice to East European countries. ACP countries could usefully target this as a particular area of co-operation.

Investment in human capital

It is axiomatic that investment in human capital increases growth but, as discussed above, this observation is not useful to policymakers unless

translated into more precise statements at the individual country level. Is the problem one of a general lack of literacy and numeracy or is it that the skills developed through the education and training system do not match the needs of the economy? Is the balance between primary, secondary and higher education correct (given scarce resources)? Is the balance between general and vocational education correct? Again, there is very little information available to ACP policymakers in deciding such crucial issues and yet decisions on these matters lie at the heart of building a successful and internationally competitive economy. As with decisions on infrastructure in general, so decisions on education and training require a close and constant interaction between the public and private sector to determine the best mix of education and training and between formal and informal training (apprenticeships and in-service training) and between public sector, private sector and the joint provision of training. ACP countries could usefully obtain assistance in answering these questions and on the basis of this, determine priority areas for action in their NIPs.

A thorough analysis of training (Biggs, *et al*, 1996) based on panel data for two hundred firms and a series of case studies in eight Sub-Saharan African countries (Burundi, Cameroon, Côte d'Ivoire, Ghana, Kenya, Tanzania, Zambia, Zimbabwe) concluded that:

- 1 Because of the complexity of technology and many uncodified elements, learning by doing, trial and error and step by step incremental learning are all important for technology transfer. Accordingly, pro-active time consuming efforts must be made by firms to transfer new process and product technologies and these investments can be costly.
- 2 Successful absorption of a new technology is only the first step. After the initial learning is mastered, it is critically important for firms to develop the ability to adapt and modify the practices as circumstances change.

- 3 The leading source of technical learning in firms in all countries comes via private channels. When firms are unable to meet their technological needs internally, there will be a demand for technical support services of government, NGOs and donor agencies to fill the gap.
- 4 Learning by doing, on-the-job training and internal tinkering, adapting and modification are cited as the most important sources of technological capability and productivity gains over the lifetime of the firm. Such technical efforts are also occurring in African firms. The firms that we interviewed in Africa are engaged in training workers, rudimentary research and development activity, and development and use of technical documentation and technical offices.
- 5 Where African firms appear to differ from their Asian and Latin American counterparts is in the overall incidence and quality of internal technical efforts. Only a very few large firms, mostly multinational corporations, have in-house training courses. The same is often true of the other elements of internal technical effort.
- 6 The internal technical efforts of the firm will not amount to much if the environment within which the firm operates is not supporting these efforts with new inflows of know-how, new market connections and access to individuals with technical expertise. The availability and quality of business support services are crucial elements in the internal learning process. That these external support services, both private and collective, have been weak and missing in some cases has limited significantly the effectiveness of enterprises' internal technical efforts.
- 7 Where African firms have access to foreign flows of technical knowledge through technical assistance contracts, technical

licence agreements and foreign ownership, studies show that they were more productive. Such private external learning mechanisms increase average firm productivity by about 30 percent. The priority task for public policy at the firm level is first to ensure that the business environment facilitates – rather than obstructs – the development and functioning of the private-to-private flow of technical know-how at home and from abroad.' (Biggs, *et al*, 1996, pp.108-111).

The challenge for a new Convention is to learn from such empirical studies and to target and channel more resources and organisational effort, both by the ACP and the EU, into substantially upgrading the technological capacity of firms.

5.8 Financial Sector Development

The changing emphasis in ACP countries towards private-sector-led development means that financial sector development assumes even greater importance. In many African states, liberalisation has not progressed as swiftly as was hoped, and their financial sectors remain underdeveloped and plagued with market failures, rent seeking behaviour and inefficiencies. Central banks are often still government-owned or controlled, private sector banks operate under severe capital constraints, and there are few, if any, financial institutions which cater for business development needs. Private and public sector savings are low, and there are few mechanisms by which savings can be mobilised into efficient and socially-desirable investment projects. Banks in most ACP countries often appear to be inadequate in all functions not only for long term investment, but also for working capital and the provision of adequate and timely pre and post export finance. 'Banks typically are uninterested in adapting financial products to meet the needs of viable small or medium enterprises. The tendency is to try to mould the customer to an existing set of financial products. As a result,

bankable small and medium enterprises have a hard time accessing overdrafts and short term capital, let alone credit for expansion' (Biggs, *et al*, 1996, p.115).

