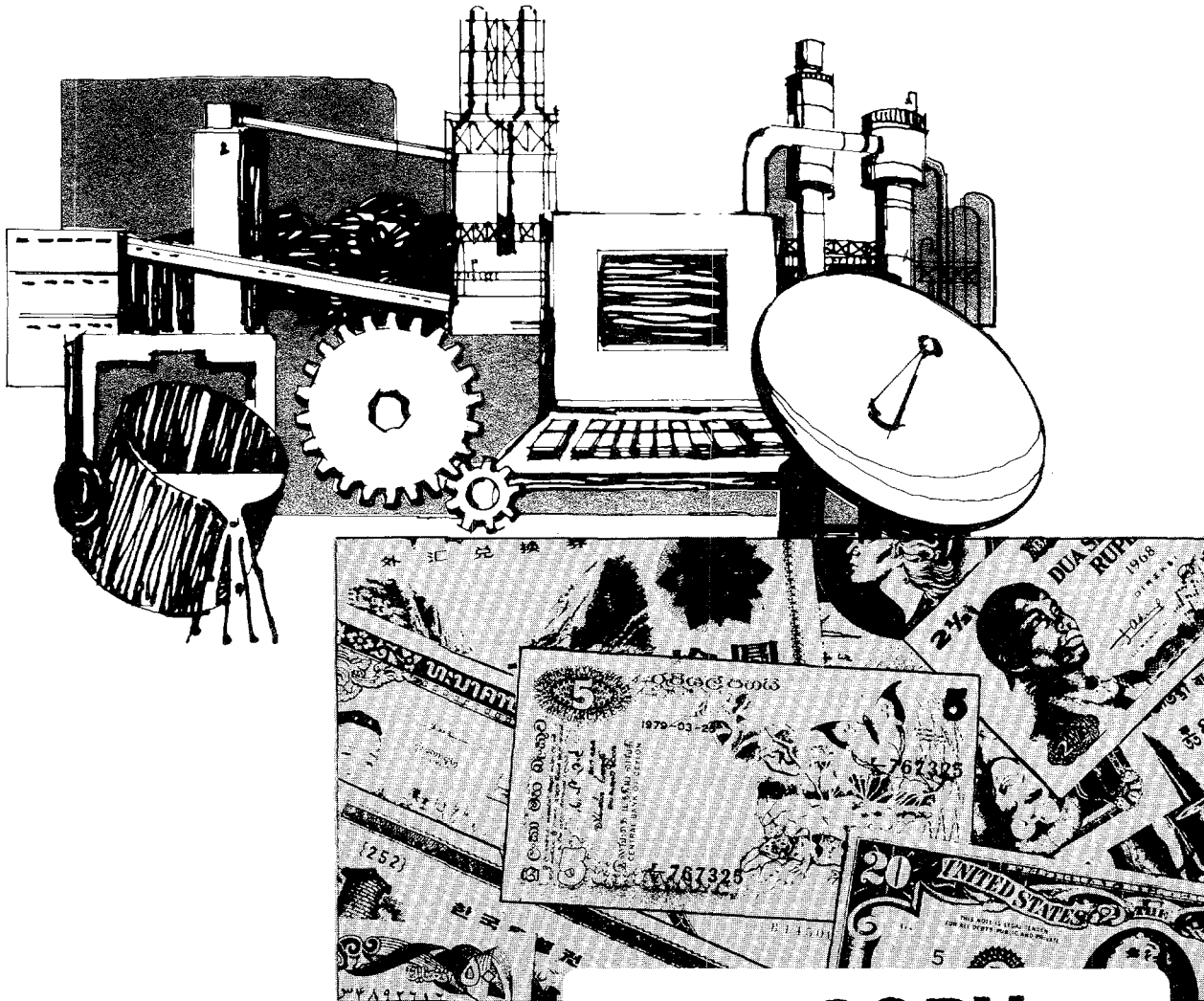


# World Bank Lending to Small Enterprises

A Review

Jacob Levitsky



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# **World Bank Lending to Small Enterprises**

**A Review**

Industry and Finance Series

Volume 16

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INDUSTRY AND FINANCE SERIES VOLUME 16

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## **A Review**

Jacob Levitsky

The World Bank  
Washington, D.C., U.S.A.

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First printing July 1986

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#### Library of Congress Cataloging-in-Publication Data

Levitsky, Jacob, 1924-

World Bank lending to small enterprises.

(Industry and finance series, ISSN 0256-2235 ; v. 16)

Bibliography: p.

1. World Bank. 2. Small business--Developing countries--Finance. 3. Loan, Foreign--Developing countries. I. Title. II. Series.

HG3881.5.W57L48 1986

332.1'532

86-15790

ISBN 0-8213-0814-9

### Abstract

In February 1978 the World Bank published a sector policy paper, "Employment and Development of Small Enterprises", laying out the case for increased lending to small enterprises in the developing countries. The main argument given for supporting small-scale enterprises (SSE) was their potential for employment creation. Other objectives in Bank lending to SSE were the mobilization of additional resources, the perceived contribution of these enterprises to the decentralization of industries, to the development of entrepreneurial skills and to the provision of basic consumer goods to the poorer sections of the population. In line with these objectives, from July 1977 to June 1985, the World Bank lent more than US\$2.2 billion in 70 different projects in 37 countries. In the fiscal year 1984, lending to small and medium enterprises (SME) reached 28.9% of all lending for industry through financial intermediaries.

This paper, World Bank Lending to Small Enterprises, analyzes the results of 10 completed small-scale industry projects approved between 1975-80 in Bangladesh, Cameroon, Colombia, Jamaica, Mexico, Morocco, Philippines, Portugal and Sri Lanka. Specific studies were undertaken in 1981-83 of some of these projects and the paper also draws heavily on project completion reports, project performance audit reports, supervision reports, and appraisals of follow-up projects. During 1985, the paper was rewritten to include some additional recent experience of Bank supported SME projects other than the original ten reviewed.

The projects studied generally made subloans in the range of US\$20,000 to US\$50,000 to existing small enterprises (sometimes rising US\$200,000 or more in the case of SME projects). In Africa and in a few Asian projects a high percentage of the subloans went to new enterprises. Only a few projects made subloans to very small, microenterprises. One surprising characteristic of some of the projects was the extent to which the borrowers succeeded in exporting their products.

As regards the major objectives, this review concludes that World Bank SME projects have created employment at less than half the prevailing investment cost per job in industry in the respective countries. They also have provided institutional finance to enterprises that previously had limited or no access to such funds. Bank lending has been less successful in mobilizing investments from owners of small scale enterprises and from the resources of the commercial banks themselves.

The most important lesson of experience is that many of the early World Bank SME projects did not recognize the importance of the policy framework. As these projects were implemented, it became increasingly evident that many policies related to incentives, trade, labor and taxation discriminated in favor of larger enterprises. These policies, therefore, impeded the attainment of SME objectives and development in general.

