



The World Bank  
and the world's poorest: V



World Bank photo

# The Bank and the development of small enterprises

Over the next 25 years, vast numbers of workers in the developing countries will need to find jobs outside agriculture, which is now their main source of employment. Although many of these countries are developing a viable and growing industrial sector, employment in industry has not expanded correspondingly. This article examines why this has happened and discusses the Bank's attempts to increase employment opportunities by encouraging the development of small local enterprises, as part of its program to reach the absolute poor.

**David L. Gordon**

Unemployment—or rather blatant underemployment in unproductive occupations yielding bare subsistence—is pervasive and persistent in most developing countries. And it is becoming more serious. Taking the developing world as a whole, the labor force expands by about 26 million persons each year, and the numbers are increasing. Roughly two out of three of these new job-seekers will need to find employment off the farm, some in villages and small towns closely linked with agriculture but the majority in larger towns and cities. And urban employment, in substantial part, must be provided through manufacturing or other industrial activities.

In most developing countries industry has been the most dynamic growth sector—with output expanding at an aggregate rate

of 6.7 per cent from 1960 to 1970 and 4.5 per cent from 1970 to 1975 in the low-income developing countries. But industrial employment has not kept pace. In Latin America, between 1960 and 1969, the rate of growth in manufacturing employment was only 40 per cent that of output for the sector. Other countries for which statistics are available show a consistent lag, by varying amounts.

Part of the reason for this disparity is that developing countries have often given priority to capital-intensive, technologically sophisticated industries—basic steel, petrochemicals, heavy machinery, vehicles, cement, and so on—that employ few people at very high investment costs, often upwards of \$200,000 a job. Further, in the establishment of other new industries of more modest scale and complexity, the sponsoring entrepreneur or government agency often opts for an advanced technology, involving heavy use of capital and energy, in preference to alternatives that are more in keeping with the country's human and natural resources and capital availability.

These relatively capital-intensive techniques may be adopted because of effective sales efforts, or availability of external finance linked to imported equipment, or

insufficient knowledge of alternatives; the more modern, capital-intensive technologies are almost always supported by marketing, servicing and financing agencies that outclass those that support simpler approaches. Sometimes, also, the choice may reflect an assumption that anything other than the latest technology is second or third best and would perpetuate the country's industrial backwardness. This assumption has often led governments to provide credit at below market interest rates, and concessional tariff and tax treatment, for imported capital equipment—which helps to make it profitable for entrepreneurs to buy such equipment and correspondingly reduce their labor requirements. Some countries have put an outright ban on used or "obsolete" equipment.

As a result, the technologies designed for rich, high-wage societies are introduced, often perversely, into the labor-surplus capital-deficit developing world. Indigenous industries, unable to make the jump into the production patterns of the late twentieth century, cannot upgrade their plants gradually and they fall by the wayside. The resulting dualism of an industrial sector based on foreign technology coexisting with an underutilization of local resources can have serious economic and social effects.

### Appropriate alternatives

It is sometimes argued that really there is no choice, that economically feasible alternative technologies do not exist. Certainly insufficient attention has been paid to the development of such alternatives, but studies of a wide range of industries show that labor-intensive techniques are available and can yield a higher return than the conventional options.

A current research project of the World Bank has reviewed numerous studies that analyze the technologies used in nine im-

portant industrial product lines—shoes, cotton cloth, cotton yarn, bricks, cornmeal, sugar, beer, leather, and fertilizer. Its initial findings are that the use of the most "appropriate" technologies (those yielding the highest present discounted value relative to capital investment), compared with the use of more capital-intensive conventional plants, would provide 1.1 to 20 times as many jobs per unit of capital invested, the ratios varying by industry but all strongly positive. Other indices also favor the "appropriate" pattern. A hypothetical composite picture for all nine product lines shows the following comparisons:

	Appropriate technology	Capital intensive technology
Employment (numbers)	304,613	59,436
Wage incomes (\$ million)	152	30
Non-wage income (\$ million)	647	345
Total value added (\$ million)	800	374
Capital/labor ratio (\$)	2,955	15,142
Value added per worker (\$)	2,625	6,363

### Less capital per job

Labor-intensive industries are often those in which smaller firms predominate and are economically viable. Even within a given industry, however, a considerable range of firm size is often feasible, with the smaller ones usually requiring less capital per worker and per unit of value added. Not all small firms use labor-intensive technology; some large plants may do so, but on average the smaller the enterprise the less the capital invested per job.