Sources of financial services outside of banking are often even more limited or are non-existent, for example, equity markets, leasing, venture capital, and insurance.

Under the present arrangement the European Commission have played a very limited role in financial sector reforms and development in ACP countries, though they have provided technical assistance to banks in some ACP countries to help them provide services to small and micro firms, and they have also assisted in the creation of a private sector development bank in Mali.

With an ever-increasing emphasis on private sector development, there will be a far greater need for increased assistance in the late nineties. Awareness of this requirement prompted the CDI to propose a new strategy for financial sector development. The first stage of this strategy stresses the need for increased dialogue with ACP governments to find appropriate ways to ensure that financial institutions become autonomous and independent from political agenda. Other subsequent measures include support in strengthening the role of central banks in bank supervision, and in interest rate policies so that market rates are established or approached, providing technical assistance to establish new specialised financial institutions such as private development banks, venture capital companies, insurance and stock exchange organisations.

With regard to capital market development, the CDI report stresses that capital markets in ACP countries are both shallow and narrow, and that in most African states banking sectors are heavily concentrated with an absence of competition, and intermediate finance institutions are not developed. It recommends that restoring the viability of financial institutions and building competitive and efficient financial markets should be given priority by the European Commission.

As with all policies discussed in this chapter,

the success of financial sector development relies heavily on the adoption of sound macro policy, and the provision of an adequate legal and regulatory framework. Within this, the CDI report recommends that strategies be focused on rehabilitating viable, distressed banks through restructuring and technical assistance, refining credit and interest rates, promoting new instruments and establishing appropriate regulations and supervisory structures, which can promote stable competitive conditions within banks and capital market institutions. These are new areas of activity for EU-ACP co-operation and the ACP will have to decide on those areas in which the Commission, as compared with other donors and sources of technical assistance, could most effectively assist them in the development of the financial sector.

The ACP may also wish to review the effectiveness of the present division of responsibilities between the Commission, the Centre for Development of Industry (CDI), and the European Investment Bank. For example, is it sensible for the EIB to be involved in financial initiatives independently of CDI and the Commission, especially when they have little or no experience of operating in a developing country and have no locally-based staff in an ACP country? What delays and missed opportunities have arisen from these arrangements? What problems have arisen from the overlapping responsibilities of the Commission and the CDI? Are there alternative and more effective modes of delivery available, for example using private sector suppliers?

5.9 Foreign Direct Investment and Centre-Satellite Programmes

Technology can be simply and easily divided into

- (a) technology which results from inflows from abroad; and
- (b) indigenous, or domestic technological activities.

For developing countries the most important external sources of technology and product upgrading, are foreign direct investment (FDI) and joint licensing agreements. Other sources include technological publications, universities and the Internet (World Wide Web).

Under the correct conditions FDI can act as a major stimulus to the private sector, however it can also result in enclaves of development and have a negative effect in terms of dualistic development. The spread of globalisation and economic liberalisation has resulted in FDI playing an even more important role in technology transfer. It has the capacity for transferring capital, skills and brand names, and for providing access to international markets. It also has potential benefits in terms of spillover effects on local skill formation, technological learning and competition (UNIDO 1996). However, most ACP countries (with the notable exception of economies such as Nigeria), and especially the least-developed economies, have experienced only low or insignificant flows of foreign investment, and much of that which has occurred is concentrated in mining and extraction. The actual benefits of FDI to host countries depends on:

- ❖ the host country's ability to negotiate a 'fair' package in terms of the use of indigenous labour, raw materials and other inputs;
- ❖ the level of industrialisation within the host country; and
- ❖ the extent to which linkages and spillovers develop, and human capital is upgraded.