This conclusion indicates a need to ensure that licensing procedures, import controls, taxation, export promotion and regulations in general do not discriminate against SME, either directly or because these enterprises are unable to cope with the onerous bureaucratic processes involved. Simplification of the regulatory procedures related to formalizing enterprises and to obtaining promotional benefits offered by the government are essential if these measures are to have a positive impact on small enterprise development. However, it cannot be expected that Bank loans for SSE, usually of modest size, will provide the leverage needed to effect major policy changes. Major policy reforms and issues relating to the financial, trade and incentives are best negotiated through SALs or sector loans. In negotiating these loans, account must be taken of the problems of SME.

The major conclusion regarding the operation of the projects themselves is that commercial banks have proved more effective in channeling credits to small enterprises than development finance institutions. Two-tier arrangements whereby commercial banks are refinanced from a fund, usually located in the central bank but sometimes in a development finance institution, have proved relatively successful in directing subloans to small enterprises. Commercial banks have shown the greatest capacity for handling such loans in those countries where the banking system has been relatively developed, although they often still display a conservatism in lending for new enterprises. Credit guarantee schemes have been tried in a number of projects but most of them have experienced operational problems that reduced their effectiveness.

As regards interest rates, there has been a gradual movement in many countries away from subsidizing lending to small enterprises. The Bank's experience has been that using subsidized finance to counteract policy induced distortions has usually been unsuccessful. Lending at negative real interest rates or below prevailing commercial rates often has led to distortions in the use of the funds, to investment in equipment for which there is no real need and to poor repayment records. The foreign exchange risk on subloans has been borne by the government in all SSE and SME loans, except in Korea, and it seems reasonable to continue this policy in light of the characteristics of the borrowers.



TABLE OF CONTENTS

I.	<u>INTRODUCTION</u> .....	1
II.	<u>THE OBJECTIVES FOR WORLD BANK ASSISTANCE TO SME</u> .....	3
	The Basis for the Program Objectives .....	3
	The Argument for Intervention .....	5
III.	<u>ECONOMIC AND SOCIAL IMPACT</u> .....	7
	Employment Creation .....	7
	Entrepreneurial Development .....	10
	Geographical Distribution .....	10
	Impact on Foreign Exchange .....	11
	Additionality .....	13
	Technology Transfer .....	15
	Subcontracting .....	16
	Sustainability of Lending Schemes .....	17
IV.	<u>ISSUES IN PROGRAM DESIGN</u> .....	18
	The Policy Framework .....	18
	Foreign Trade .....	18
	Investment .....	18
	Regulations .....	19
	Credit .....	19
	Financing Arrangements .....	19
	Choice of Intermediary .....	19
	Development Finance Companies .....	19
	Commercial Banks .....	20
	Promotional Agencies .....	21
	Rediscounting Arrangements .....	22
	Credit Guarantee Schemes .....	23
	Eligibility and Target Groups .....	24
	Terms and Arrears on Subloans .....	27
	The Interest Rate .....	27
	Foreign Exchange Risk .....	28
	Maturities .....	28
	Repayment Periods .....	28
	Grace Periods .....	28
	Lender Margins .....	29
	Arrears on Subloans .....	31

TABLE OF CONTENTS (Continued)

Delivering Non-Financial Assistance .....	33
Foreign Advisers .....	33
Specialized Service Centers and Industrial Estates ..	34
Extension Services .....	34
Public Institutions .....	35
Financial Institutions .....	35
Some General Conclusions on Technical Assistance ....	35
V. <u>CONCLUSIONS AND LESSONS FOR FUTURE PROJECTS</u> .....	37
Policy Factors .....	37
Trade and Pricing Policies .....	37
Labor Legislation .....	37
Capital Formation .....	38
Subcontracting .....	38
Banking Regulations and Financial Policies .....	38
Bureaucratic Constraints .....	39
Affirmative Measures .....	39
Conclusions on Policy Issues .....	39
Other Operational Lessons .....	40
Intermediaries .....	40
Subproject Considerations .....	41
Technical Assistance .....	42
Microenterprises .....	42
Size of Future Projects .....	43
<u>ANNEX - REVIEW OF SUBPROJECTS</u> .....	44
Bangladesh .....	44
Cameroon .....	45
Colombia .....	46
Cote d'Ivoire .....	47
Kenya .....	48
Republic of Korea .....	49
Mexico .....	50
Morocco .....	51
Philippines .....	51

## I. INTRODUCTION

In 1975, the World Bank made a conscious decision to increase lending to small enterprises based on the belief that the sector had benefitted little from previous lending to assist industrial development. Early studies show that in the absence of special SME <sup>1/</sup> programs to provide financial, technical and managerial assistance small enterprises often were barred adequate access to institutional finance. Discussions in the World Bank during the 1975-77 period focused on how the World Bank could help SMEs. These culminated in February 1978 with the publication of a policy paper entitled "Employment and Development of Small Enterprises", which laid down the formal basis for World Bank lending to small enterprises. The paper, arguing in favor of special SSE lending projects, points out that between 1972 and 1976 the World Bank lent US\$2.2 billion to development finance companies (DFCs) for onlending to industrial enterprises. Only US\$100 million of the total amount was specifically directed to small enterprises. During the same period US\$3.1 billion was lent directly by the World Bank for large scale mining and industrial projects.

Although little specific effort was made to direct World Bank lending to smaller enterprises prior to 1975, some of the finance made available through the DFCs did in fact reach the sector. A large sample of beneficiaries of World Bank associated DFCs - approximately 5,000 enterprises - revealed that 50% of these had fixed assets of less than US\$300,000 after project completion and about 30% of them less than US\$100,000. Thus the DFCs being supported by the World Bank did have a significant number of small borrowers in their loan portfolios.

Following the new initiative, from July 1977 through June 1984, the World Bank lent US\$1.97 billion in 63 projects to support small and medium enterprises in 35 countries. During this period several countries received more than one loan - the Republic of Korea, 4; the Philippines, Indonesia, Mexico, and Colombia, 3 each; and Bangladesh, Cameroon, Morocco, Pakistan, Portugal, Ecuador and Indonesia, 2 each. In the fiscal year 1984 lending to SME reached 28.9% of all lending for industry through financial intermediaries.

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<sup>1/</sup> The term SME (small and medium enterprises) is used throughout the report whenever this is applicable as a description of the target group. It is used rather than SMI (small and medium industries) as the majority of Bank projects financed more than manufacturing industries. SSE (small scale enterprises) is used when the target group was referred to as such in a particular project or document. Although some earlier projects referred to SSE, several (The Republic of Korea, the Philippines, Mexico, Colombia, Cameroon) clearly designated the target group as SME.

In practical terms, greater concentration on lending to SME meant the transfer of more resources to intermediaries who were willing and able to onlend these funds to small enterprises. It also involved the establishment or strengthening of institutions able to promote small enterprises and deliver financial, technical and managerial assistance. Typically these projects provided term lending for small and possibly medium scale enterprises. Since there was general agreement that financial assistance alone was inadequate to effect the growth of the SME sector, part of the World Bank's help was directed to establishing or improving technical assistance facilities. In this way assistance would be given to entrepreneurs in the preparation of new small enterprise projects, and the expansion and improvement of existing firms and their operations. The early SME lending projects were regarded as pilot projects, and they were expected to teach the World Bank more about the policies, institutional arrangements, and types of assistance and services that the sector needed and which could be effective in promoting its development.