Other considerations also weigh in favor of small enterprise:

- Small firms, using simple technology, can often adjust more readily to a developing country's social and cultural environment, and can more easily develop links with nonmanufacturing sectors and avoid the duality associated with large units, which are often owned by or are dependent on foreign companies; this is particularly important in countries that are just starting on the road to industrialization.
- Development of smaller enterprises helps to enlist broader participation in economic benefits and decisions.
- Small firms are often technically innovative, devising or adapting production techniques suited to the country's particular circumstances; the most modern technologies offer little scope for improvement through indigenous ingenuity.
- Small enterprises can often better serve the limited, fragmented markets typical of

many developing countries than larger units.

• The development of small enterprises facilitates the dispersion of manufacturing activity, and so can help reduce regional imbalance, urban concentration, and (often) adverse environmental impact.

On the other hand, it is evident that, for some industries, economies of scale are so important that very large, capital-intensive units are mandatory. Examples are synthetic fertilizer and other petrochemicals, basic steel, and heavy equipment. But even industries where large size is often assumed to be typical and inevitable—such as automobile, truck, and tractor manufacture—can be organized quite efficiently, largely on the basis of production by small units; about 95 per cent of the companies producing for Japan's automotive industry are small firms—over 45,000 of them by recent count. Shipbuilding requires heavy capital investment, but hundreds of ship-fitting operations are highly labor-intensive, and involve components that can be produced by still more labor-intensive small units.

In assessing the employment created by industrial investment, one must take account also of secondary and tertiary effects. Apart from the jobs directly created in a particular manufacturing process, there are auxiliary services, suppliers of material inputs, wholesale and retail distributors of the product, and so on. Jobs in these associated activities usually constitute a multiple of the direct manufacturing employment, and their capital cost per job is usually much lower. Thus, the manufacturing industry can be a powerful engine for employment creation as well as for economic growth, if the cost of the industrial jobs is not so high as to swamp the auxiliary employment contribution.

### Achieving balance

The concept of technologies smaller in scale, simpler, and more labor-intensive than most Western or Soviet models is beguiling; it is also frequently valid. But to steer between a rather romantic "small is beautiful" approach and the uncritical acceptance of "modern" technologies as intrinsically superior requires a hardheaded analysis of specific country and industry situations. It may help to simplify the analytical process and make it easier to give appropriate emphasis, balance, and sequence of development to different industrial categories, in the light of relative factor endowments, if policy biases that exist in many countries can be reduced or eliminated. Such biases often tend to distort the allocation of resources, by underpricing capital equipment, infrastructure, and ser-

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Giuseppe Franchini for I&D

VICES for large industries, pushing up their labor costs, or overprotecting them from import competition. This approach should help market forces to favor, rather than discourage, an efficient mix and interaction of labor-intensive and capital-intensive production modes. The Bank's country economic and industry sector studies attempt to analyze existing distortions and their effects, and the likely shape of an undistorted industrial development pattern, as a basis for a continuing dialogue with governments on industrial strategy.

It would be unrealistic to assume, however, that a proper adjustment of factor prices (even if that could be done to everyone's satisfaction) would by itself cause the optimum mix of large or small, capital-intensive or labor-intensive, to evolve. In the first place, large firms possess certain inherent advantages more or less regardless of their economic efficiency. They are more immune from risk of failure, in the sense of disappearing or being abandoned; they will usually be propped up indefinitely or, if their performance is too dismal for too long, they will continue under new ownership or management. They have more market influence and bargaining power than smaller competitors or associates, and may use this strength to stifle competition or to encroach on the profit margins of smaller dependents. They have readier access to public officials and bankers, who have an occupational predilection toward bigness.