Under the correct conditions, then, FDI has the potential to enhance the performance and development of the small and medium sector. The establishment of large upstream firms acts as a catalyst for downstream small-scale firms to locate as their suppliers. In this way backward linkages and networks develop. However, given that TNCs seek global competitiveness, they will not locate without the pre-conditions of economic and political stability, simplicity and

clarity of domestic markets, infrastructure and competitively priced factor inputs and intermediates, (Greenaway and Milner 1996). This represents a major challenge for many ACP countries as MNEs will not locate even if offered the most attractive terms.

Even without FDI, ACP countries must attempt to develop indigenous, innovative capabilities. At higher stages of industrialisation this need is heightened. Countries such as Kenya, Mauritius, Nigeria and Zimbabwe have benefited from technology and know-how agreements as substitutes for FDI (UNIDO 1996). If FDI is not forthcoming, this is an important means of obtaining technology.

5.10 Centre-Satellite Programmes

An important way of harnessing the potential benefits is by implementing a centre-satellite programme. However, as is discussed elsewhere in this report, many ACP countries cannot rely on inward investment. A major advantage of a centre-satellite (C-S) programme is that it is also equally applicable for large domestic firms (private or public) and for joint ventures. If, as is discussed in Chapter 4, private investment in a key industry is not forthcoming, efficient public sector investment could provide the necessary stimulus for small downstream firms. By harnessing the development of small firms in a formal system rather than allowing ad hoc development, the benefits are greatly increased.

- ❖ Institutes and organisations can be developed to assist small firms in all areas of production.
- ❖ Small firms have a guaranteed market for their products.
- ❖ If, as is usually the case, the centre firm is an exporter it imposes the discipline of international quality standards on its suppliers.
- ❖ There is a potential for the development of management and other skills.

- ❖ Competition and co-operation develop simultaneously between SMEs as chains of subcontractors develop.
- ❖ Once experienced, centre employees may set up on their own as suppliers of components, and often retain strong links with the centre firms, which can provide training, or contribute to satellite development in some other way.

Firms recognise mutual dependence and trust and bonds develop. More so if members of extended families are involved in the chain.

From a policy point of view the goal of a centre-satellite programme is to promote more unified production between large and small enterprises, with small downstream firms developing from suppliers of raw materials to suppliers of component parts. For example:

Centre-satellites also provide opportunities for employment, homeworking, and new enterprise creation. For example one could visualise a chain of suppliers of component parts and assemblers in the bicycle industry. Small suppliers, themselves subcontractors, provide work for homeworkers (with the necessary quality control). If, as would usually be the case, the centre firm was a national or international exporter, further benefits in the form of the upgrading of technology, management and marketing may accrue to small firms. An example should serve to underline the advantages.

A firm designated as a centre (by some national authoritative board), would have to achieve a certain quality standard (e.g. world quality standards). This firm would then subcontract work to smaller firms. In order that the satellite firms' production was of the required standard, the centre firm would give advice on production techniques and training. What usually happens in Taiwan under such schemes is that local centre employees set up as entrepreneurs once they are experienced, and work is contracted out to them. Further subcontracting by satellite firms increases the diffusion and adaptation of knowledge, know-how and tech-

• Centre factory	–	an assembly industry
Satellite factory	–	manufacture of spare parts and accessories
• Centre factory	–	producer of intermediate materials
Satellite factory	–	processing firm obtaining raw materials from upstream
• Centre factory	–	bicycle or textile firm
Satellite factory	–	equipment, component supplier

(Adapted from Development Merit 1994)

niques, and clusters of small firms develop. From these clusters some firms will emerge, over time, as more dynamic enterprises, with the aspirations and potential to develop into centre-firms and/or exporters in their own right. However, whilst still infant, such enterprises have the security of supplying, at least part of their output, to the centre. Further development of these firms depends critically on the support systems available to them as they attempt to start up, and later as inexperienced exporters. In addition, traders form an important export channel for infant firms both in terms of information collection and dissemination, and market access. Over time, research, marketing and management centres will need to be provided either by the private sector or by joint private-state enterprises. Examples of domestic enterprises as centre firms can be seen in agro-industry, light manufactures, or when the informal craft sector is positioned to upgrade.