How effective have these lending programs been? Three aspects of this question are considered in this review:

- (i) Objectives: In light of the experience accrued on lending to small enterprises, it may be timely to re-examine the appropriateness of the objectives set for SSE lending programs.
- (ii) Impact: How well have the programs worked when measured against their stated objectives and the intended economic and social impact?
- (iii) Design: Considering past experience, were the projects designed in the most effective fashion?

Section IV of this review summarizes the issues and Section V contains some conclusions as regards future SME projects.

The review is based on a study of 10 completed small scale industry projects, in Bangladesh, Cameroon, Colombia, Jamaica, Kenya, Mexico, Morocco, the Philipines, Portugal and Sri Lanka. The review draws on project completion reports, supervision reports, and specific studies of the projects. In addition occasional reference is made to SME projects financed by the World Bank in other countries. Finally an annex is appended giving some performance data on the subprojects financed in Bangladesh, Cameroon, Colombia, Cote d'Ivoire, Kenya, Korea, Mexico, Morocco, and the Philippines.

## II. THE OBJECTIVES FOR WORLD BANK ASSISTANCE TO SME

When the SME lending programs were initiated, small enterprises in less developed countries were considered to have certain desirable traits, apart from size, that distinguished them from larger enterprises and made them particularly suited for the attainment of certain economic and social objectives.

### The Basis for the Program's Objectives

The following are the most commonly stated objectives of assistance programs and the characteristics small enterprises possess to support them:

Employment: The primary objective of most SME assistance programs was job creation. This was considered vital in view of the growing urban populations and the poverty created by the dearth of employment opportunities. It was accepted that small enterprises typically provide more jobs per unit of investment than larger ones. Aggregate data do show that decreasing firm size is associated with increasing numbers of workers relative to capital invested. Thus directing lending to small enterprises would be more effective in creating employment from limited capital inputs.

However, it is also clear that there are significant differences in labor intensity between industries and countries. Hence focusing lending on certain industries might have been a more effective method of job creation than lending according to firm size. It is also evident that the gradual introduction of machinery into very small enterprises (with artisanal forms of production) results in a higher degree of labor intensity than starting new enterprises by providing them with equipment from the outset.

Entrepreneurship: As entrepreneurial talent is scarce in the developing world, it was hoped that small enterprises could effectively develop the limited entrepreneurship available. Small enterprises are typically run by their owners who tend to be former skilled workers or merchant traders. These entrepreneurs, when they develop from skilled workers tend to be proficient in the manufacturing process but weak in management and marketing. In small enterprises started by merchants, the marketing and financial management of the firm may be more effective, but the operational efficiency of the production process may be deficient.

Industrial Dispersal: Urban concentration in developing countries is a major socioeconomic problem. Since small enterprises need less social and physical infrastructure, it was hoped that SSE's would lead to a greater decentralization of industry. But there are differences in the degree to which small enterprises depend on such infrastructural factors as power and water supplies, repair services, transport facilities and warehousing. Only the smaller establishments are able to adapt easily to different locations. Hence the geographical dispersal of industry is an objective that would tend to work more for the smaller enterprises. Those where proximity to market is an important factor tend to locate around urban centers.

Exports: Foreign exchange is scarce in many developing countries. It was believed that small enterprises could develop with limited need for foreign exchange as they produce primarily for the domestic market and generally make only limited contributions to exports. However, experience does show that some small enterprises are more able to produce products for export than might have been considered. Also, small industries are often able to use local materials for products sold on the domestic market but in order to produce the quality of goods acceptable in export markets, they may need imported materials.

Additionality: Since small enterprises, in their first years, were seen to depend to a great extent on the personal savings of their owners and families for financing, it was hoped that promoting these enterprises would help mobilize more of such resources. Evidence confirms this feature. The resources invested by small scale entrepreneurs tend to come from agriculture, trading, and wages in manufacturing. There is only limited recourse to institutional lending. Thus through the creation of credit lines for SME it was considered that the World Bank's lending would both complement and help mobilize personal and family savings.

Technology Adaptation: Small enterprises were also seen to be more likely than large firms to use relatively simple, general-purpose equipment, better adapted to local conditions. Hence the provision of such appropriate technologies was an objective of most SME lending programs. The use of less sophisticated and more appropriate technologies by small enterprises is evident in their concentration in labor intensive manufacturing activities. There is, however, a distinct limitation in the role of small firms in the transfer and adaptation of certain types of foreign technologies.

Utilization of Local Resources: In many developing countries, large scale processing and production is not feasible in certain fields. Supplies of domestic raw materials may be too limited for large scale processing but may be sufficient for small scale operations. Leather tanning, food processing, sawmilling, woodworking, ceramics and quarrying are examples where, in many cases, only small scale processing with the locally available materials is possible. In this way small industries can contribute not only to direct employment creation, but also in indirect job-creation in the development of indigenous materials.

Linkages: As industrial development proceeds in most countries, a symbiotic relationship develops between large and small scale industries. These industries link together as each supplies the other with inputs. Large aluminium smelters, steel plants or cotton spinning mills may provide small industries with raw materials for further processing. In turn, a balanced economy requires that large firms buy items, components and services from smaller firms, integrating these inputs into their production lines through subcontracting. A healthy small industry sector with specialized capabilities and cost effective production for component markets is indispensable for the development of many larger industries. Thus assistance to SSEs ultimately helps not only that sector but the whole process of industrial development, including large industries.

## The Argument for Intervention

Small firms may be labor intensive for lack of access to institutional finance. Providing them with that access may, therefore, only serve to make them capital intensive. In this way assistance programs may change the characteristics of small firms. Thus an analysis of the conditions under which small enterprises operate can help determine the most effective form of intervention. In the case of small enterprises, there are three sets of underlying conditions that would justify some form of intervention.

Factor Price Distortions: The prices of labor, capital and foreign exchange are distorted in many developing countries. These distortions are caused by such policies as interest rate ceilings, investment incentives, public sector lending, trade barriers, an overvalued currency and minimum wages. These policies tend to make capital and foreign exchange cheap relative to labor, for certain manufacturing firms. These firms may then respond by becoming capital intensive, import dependent and larger. For those firms that are less able to benefit from the policy distortions the costs of capital and foreign exchange remain relatively high if not prohibitive. In these cases most small firms remain labor intensive and small. Under these circumstances special lending programs for SMEs can be viewed as attempts to redress this imbalance, although experience has shown that it is usually better to correct these policy distortions directly and that financial market interventions are likely to have only a limited impact on real sector distortions.

It is clear that such SME lending programs can reach only a limited number of small enterprises. Given that many enterprises will be left out, it is a question whether these programs are really compensating for the price distortions. These programs generally offer funds at somewhat better terms than otherwise available to small firms. If policies could be reformed to remove the existing distortions, SSEs might have less need for special lending programs.