Smaller firms do not usually have such a safety net; those that fail disappear. Typically, entrepreneurs have personally to oversee and make decisions on most aspects of their business. When specific problems of law and regulation, finance, technology, or marketing arise that are beyond the limits of their expertise (as may frequently occur at crucial stages of a firm's survival, or its expansion, or transition into a more sophisticated product line or market), they cannot afford to employ consultants to advise them. Moreover, the public infrastructure and services available to these firms are often inadequate, their financial resources scanty, and credit institutions unsympathetic. These disabilities, which inhibit their efficient operation, are due in part to the widely prevalent view that they are necessarily inefficient and not conducive to the development process.

There may be a need, therefore, for a variety of governmental interventions: to counteract the simplified, often wrong-headed, impression just mentioned; to restrain unfair competitive practices by larger firms; to supply needed technological and business information and advice; to ease

access to institutional credit on reasonable terms, for worthy productive purposes; to facilitate, and in a measure regulate, the development of mutually advantageous cooperation between small and large firms through, for example, subcontracting or marketing arrangements. Such intervention, properly designed and accessible, should enable small firms to function more efficiently, to make a greater contribution to activities that are not subject to major economies of scale, and to function alongside and reinforce big firms in doing the things that they, as small undertakings, do best.

On the other hand, one must recognize that governments sometimes overprotect client enterprises, small as well as large, that should rather be subjected to a more vigorous competitive stimulus. So again, public measures in support of small enterprise need to be selectively and judiciously applied.

### The Bank's involvement

The World Bank Group finances industry through three loosely coordinated channels: (1) through direct loans or credits from the Bank or the International Development Association (IDA), usually of \$50 million and up, for major industrial projects, often government-owned or sponsored; (2) through loans and investment by the International Finance Corporation (IFC) in private sector projects smaller than those financed directly by the Bank but relatively large in the country concerned; and (3) through lines of credit (and some equity investments by the IFC) for national or regional development finance companies (DFCs), which retail credits to local enterprises in accordance with terms and criteria agreed with the Bank and subject to the Bank's supervision and approval. The last channel, which delegates the responsibility for day-to-day loan appraisal and subsequent administration to DFCs in the respective developing countries, enables the Bank to address the needs of a much greater number of smaller and more dispersed enterprises than it could possibly deal with directly. Nevertheless, even through these locally based institutions, Bank financing has generally been accessible only to the larger, relatively capital-intensive segment of industry, perhaps the top 20 per cent in number—firms that may be small by the standards of industrial countries but loom large in the local economy.

In 1975 the Bank began to look seriously at the case, and the potential, for assisting in the development of small enterprises. The sector policy paper approved in 1977, *Employment and Development of Small Enter-*

*prises*, concluded that this objective holds promise and deserves support. It estimated that only 8 per cent of prior Bank and IDA lending channeled through DFCs had so far gone to small enterprises, and it proposed a major increase in this share— notionally to about one third of total lending in FY 1981. In FY 1978 the share reached 24 per cent.

Most World Bank projects to assist the development of small enterprises incorporate a variety of nonfinancial elements as well as provision of credit and (sometimes) equity financing. An especially comprehensive project was the object of a loan to Mexico approved early in 1978. It comprises:

- A credit and guarantee program to enable small and medium-sized firms to obtain needed equipment and working capital. Loans are made and administered by the commercial banking network and are reviewed and guaranteed by a special national entity.

- An expanded program to provide risk capital, on a temporary and minority shareholder basis, to strengthen the financial viability of promising small firms.

- A program to lease plant and equipment to small and medium-sized enterprises, thereby reducing their need to tie up capital in the initial or expansion phases of development.