Under the present Lomé Convention, the CDI has been the main instrument for providing technology advisory services to SMEs. The development of centre-satellite systems would provide opportunities for the CDI, and other organisations to extend their work in this area and to co-ordinate and develop technological capacity, particularly in the higher income ACP countries, and basic manufacturing capacity in others. Technology transferred must be appropriate for any individual country, and 'imported technology' may need to be adapted to meet local needs and conditions. In Taiwan ROC, the China Productivity Centre,

monitored standards and requirements and co-ordinated with research institutes on adaptations required. In the early days of its industrialisation, research institutes consultants and engineers from abroad all played a critical role in adapting basic technologies.

5.11 Small and Medium-sized Enterprise Development

Policies aimed at supporting the SMEs

Developing countries in general lack appropriate, effective policy frameworks to promote the growth of SMEs and, where they do exist, they are fragmented rather than fully integrated into macro-economic policies. Little attention is given to the specific fiscal and financial measures needed to promote SMEs. Article 97 refers to the development of financing schemes in favour of SMEs, but individual countries must also adapt their legal and tax systems to favour small firms.

In policy terms, as is stated in the discussion paper on Private Sector Development Framework (European Commission 1996a), any approach must be based on identifying a country's needs and the building of a private sector support system which tackles the country's main deficiencies.

Upgrading the legal and regulatory framework to meet the requirements of SMEs

Over time, legal and regulatory frameworks evolve within countries to regulate and govern the activities of large enterprises within the industrial sector. It is important that rules and regulations relating to business operations and performance are changed and updated to meet the needs and the requirement of small, medium, and micro enterprise operations. Deregulation and structural reform should ensure that SMEs are treated on an equal basis to that of their large firm counterparts, and that an appropriate policy mix is established. Business practice is frequently hampered by numerous regulations, and small firms find themselves encumbered with rules designed for larger enterprises that are not applic-

able for small firms. Lengthy procedures also impinge more heavily, in relative terms, on small firms. In a field study of micro-enterprises operating in seven countries, including Swaziland and Niger, Morrisson *et al* (1994) found that the major institutional problems relating to start-up of micro enterprises revolved around difficulties in obtaining authorisation to operate, and submitting to certain types of inspection. In contrast, established firm problems focused more on taxation.

Small firms also experience difficulties in their attempts to adhere to international and domestic regulations concerning environmental and labour related issues. The 1996 Green Paper states the need for industrial development to be in line with world environment standards and labour laws. Both still pose major problems for ACP countries.

Institutional capacity

As has been mentioned previously, in many ACP countries there is a need to expand the institutional framework to cover areas such as design and productivity improvements, as well as technical, managerial and marketing support. In their study of Mauritius, Lall and Wignaraja (1997) point out that SMEs are handicapped in terms of poor quality, management, rudimentary design capabilities and low incidence of technology contracts. More institutions which are involved in helping SMEs to achieve world standards such as ISO 9000 are needed. In Mauritius the Mauritius Standards Bureau and Diffusion System was set up as part of a World Bank competitiveness upgrading project.

Small and medium-sized enterprise sector development

SMEs are fundamentally different from large firms in terms of aspirations, management, operations and behaviour. The large enterprise, with its focus on scale economies, internalises to reduce transaction costs and achieve efficiency whereas small firms' advantages lie in their flexibility and speed of reaction. They rely on

product differentiation, economies of scope and niche market penetration. Whilst their small scale gives flexibility, it also heightens their vulnerability to changes in demand and supply, in both national and international markets. To overcome this small firms engage heavily in sub-contracting and need outside channels for marketing their products and for technology diffusion. A small firm sector, or cluster, operates by networking at all levels of business operations.