Market Failure: In the absence of price distortions, the incubation of entrepreneurs is arguably the most important function of small firms. However, the market, if left to itself, cannot be expected to supply entrepreneurs in the numbers warranted by their real contributions. This is because there are social gains from entrepreneurial activity for which the individual entrepreneur is not rewarded. Competition often erodes the profits from innovation quite rapidly but society benefits from the cost reductions and the new products. Whether the entrepreneur succeeds or fails, his experience provides valuable information to the economy about what works and what does not. He cannot charge the economy for this information, yet he bears the risk of failure and this risk is a deterrent to his making the investment. Since entrepreneurship is underrewarded relative to the benefits it provides society, there is a case for subsidizing it. Otherwise, there will be too few entrepreneurs for the needs of economic development.

Lending programs for SMEs can, in this case, be seen as a way to correct market failure by helping small firms in the development of indigenous entrepreneurs. However, there may be a danger of developing the

wrong kind of entrepreneur. The need is for individuals who know how to organize economic activity and choose between investment risks, not for people who are merely skilled at obtaining special privileges from the government. Hence it is important to design programs so that the assistance they get does not shield them from the discipline of the market.

Inequity: Income inequality is a striking problem in many developing countries. In part, this problem may be attributable to the price distortions already mentioned, in which the rich benefit at the expense of the poor. However, it is possible that even after price distortions and market failures are alleviated to some degree, the outcome would still be a distribution of income so skewed that some rectification would be necessary for social reasons. In this case, the lending programs for SSEs can be seen as schemes to reduce income disparities.

There are other transfer mechanisms, such as taxation and welfare programs, that may be more effective in reducing income inequities. The owners of small firms are usually among the better off in the general population. It is true that these small firms generally employ more unskilled workers per unit of investment, they may also produce consumer items for the poorer sections of the population than do the larger firms. But this pattern of employment may be accentuated by existing price distortions. Larger firms, for example, may hire highly skilled workers because they are able to operate the more sophisticated equipment these firms acquire by means of their access to low-cost funds. If these distortions are reduced, then there will be less need to assist small firms in order to offset the tendencies of larger firms to adopt overly capital intensive methods.



### III. ECONOMIC AND SOCIAL IMPACT

#### Employment Creation

There seems little doubt that small scale industry has generally been able to generate jobs at a lower investment cost than larger industrial projects in the same country, but it would be incorrect to say that in all cases these jobs are created at the lowest possible cost.<sup>2/</sup> For instance, the investment cost per job of certain small enterprises in West Africa is two or three times higher than that in some Asian countries for the same activities. Several World Bank SSE loans have resulted in higher costs per job than originally projected by the Bank's appraisals. However, in most cases these costs have been less than half of the average cost per direct job for industry as a whole in that country. It is also worth noting that most conventional DFC projects financed by the World Bank in the 1975-82 period are considered to have a cost per job of around US\$20,000 - US\$25,000 which is much higher than the average cost per job in the SSE projects.<sup>3/</sup> Table 1, taken from data on five projects, gives an idea of the considerable variations in job costs between SMI projects and industry in general within each country and between the various countries.

As might be expected, there is a higher average cost per job in more complex economies, such as Colombia and Portugal. The higher level of education and skills, and the need to be competitive has led to investment in modern, more complex machinery and technologies. But there are surprises in countries such as Cameroon and Kenya,<sup>4/</sup> where labor costs must be considered quite low. Cost per job in these countries are higher than might have been expected. One explanation is that the low skill level in these countries encourages entrepreneurs and industrialists to invest in automatic machinery, rather than relying on available skills or investing in training. Perhaps managers in these countries feel that "it is easier to manage machines than men" and that where only a very unskilled, uneducated labor force is available, and management skills are scarce, it is better to rely on more automatic machinery that can be maintained by one or two skilled mechanics. Economies such as Sri Lanka, the Philippines, India and Pakistan, with a relatively well-educated labor force have tended

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<sup>2/</sup> "Economic Issues of Small Enterprise Development in Africa," Industry Department, World Bank, March 1984.

<sup>3/</sup> A report by the World Bank Operations Evaluation Department (OED), which reviewed 47 projects assisting DFCs in 1970-80 found that the five SSE projects among them created jobs at an investment cost (US\$6,400), approximately one third of the average for jobs created in all the projects (US\$20,000).

<sup>4/</sup> The subprojects financed in the Kenya (KIE) project were made up of a small number (about 12%) of relatively large investments (above KSh1 million, i.e., US\$60,000 to US\$130,000) where the investments costs per job were relatively high - over US\$10,000 - and a large number of much smaller subprojects - mostly below US\$30,000 - where the job cost was in the range US\$1,500 to US\$3,000. This resulted in an average job cost of US\$3,600 as measured in 109 IDA financed projects evaluated.

to have lower investment costs per job. In these cases, a reasonably educated and skilled labor force is available at low cost due to the general low wage levels, and so there seems to be less motivation for entrepreneurs to replace workers by machinery.

Table 1

JOB COSTS (in US\$)

Country	Average Cost per Job in SME Project	Average Cost per Job for Industry in General
Cameroon	14,000	20,000
Kenya	3,600	20,000
Jamaica	16,700	37,000 (1970-75)
Morocco	4,900 - 5,000	60,000 (subprojects of BNDE)
		30,000 in industry in general
Mexico	6,000 (FOGAIN survey)	10,000 (based on figures of 1970 census)

Source: World Bank data.

The variation in the degree of labor intensity in the same sub-sectors, from country to country, is not easy to explain. In Mexico, for example, the food and beverages subsector had a much higher cost per job in comparison with the same sector in Colombia, the Philippines and Portugal. The non-metal, mineral products subsector generated jobs at low cost in Mexico and the Philippines, but had one of the highest costs in Colombia. Some of these differences were undoubtedly due to the different goods and items being produced in these heterogeneous industrial categories, but they may also be the outcome of specific economic and social characteristics of the communities involved.

A sample of borrowers surveyed in Colombia showed that firms with assets of less than US\$300,000 had investment costs per job of approximately US\$13,000 but this rose considerably for larger firms. Small enterprises in Mexico, that is, those with assets less than the equivalent of US\$300,000, generated twice as many jobs for the amount invested as the medium sized enterprises with up to US\$2 million investment. In lending by the Development Bank of the Philippines (DBP) actual investment costs per job were 5 to 6 times as high for larger DBP loans as for the smaller ones.<sup>5/</sup> In 1978-80 fewer new jobs were created in Portugal and Jamaica through World Bank assisted SSE projects primarily because projects were designed to reduce labor costs, save existing jobs and improve the

5/ It should be noted that the ratio was over 2.5 to 1 when subloans were made to both large and small firms from the same Bank loan to DBP. However the investment cost per job was substantially lower in the DBP loan for small enterprises only averaging about one sixth (Ps 36,000 against Ps 253,000) of the large enterprise subloans.

competitiveness of enterprises so that they could export more. There were even cases in Mexico, Korea and Portugal where subprojects resulted in the elimination of jobs.