- Establishment and training of a corps of industrial development extension agents to help small entrepreneurs to identify and diagnose their problems, to prescribe solutions where possible, or to introduce or refer entrepreneurs to appropriate sources of financial or technical assistance.

These elements appear in most other small enterprise development projects financed by the Bank—sometimes introduced simultaneously, sometimes in stages, and often building on or supplementing domestic initiatives or the efforts of other aid-givers. Frequently, also, the Bank undertakes or assists studies of the incentive structure, government procurement policies, subcontracting policies and procedures, and other institutional questions that may substantially affect the development of small enterprises.

Bank and IDA loan commitments since the start of FY 1978, when the new emphasis on small-scale enterprise became effective, show a dramatic shift in that direction—based on preparatory work in the preceding two years. The dollar amount of loans earmarked for small enterprises was over 10 times the average for the preceding four years. But even on the most optimistic assumptions, Bank and IDA projects can be of direct assistance to only a small fraction of the burgeoning labor force in the

developing world that the agricultural sector can no longer absorb. The Bank contribution will be mainly by way of experiment and example.

However, in attempting to address the problem of urban and off-farm rural poverty by expanding employment in industrial and related activities, the Bank has been led to examine in greater depth the industrialization strategies appropriate for countries with differing characteristics and at different stages of development. The result has been partly to give greater emphasis to support of small enterprises, through a variety of intermediaries, and also to clarify the desirable balance and interaction between small and large enterprises, in order to maximize the yield of both employment and output for the benefit of the countries in question. These findings, as they emerge, are being incorporated into the Bank's policy dialogue with member governments; it is hoped that they may stimulate initiatives of much broader scope, with roots deeper in the local soil, than the Bank could conceive or carry out. This fractional contribution, if it is indeed seminal, will justify the effort.



#### Related Reading

- Barend A. de Vries, "Industrialization and Employment: The Role of Small and Medium-Sized Manufacturing Firms," in *International Economic Development and Resource Transfer* (Kiel, Institut für Weltwirtschaft, and Tübingen, J.C.B. Mohr, forthcoming).
- D. Morawetz, "Employment Implications of Industrialization in Developing Countries," *World Bank Staff Working Paper* (January 1974).
- Philip Neck, ed., *Small Enterprise Development: Policies and Programmes* (Geneva, ILO, 1977).
- Rein Peterson, *Small Business: Building a Balanced Economy* (Ontario, Press Perspective, 1977).
- James Pickett, "The Choice of Technology in Developing Countries," *World Development* (Oxford, September/October 1977).
- E. Staley and R. Morse, *Modern Small Industry for Developing Countries* (New York, McGraw-Hill, 1965).
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# Labor market developments in the major industrial countries

Unemployment has remained at a very high level in the major industrial countries since 1975. However, this absence of a marked change in the overall unemployment rate does not reflect a uniform experience. There has been a considerable diversity of underlying labor market developments in individual countries. This article analyzes recent labor market conditions from a historical perspective.

Michael Deppler and Klaus Regling

The economic forces affecting recent unemployment rates have been generally similar among the seven major industrial countries (Canada, France, the Federal Republic of Germany, Italy, Japan, the United Kingdom, and the United States). First, on a long-term basis, various structural changes in labor markets have tended to push up national unemployment rates in most of these countries. Second, the impact of cyclical developments on unemployment rates in the past several years has resulted in a number of broadly parallel movements among countries, as might have been expected. However, this semblance of uniformity masks a very considerable diversity of developments in the supply and demand for labor underlying national unemployment rates.

## Unemployment

The overall unemployment rate in the major industrial countries has declined only slightly since the trough of the 1975 recession. In that year, reported unemployment in these countries reached 5.1 per cent of the combined labor force, a rate substantially above the rates (varying between 2.3 and 3.5 per cent) that prevailed during the 1960s and early 1970s (see Table 1). Overall, the unemployment rate for the larger industrial countries hovered close to 5 per cent from 1976 through 1978.