It is highly unlikely, in developing countries, that the on-going proliferation of small firms will occur spontaneously. The small firm sector cannot flourish without the development of an efficient support system, which adapts, upgrades and evolves in line with the needs of small firms. Without such support individual firms cannot develop the networking required for dynamic growth. Typical areas of specialisation and operations include private financial institutions to provide medium and long term loans to small enterprises, marketing institutions and organisations of trades, Chambers of Commerce, and industrialised development centres.

Problems facing micro, small, and medium-sized enterprises

Finance

Many small firms lack access to institutional funds. Successful rural revolving credit schemes have been developed by NGOs, but there is a need for increasing the numbers and availability of such schemes. Slightly larger new firms, and established ones seeking to expand, have higher funding requirements. These entrepreneurs often face insurmountable problems in trying to gain access to more formal lending channels. Unable to provide the collateral or business plans required by banks, these businesses are denied funds despite the small size of the loans they require and the fact that, on average, small firms in developing countries have been found to be no less creditworthy than large ones (UNIDO 1989).

Sufficient effective mechanisms for the delivery

of funding to enterprises still need to be developed. Small firms' competitive advantages are based on flexibility and fast reaction time – if opportunities arise they must be ready and able to respond. There is little point in applying for loans or grants if the bureaucracy is so great that the process takes several months – by that time market conditions may have changed and opportunities lost.

Related to this is the need for efficient institutions which are able to provide small, as well as large, amounts of credit. At the moment the EIB has a budget of 100mEcu for developing countries. However, the main thrust of the EIB operations is as a financing institution for European banks. Banks are, by nature, risk averse and do not have the facilities to execute many hundreds of small loans. Because of this, funds are not always taken up. What is needed is a re-think in terms of the distribution of loans with increased focus on the requirements of small firms and projects rather than large ones. 'Europe needs to take risks when looking for financial return' (Report on Europe's Development Aid, Wilton Park Conference, Feb. 1997).

Training

Shortages in training may arise because:

- ❖ individual managers/entrepreneurs are unaware of the need;
- ❖ there is a deficiency in the provision of finances, institutions, agencies and individuals for the provision of training;
- ❖ there is a mismatch in the training offered and that required by entrepreneurs at any given time;
- ❖ there is insufficient funding within enterprises.

As discussed earlier, insufficient training will be provided by the market and some form of intervention is required to make up the short fall.

However, small firms are not homogenous in their aspirations and abilities to grow. Many owners of family firms do not aspire to become large national or international traders, but desire

only a modest income. Other 'true' entrepreneurs are motivated by profit, growth and status. The most important aspect of training is, like all other features of private development, that it be targeted correctly and planned systematically. Given the limited resources available for training it is important that expensive training packages are not wasted on firms which do not require them.

Empirical studies can provide assistance in categorising and selecting firms for different types of training.

The CDI's 1995 discussion paper (aforementioned) states that 'Actions will be developed to provide professional management development in specific skills and continuous training at appropriate levels, both in the public and private sectors'. The development of a centre-satellite programme would enable small firm managers via their links with large enterprises to enhance their skills. Such schemes would be complementary to CDI practice.

CDI policy for strengthening trade links for the private sectors includes the development of more trade associations, programmes to support enterprises in specific sub-sectors which place emphasis on product quality improvement, market research, the strengthening of trade-related infrastructure and services, and the development of national or regional trade development programmes (European Commission 1996a). These policies require adequate funding and support if they are to achieve their goals.

Finally, as discussed earlier, educational requirements need to be anticipated, and training programmes co-ordinated to provide the skills needed by firms.