In general, subprojects involved in the establishment of new enterprises created more jobs for a given investment than did those involving modernization, restructuring or expansion. Most of the figures given on the employment generation in the SSE projects refer only to direct employment generated in the enterprise assisted. These figures omit account of any indirectly generated employment, whether upstream or downstream through forward or backward linkages. It is very difficult to quantify precisely the additional indirect employment created by a subproject, but in a sample of subprojects in Colombia, it was estimated that such jobs accounted for 48% of the direct employment generated.

Despite the difficulty in quantifying the amount of indirect employment generated it would be wrong to ignore its existence. Industries which process raw materials - for example wood, cork, leather, food manufacture or agro-processing - are likely to generate jobs indirectly in agriculture, forestry, animal husbandry, and fishing. An interesting example, from Portugal, is provided by the marble industry, where a number of relatively small subprojects were financed by the World Bank. This was a fast growing export industry where highly mechanized processing generated jobs in labor intensive quarrying and transport. At first sight, it appeared that subloans to marble enterprises were only creating direct jobs at close to US\$20,000 each but when taking into account the indirect jobs the figure was actually well below half this level. Bakeries, a significant number of subborrowers in African countries (Cote d'Ivoire, Cameroon, Kenya) and Bangladesh, created employment for at least as many transport drivers and delivery men as bakery employees. Taking account of indirect job creation would quickly lead to recognition of the need to give more priority to subprojects based on local resources.

In most cases, the actual number and cost per job created differed from the estimates in project appraisals. In Sri Lanka 17,000 jobs were created at a cost of less than US\$1,000 each. Even though this is fewer jobs than projected at appraisal, the project stands out as the most successful in creating employment.

Figures on jobs created refer mostly to projections from subloan applications and only in a few cases were these later verified in sample surveys. The DBP reported 31% more employment at about 15% lower cost in practice than projected in the subloan applications. In a sample studied in Mexico the number of actual jobs created fell short of projections but their cost was lower than in the subloan appraisals.

In Morocco the 214 subprojects financed generated 8,500 direct jobs - according to the subloan applications - at an average cost of around US\$5,000 each. The very small subprojects (those with assets below US\$100,000) created jobs at around US\$4,000 each, while the direct jobs generated by the larger subprojects (with assets of over US\$500,000) cost slightly over US\$6,000 on average. The figure of 8,500 new jobs was substantially higher than the 5,000 estimated when the Moroccan project was appraised.

### Entrepreneurial Development

One of the aims of World Bank lending to SSEs was that an expanded SSE sector would provide opportunities for skilled workers, traders and farmers to establish manufacturing enterprises. The growth of entrepreneurship is considered essential for broad based industrialization. However, analysis shows that less than 10% of the subprojects in Colombia, Mexico and the IGLF <sup>6/</sup> component of the Philippine loan, involved new enterprise development. In contrast, more than 50% of the subprojects in Bangladesh, Cameroon, Kenya, Morocco and the DBP component of the Philippine loan, involved the establishment of new enterprises. Distinction should be made, however, between "new enterprises" and "new (first time) entrepreneurs." Some reports and studies on Colombia, Kenya, Jamaica, Bangladesh and the Philippines show that many owners of the new enterprises established were in business (usually commercial) before and some even owned other manufacturing firms. Other entrepreneurs generally came from trading, farming, artisanship and government service.

In Bangladesh and Morocco there was a dominance of former merchants among the new entrepreneurs. In contrast, half of the small number of successful SME projects in Cameroon were started by artisans. Some entrepreneurs were formerly public servants or politicians in Kenya and Cameroon. University graduates were generally absent from among the entrepreneurial group except in a few cases in the Philippines.

In a number of projects, management training programs were carried out to improve the quality of entrepreneurship. Although these programs were helpful in raising standards of management, there is no evidence to show that these cases included persons not yet in business who later developed into entrepreneurs and became recipients of World Bank SSE lending. Very few World Bank subloans seem to have gone to skilled workers who left their jobs to start new businesses and only a few (Cameroon mainly) to active artisans who were upgrading their activities into small enterprises. This may be explained by the fact that most financial institutions demanded collateral and such persons were not able to meet the requirements in this respect.

It must be recognized that if programs were to be aimed at creating industrial entrepreneurs out of farmers, skilled workers, recent university graduates and artisans, with little business experience, there would be a higher level of arrears and defaults. There is inevitably some contradiction between concern for a good subloan portfolio and the objective of entrepreneurial development, as well as a contradiction between keeping interest rates low and covering the lending institution's risks.

### Geographical Distribution

Evidence from World Bank lending to SSE projects seems to show that merely directing credit to subprojects outside the metropolitan centers is not sufficient to ensure industrial decentralization.

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6/ Industrial Guarantee and Loan Fund.

One of the countries where decentralization policies did have some success is Mexico. This is reflected in the geographical distribution of the beneficiaries of the World Bank's SSE loan. Undoubtedly decentralization is a burning issue of industrial development in Mexico where moving industry away from Mexico City, Guadalajara and Monterrey is a paramount objective of industrial policy. However, in Morocco, where there is a heavy concentration of industry in the Casablanca area, the World Bank loan was far less successful in directing subprojects away from the overcrowded region. The explanation of this may lie in fewer measures taken in Morocco, both positive and negative, to encourage decentralization. It should be pointed out that in Mexico, in addition to the incentives, some costs such as land, water, transport delays, etc., have risen considerably in the highly congested metropolitan centers thus making the smaller town location relatively more attractive.

There is a tendency for larger subprojects to be located in or near the major urban centers. Hence, the lower the average subloan size the wider the geographical distribution of the beneficiaries will be. This was shown quite clearly in the successful wide scale distribution of beneficiaries in Sri Lanka and in the rural part of the KIE loan in Kenya, where the average subloan size was low - less than US\$ 20,000.

Achieving geographical distribution is helped by an appropriate organizational structure of intermediaries and institutions. Where commercial banks with wide branch networks were used, as in Mexico and Sri Lanka, greater success was achieved in distributing the loan to subborrowers in the different parts of the country. In Colombia, between the first and second projects, the intermediary bank strengthened its regional branch network resulting in a significant decentralization of subprojects assisted from the World Bank's funds.

The subsectoral distribution of subprojects also influences the degree of decentralization. As seen in several cases the number of small agro-processing units such as rice mills, saw mills, canneries, etc.; service firms such as bakeries and repair shops; or enterprises based on local raw materials such as brick making, stone crushing, ceramics or marble, all increase the likelihood of a wider dispersion of subprojects. This is especially true when these materials are located in more rural districts.

SSEs tend to be started by entrepreneurs who come from the locality. The limited generation of SSE projects in less populated or less developed areas reflected a lack of promotional effort and government support. There is also a shortage of skills and groups where one might expect to find entrepreneurial initiative. Unless efforts are made to decentralize government, banking and technical institutions, there will always be a serious handicap to wider geographical distribution of industries and SSEs.

#### Impact on Foreign Exchange

Small scale enterprises produce primarily for domestic markets. Most export incentives are aimed at large exporters and seldom do

government policies address problems specific to exporting by small enterprises.

In the earlier World Bank projects, owing to the belief that SSEs contribute little to exporting, the subject was rarely mentioned. In fact, among the early World Bank SSE projects the aim of assisting these enterprises to become export oriented was explicitly mentioned in only Colombia and Portugal. In the case of Portugal 50% of the credit line was expected to go to exporting enterprises, that is, those that exported at least 20% of their output. The Colombian project merely mentioned that 10% of the subprojects would be for SSEs that exported.

The degree of success in getting SSEs to increase exports varied with the general economic situation and the export incentives offered. In Portugal, where manufacturing accounts for 70% of exports, many of the firms assisted belonged to subsectors in which most output was exported - garments, footwear, marble, etc. One out of five registered SSEs in Portugal qualifies as an exporter and, consequently, it was reasonable to expect that a large portion of the loan amount would go to SSEs that exported. In actual fact, the results of the first Portugal SMI project showed that 34.8% (32% of the subprojects) and 36.4% (33.9% of the subprojects) was lent to small enterprises exporting at least 50% and 20% of their respective output. In all, 71.2% of the amount (65.9% of the projects) went to firms exporting more than 20% of their output. This can be considered an achievement in supporting the export orientation of Portuguese small enterprises.

In contrast, in Colombia only 4% of the subprojects, which received 6.7% of the loan, were exporters. The explanation is found in the poor performance of the entire Colombian manufacturing industry in the export field. A number of factors, including an overvalued currency and a highly protected domestic market, worked strongly against the development of manufacturing exports, from both small and large producers, in Colombia.

In the Philippines in a survey of 45 IGLF assisted firms 18 actually had exported some of their production - a higher number than those expressing an intention to export when the subloans were appraised.

The other country studied <sup>7/</sup> where a significant number of assisted SMEs subborrowers were exporters was Morocco. It was estimated that in some cases, as indicated by a sample survey, as much as 70% of the sales resulting from some subprojects in the first Moroccan SMI project were exported. A later estimate, after project completion, was that at least 20% of the beneficiaries were exporters and the export share of their production ranged from 30 to 55%. In recent years the export competitiveness of small scale manufacturing is evidenced in estimations

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<sup>7/</sup> This refers to the 10 World Bank SSE projects studied. It should be noted that over 30% of beneficiaries of World Bank assisted SME in Korea were exporters, reflecting the general contribution of SME to exports in that country and the export orientation of economic policies.

that SMEs exported 30% of their total production, as compared to 10% for Moroccan industry as a whole. Significantly increasing exports from SME was not included as a specific objective in the Morocco project when it was designed.

Clearly the World Bank subloans were only a small factor in encouraging SSEs to export. Appropriate government policies and incentives as well as competitiveness and product acceptability were far more important. None of the projects, even those that had the objective of increasing SSE exports, provided any export credits or made any special efforts to address the problems that prevent SSEs from expanding exports. Since 1981 a number of export promotion projects have been developed by the Bank, but these have had little relation to support programs for SSEs.

Another objective of SSE projects was to increase the value added by encouraging the use of local resources. The second SSE project in Bangladesh, for instance, required that all subprojects should use at least 60% local raw materials and most of the subprojects assisted met this target. However in other cases, such as Jamaica, it was recognized that the SSE would be dependent on imported raw materials and foreign exchange was made available for these imports. In Sri Lanka, Jamaica, Kenya and Cameroon, a large part of the small enterprises helped were dependent on imported raw materials. In all these projects this dependence caused problems for subborrowers, in most cases because they lacked access to the foreign exchange rationing process. Here government policies tended to discriminate against SSE.

#### Additionality

Mobilization of personal and family savings has always been one of the objectives of SSE lending. Thus it may be asked whether the finance made available by the World Bank through its SME lending projects represented a net increase in resources for the SME sector or if it merely replaced what was already available from other sources. The issue is complex since there are various ways in which the question may be considered. If small scale entrepreneurs who would otherwise have used their own funds for investment now divert these to non-productive expenditures because of their newly found access to finance then, clearly, there has been no "additionality". This also applies if Bank funding replaces commercial banks' own resources or suppliers' credits.

Two factors particularly complicate the consideration of this problem. These are:

- (1) It is well known and documented that when lending is highly subsidized (as in Mexico, particularly in 1979-81), there is a tendency for the misdirection of funds and some diversion of entrepreneurial resources to less productive purposes, resulting in less "additionality". Several SSE projects in Jamaica, Kenya, and Indonesia also had this situation to a greater or lesser degree.

- (ii) In several countries (e.g., Portugal, Morocco, etc.), there were severe credit restrictions. The question of "additionality" is therefore bound up with permission for banks - given in both cases - to use the World Bank loan outside the credit ceilings.

Nevertheless, there is limited evidence that there was some "additionality" in most cases. Data derived from a sample study of subprojects from the second Colombia project showed that while the World Bank loan accounted for over 80% of CFP lending to SSE over a certain period the institution contributed on average only 47% of subproject cost, with 15% coming from other financial institutions and 38% from the entrepreneurs' own resources. Thus, it may be argued that the availability of the World Bank funds generated additional investments from institutions and entrepreneurs themselves.

Other estimates show that subproject costs of 40% in Mexico and over 50% in Sri Lanka were financed by the entrepreneurs themselves. In poorer countries, Bangladesh, Kenya and Cameroon, there is strong evidence that without the World Bank credits the subprojects, mostly for new enterprises, would not have been implemented as there were no other resources to carry through the investments. However, there are some cases, such as in Kenya (KIE), where subsequent experience suggests that some of the subprojects were of doubtful viability with questionable technical and managerial capacity. Thus it might be argued that resources would have been saved if the subprojects had not been financed.

Even though available evidence seems to suggest that there was some "additionality" and that World Bank funds did help to create SSE investments which would not have taken place if this funding were not available, it is also true that in some projects too little finance was mobilized by the promoters of projects, local institutions, or commercial banks (Morocco, Philippines). In particular, there is little evidence that there was a significant increase in the amounts of long-term lending to SSE from the intermediaries' own resources. When special, SSE oriented institutions made the loans, they typically have used only funds from international organizations and the government. The sums lent through the commercial banks have largely been limited to those that are eligible for rediscounting schemes, which were usually set at 80-100% of the subloan amount. Of course, the commercial banks may have made short-term loans to the subborrowers for working capital, probably finding this form of lending more profitable than long-term loans for fixed assets. Thus, there remains the challenge of designing SME projects that attract more domestically mobilized resources.



## Technology Transfer

The machinery bought with World Bank subloans was mostly imported, the exceptions being a few cases in Portugal and Mexico.<sup>8/</sup> Foreign equipment manufacturers appear to have been active in the provision of training, assistance and with machinery installation in Cameroon, Kenya, and Morocco. Some local adaptation of imported machinery was evident in Cameroon, Sri Lanka and Mexico.

Only in the Colombian projects was a special fund set up for assistance in equipment selection and choice of technology. In the end, after delays in disbursement, this fund was used primarily to pay consultants for subproject preparation.