5.12 Conclusions

If ACP countries are to be integrated into the global economy, adequate policies to stimulate growth via private sector development and trade are required. Under Lomé IV, EU policy includes financial and technical measures to support structural reforms, and to promote support in areas such as infrastructure, agriculture, industry, ser-

vices, and human resource development, as well as direct support for private sector development, in the form of investments, trade and enterprise development, and financial and technical support provided by the EIB and CDI (European Commission 1996b).

Despite these efforts in many ACP countries, particularly the African states where liberalisation is still not complete, the desired growth has failed to materialise.

Any new arrangement must prioritise and target support, to ensure that a workable and equal partnership between the EU and ACP governments must be established. The Commission must address its bureaucratic procedures, decentralise, reduce the number of policy instruments available, and target them specifically.

Currently, the CDI has a wide mandate and limited capacity and resources. It has developed a sound range of strategies to stimulate private sector development, but cannot do so without increased funding.

Other organisations may be well positioned to augment CDI activities, ensure that there is no monopoly on industrial assistance, and allow CDI to focus on where they have a competitive advantage.

FDI is a potentially important channel, but is of limited importance in most ACP countries; and there appears little prospect of this changing in the near future. Mechanisms through which other channels of technology upgrading can evolve need to be developed, and steps need to be taken to develop indigenous technological capacity at all levels. Centre-satellite systems, which have proved so successful in Taiwan ROC, have the potential to do this and integrate large and small enterprises within an industrial sector or industry. Further work in this area may prove useful.

Under the correct conditions, SMEs have the potential to become the backbone of a manufacturing sector and of exports. However, their ongoing proliferation requires the establishment of a network of support systems, and the integration of policies aimed at SME development into

a general macro framework. A future agreement needs to target resources to these ends.

Similarly more channels through which small firms can access funds swiftly need to be developed. As highlighted by the CDI, priority must be given to the development of the financial sector and markets, and also to tackling the other problems facing small firms in the areas of training, management and marketing their products.

There is a growing weight of evidence to suggest that the most effective way for developing countries to improve their situations is through the promotion of SMEs. The reasons for this seem fairly straightforward:

- ❖ towns, villages and even families tend to relate more naturally to the 'small, family business' type of organisation;
- ❖ the resources (finance, expertise, people, R & D, technology, skills, infrastructure, etc) required by SMEs are by definition much less than those demanded by larger organisations, so they are quicker and easier to set up;
- ❖ SMEs are more fleet of foot and can therefore respond more rapidly to changing market requirements;
- ❖ they can also operate in market niches too small to be viable for larger organisations;
- ❖ as SMEs expand, they tend to favour an outsourcing approach (rather than the alternative of increasing their own cost base significantly, thereby providing work for other SMEs in related areas; and
- ❖ the need for (often scarce) management skills is kept to a minimum due to the small size.

If we accept that promoting the proliferation of SMEs is a sound policy, we need to be able to encourage individuals to set up as small time entrepreneurs.

This doesn't mean that MNEs should not be encouraged. Nor does it mean that there is no role for the government in providing public sector

organisations. Indeed quite the opposite is true.

SMEs operate most effectively in groups (or clusters). Under such conditions horizontal and vertical linkages develop between firms. This network of relationships leads to stability, strength and efficiency. Clearly in order for clusters to develop individual enterprises have to start somewhere and start-ups tend to involve an entrepreneurial spirit as a driving force. However, entrepreneurial talents are often latent or absent in many ACP countries, and steps are required to reduce the perceived risks, and to create an environment in which micro, small, and medium-sized firms can flourish. Existing and potential entrepreneurs need specific knowledge and/or skills (in products, markets, manufacturing techniques, etc.) which reduce the risks to manageable proportions.