According to a World Bank study on Colombian SMEs <sup>9/</sup>, which examined the issue of appropriate technology for small firms, economic performance and technical efficiency were highest for firms using intermediate technology rather than technologies that could be categorized as simple or sophisticated. The use of sophisticated technology in very small firms, or simple technology in larger firms, resulted in less than optimum technical efficiency.

The Colombian study also shows that second-hand machinery accounted for approximately one-quarter of all equipment used in the SMEs surveyed. It might be expected that the proportion of used machinery in World Bank-funded projects would be much lower, because commercial banks are generally reluctant to finance the acquisition of used machines as they are difficult to value and assess. Banks in the Philippines, however, were apparently willing to lend for second-hand equipment and at least one subproject in the Kenyan sample used equipment from an old plant in Norway. Although a clear policy has never been formulated, the World Bank has generally displayed a reluctance to finance second-hand equipment.

In view of the widespread purchase by SME of such machinery clearer guidelines by the World Bank on this matter are desirable. In Chile, for instance, many SMEs are interested and in a position to buy used equipment in large quantities due to the bankruptcies of numerous firms of all sizes in that country in recent years. The cost of such used equipment is considerably lower than that of the new, imported versions of the same machines. In some countries the used equipment available is technologically more suitable to the needs of SME than the more modern, sophisticated

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<sup>8/</sup> In other countries where the World Bank has SSE projects the use of local equipment is becoming more general, particularly in Korea and Pakistan. The Bank is now willing for its funds to be used for purchase of local equipment, being prepared to cover the estimate of indirect imported inputs - usually around 60%. In other countries, e.g., Korea, the governments prefer to have the loans used only for foreign equipment.

<sup>9/</sup> M. Cortes, A. Berry and A. Ishaq, "What Makes for Success in Small and Medium Scale Industries: The Evidence from Colombia." DED, Washington, D.C., World Bank (forthcoming).

and newer versions. It is clear that the financing of used equipment raises several problems. Among these are how to assess the real value and ensure that the equipment has been satisfactorily maintained. Despite these problems, finding suitable arrangements and permitting World Bank funds to be used for the purchase of such equipment is a necessary step in recognizing the reality of SME needs.

There were some indications that rigid adherence to cost-per-job limits may have forced some irrational technology decisions. There was one case in Kenya where the technology chosen to keep capital costs per job low saddled an aluminum processing plant with production costs which were 25% higher than necessary. This occurred mainly because raw material wastage was high in comparison with the best alternative equipment available. Financial institutions in Morocco and Bangladesh complained that cost-per-job limits were hard to attain if the technologies which entrepreneurs considered most suitable to obtain the maximum output for the capital invested were used.

More technical assistance is needed if better choices of technology are to be made. In most countries the institutions involved lacked the capability to develop the technical assistance needed to improve decisions on equipment selection. In many cases advice on equipment to be procured still comes from the agents of machinery manufacturers or importers, as evidenced in the case of Morocco. The criterion in loan agreements of low investment costs per job, without consideration of technological options, subsectoral differences and technical assistance needed in the decision, may result in loss of efficiency. Where investment costs per job are set in the interest of promoting greater labor intensity they should be set more in relation to the technological needs of different subsectors and applied with some flexibility.

### Subcontracting

Most World Bank projects included no special measures to stimulate forward and backward linkages, even though most appraisal reports mentioned the need to promote subcontracting. The importance of assisting the development of subcontracting was recognized in two projects, Bangladesh and Sri Lanka, by the inclusion of components to assist in establishing subcontracting exchanges. In these centers, information on the expertise and availability of potential small subcontractors was collected and matched with the demand of larger firms for such facilities. It was hoped that after such contacts were established, subcontracting links would develop. It was also thought that these exchanges or some other technical assistance institution could assist the subcontracting relationship by providing advice on production problems, quality and delivery schedules.

Neither Bangladesh nor Sri Lanka implemented this component of the project within the period of time taken to commit the credit part of the loan. In 1982-83 some Indian experts visited the countries to assist in setting up the exchanges and efforts continued in subsequent loans to establish and operate these subcontracting centers. In Bangladesh a subcontracting exchange did start operations in a limited way in 1985.

A study is to be financed in a recent Korea SME loan to identify the impediments to an increased volume of subcontracting. Another project planned in Turkey will also attempt to increase the flow of information between firms with a view to expanding subcontracting links.

Outside the direct assistance of World Bank loans, efforts to set up subcontracting exchanges were also made by industrial institutions in Mexico (Guadalajara, Pueblo, Monterey, Queretero, etc.) and the Philippines (Manila). Few examples of successful subcontracting exchanges can be cited thus far, except possibly in Europe (France, Spain) and India.

### Sustainability of Lending Schemes

Although as stated, in several countries (Colombia, Philippines, Mexico, Korea, etc.) the World Bank has approved three or more loans over a ten year period, there is little evidence that any of the beneficiary institutions are making substantial progress towards the stage of reducing dependence on external sources to finance SME lending programs. Some countries and institutions are obtaining credits for SME from other donor agencies (regional development banks - ADB, AFDB, IDB, OPEC funds, USAID, KFW-Germany, Caisse Centrale-France, and other bilateral agencies) as well as domestic funding from governments. However, most SSE lending programs to which the World Bank has provided funding are far from being able to sustain an acceptable level of lending from the incomes received from repayments, much less expand programs to meet increased demand, owing to repayment problems and erosion of funds due to subsidized interest rates and inflationary pressures. This also applies to programs rediscounting lending to SME through commercial banks. These banks have been reluctant to increase lending to the sector out of their own funds, so that the rediscounting programs, dependent on external sources, are necessary to maintain and expand SME lending. To achieve greater sustainability it may be necessary to consider subsidies to the commercial banks that are related to the amount of their own resources lent to SSE.

There is a case in repeater projects - second, third and subsequent loans through the same financial institutions - to press to increase the participation of the lending institution with its own funds in financing each subloan. More long-term programming is needed to achieve a greater degree of self financing of SME lending schemes with progressively less recourse to external funds from donors such as the Bank.

The degree of financial dependence of some institutions on the World Bank as a continuous source of funds (such as CFP in Colombia, DIB in Egypt) should be a cause for concern.

#### IV. ISSUES IN PROGRAM DESIGN

##### The Policy Framework

The special policy measures adopted by governments to assist SMEs usually consist of making available credit, technical assistance and training.<sup>10/</sup> Apart from special "affirmative" programs or measures, SMEs are also affected by general government policies in the areas of taxation, trade and labor. Most of the earlier World Bank projects were aimed at directing resources to SME through intermediary institutions, to counteract perceived distortions in financial markets. It also was realized that finance alone could not provide the support needed for the appropriate development of SMEs and so efforts were made to locate and strengthen institutions that would provide training and technical assistance.

As experience developed in the early projects it became increasingly evident that the policy environment often represented an important constraint to the development prospects of small enterprises. Small enterprises operating in an inimical policy environment encountered difficulties in competing successfully and in coping with a bureaucratic, governmental framework, even if provided finance and technical assistance. As a result, the World Bank became more concerned with the impact of the policy framework. These policy concerns became more important in the second and third wave of World Bank SME projects.