Indeed if entrepreneurs are not risk takers, then, it follows that they will be encouraged to set up operations only when certain conditions are in place. These conditions will vary between individuals, companies, markets, and countries, but it is possible to draw up a basic requirements list:

- ❖ availability of appropriate funding and access to finance on an on-going basis;
- ❖ availability of appropriately-skilled people;
- ❖ ability to 'ship' output (i.e. suitable road, rail and sea links);
- ❖ access to new technologies;
- ❖ access to market knowledge;
- ❖ availability of raw materials (or sub-assemblies) of acceptable quality;
- ❖ assistance with legal, exporting, etc procedures;
- ❖ assistance with adherence to internationally-recognized quality standards;
- ❖ freedom from over-burdensome bureaucracy; and
- ❖ stability in terms of the economy in which

they operate, enduring policies, etc. i.e. If I set up now, will it be impossible to operate in the future if policies changes?

Individual ACP governments, therefore, face the challenge of, and the responsibility for, creating such a fertile environment. In terms of promoting specific industries, centre-satellite systems have been shown to be very effective elsewhere for encouraging the start-ups of SMEs in particular areas; a 'centre' firm may manufacture bicycles, but subcontract the manufacture of many of the components (spokes, wheels, brake assemblies) to 'satellite' firms.

In such situations it is the role of governments, the private sector and organisations like the CDI to work together to identify appropriate industries (from knowledge of local/international markets, technology requirements/availability, manufacturing requirements/capability, etc.) and 'incentivise' companies to set up in these areas through skill training, knowledge transfer, financial assistance and so on.

In the same way FDI can be encouraged. FDI has the added advantage, when correctly managed, of introducing new technologies and skills which are then transferred to other companies in the chain (or centre-satellite system).

In return for providing help in these areas, those involved in providing it are able to feed information back to the centre (the planning hub) that provides input to adjust or enhance the plan in the light of successes, failures, shortfalls, etc.

In this way such an integrated process is able to identify requirements, attach priorities, and devise responses in a constructive and cost-effective manner providing (or facilitating) appropriate training as differing needs arise, easing the route to funding in appropriate cases, creating partnerships where necessary, and easing the administrative/legislative burden where possible.

Governments have, or have access to via the EU (and other institutions and organisations), significant expertise in/knowledge of world markets, quality standards, appropriate technologies, exporting procedures and so on, and

they and the EU can contribute enormously by making such expertise readily (and cost-effectively) available. Institution capacity, a fundamental requirement for industrial development, needs to be expanded and developed in order to face the new and changing requirements of the small scale sector. There is a critical need to analyse both needs and weaknesses in physical and business infrastructure (roads, communications links, exporting support etc.), within individual economies, and many ACP countries require assistance here.

For maximum effect such initiatives to promote the private sector would need to form part of an agreed and integrated policy and be targeted at certain areas and/or business sectors, with decision-making ability being devolved to the local level so as to take account of regional variations and to provide the speed of response that entrepreneurial organisation thrive on (or die without). In addition to this, a network of support systems to include research institutes, training programmes, marketing institutions, financial institutions and packages, export agencies, design and engineering agencies, to support small firms, is required if the proliferation of firms is to be sustained. Such a network would consist of both private and public agencies, balanced in the appropriate proportions, according to priorities, needs, skills and finance. To ensure co-ordination, information flows, and appropriate timing and execution of policies, efficient channels of communications are crucial. At present a comprehensive range of support agencies and packages is lacking in most ACP economies, and where it does exist, problems often arise in co-ordination and communications between agencies or institutions, or between them and the enterprises they are trying to assist. In small economies, or where the SME sector is underdeveloped, much of the necessary support could be provided by or co-ordinated by an overall body, thus eliminating information breakdown and time-lag problems. This is of particular importance in the areas of upgrading, technology transfer and finance.

Small firms' competitive advantages result from their flexibility and speed of reaction time, and their ability to adapt appropriate technologies to suit local conditions and different markets. Without appropriate support, ACP entrepreneurs will not enter markets in sufficient numbers for

them to achieve these advantages, or to act as catalysts for sustained growth and development. The EU and the ACP countries face the challenge of finding the most appropriate ways for individual countries to provide the necessary environment and support systems.

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