Four types of policies are of particular concern - those governing foreign trade, those encouraging investment, the regulatory environment, and credit policies.

##### Foreign Trade

In practice, most government policies in the area of export subsidies, import control and licensing procedures tend to discriminate against SMEs. In some cases SMEs are explicitly excluded, but more often the procedures involved are too onerous for the SMEs or favor the larger firms.

##### Investment

Investment codes in some developing countries discriminate openly against SMEs (in Francophone Africa for instance) by limiting the size of firms that can benefit from investment privileges. Tax and regulatory exemptions are of minimum value in many countries as SMEs operate outside the tax and regulatory framework.

Investment incentives, such as relief from taxes on capital equipment and duties, and favorable depreciation treatment (often against the background of an overvalued currency), are measures that can work

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<sup>10/</sup> In a few countries, e.g., India, legal measures are taken to reserve certain items exclusively for small scale manufacture and constrain large industry development (see page 39). Thus far, such measures have not been enacted in the countries where the Bank has given loans for SSEs.

against SME and encourage overly capital intensive investment. Labor legislation has been mentioned as a burden on SMEs but it is difficult to find real evidence of this. Where there exists a regime of minimum wages, social insurance requirements, severance pay and other restrictions inhibiting the hiring and firing of labor, these are often circumvented by small enterprises. Nonetheless there are cases, as in Portugal and Jamaica, where such regulations have been the subject of complaints by small scale entrepreneurs. Subsidies for employment and restrictions on wage increases by larger firms have been mentioned favorably by SMEs, as this enables them to compete for skilled labor, but such measures may have other, less desirable economic consequences.

### Regulations

Certain measures taken by governments often involve bureaucratic requirements which are burdensome for SMEs. The various regulatory procedures involved in obtaining licenses for the acquisition and use of vehicles, electrical and telephone connections, and zoning permits are all sources of complaints by SME who charge that they usually lack the political influence to overcome bureaucratic delays. This is one reason the informal and underground economy may account for a significant portion of the gross national product in some countries, e.g., Peru.

### Credit

Where credit is controlled, the rationing process tends to give larger firms access to these resources at favorable terms. This may also be true of foreign exchange when this is in short supply. Thus, large firms may become capital intensive and import dependent while small firms encounter difficulties in financing the equipment and materials they need.

In recent loans, the World Bank has initiated discussions with governments on how to improve the general policy framework for SME. Despite the limited leverage of SME projects, the World Bank needs to take account of policy considerations and SME development in designing projects and in its general sector and policy work. While policy changes have been conditions for World Bank structural adjustment and sector loans since the 1980s, the impact of the policy environment on the SME sector needs to be given much more consideration.

## Financing Arrangements

### Choice of Intermediary

Development Finance Companies. The World Bank's early projects in support of small enterprises, such as those in Cameroon, Korea, Philippines and Colombia,<sup>11/</sup> were channelled through DFCs. Many DFC

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<sup>11/</sup> The institution used in Colombia was the Corporacion Financiera Popular (CFP), a special DFC catering only to small and medium industries. In Korea the Small and Medium Industry Bank (SMIB) was a similar specialized institution.

projects for SMEs were developed through the World Bank's initiative, encouragement or assistance. However, it soon became clear that using DFCs as the only channels for onlending to small scale enterprises had its limitations.

In general, conventional DFCs were too centralized. In some cases they had few or no branches thus making it difficult for the small scale entrepreneur, particularly those outside the metropolitan centers, to make contact.<sup>12/</sup> Secondly, DFCs made careful appraisals of complex projects to ensure their viability. In this process DFCs were accustomed to demanding and receiving extensive documentation; for this, they relied on the record keeping of clients. Such procedures were possible for large scale enterprises but were cumbersome or beyond the capacity of small enterprises.

Furthermore, DFCs generally lacked domestic resources for working capital - the major financial requirement of small enterprises. When SMEs obtained working capital from the organized financial sector it usually came from commercial banks. Small scale entrepreneurs naturally found it more convenient to seek their term loans for new investments from the same sources that provided them with working capital.

Commercial Banks. Since 1978 the World Bank has channelled a large portion of its SME lending through commercial banks. As of June 1985, commercial banks were involved in World Bank financing programs for SME in 15 countries. There are some distinct advantages in using commercial banks as intermediaries for SSE lending: (i) they have the necessary domestic resources and as such are better able to meet the need for working capital and term loans for fixed assets; (ii) they offer a greater variety of banking services; (iii) they usually have a large branch network permitting contact with small enterprises on a local basis; (iv) they are better able to respond quickly to the needs of small businesses; and (v) they are more experienced in debt collection than the DFCs. Commercial banks are attracted to lending to SMEs by their interest in acquiring new clients for their other banking activities.

On the other hand, because of their greater concern for profitability, commercial banks tend to perceive loans to SMEs as particularly risky and administratively expensive. Commercial banks are also wary of term lending, they prefer to lend on short term in keeping with their sources of funds, which are primarily from deposits. In many cases, interest rate ceilings or other financial policies hinder commercial bank lending to SMEs. These measures prevent the banks from charging rates which will compensate for higher risks, added transaction costs and longer loan maturities.

Experience has shown that commercial banks also are reluctant to invest in staff preparation and specialization which would enable them to

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<sup>12/</sup> Specialized DFCs lending only to SMEs are usually exceptions. For example, the SMIB in Korea has an extensive branch network, the CFP in Colombia has developed 18 regional offices and the Halk Bank in Turkey has hundreds of branches.

assist small business in preparing their projects properly. Commercial banks prefer to rely more on the creditworthiness of clients and on collateral than on project appraisal. Being less concerned with development aspects, commercial banks are less likely to engage in extensive supervision of clients, so long as repayment records are satisfactory.

This may be acceptable so long as there is some form of supervision, such as by the refinancing agency, to ensure that the funds are made available only to those eligible and the loans are used for the purposes for which they were approved. Until now refinancing agencies have only screened applications as regards eligibility but have not been involved in subproject supervision. Even so, there is no evidence of any widespread misuse of funds. The degree of supervision of subprojects undertaken by commercial banks will inevitably depend on the repayment situation and the spread allowed.

In general commercial banks continue to display reluctance in becoming too involved in lending to SME and too much government pressure may, in fact, prove counterproductive. Since these banks differ in character from country to country (state owned or private, foreign or locally owned, cooperative or popular, etc.) the readiness of these institutions to participate in SME lending programs also varies from country to country. There are still several countries (in Africa especially) where the World Bank still faces the challenge of overcoming the reluctance of commercial banks to participate in lending programs to SSE in any form. Various approaches will be needed including offering increased spreads for the lending institution, risk sharing or guarantee schemes where feasible, and assistance by promotional agencies in project preparation and technical assistance to subborrowers to improve operations and subloan repayment capacity.

Promotional Agencies. Prior to 1978,<sup>13/</sup> a few Bank projects were designed to use promotional institutions for lending to SME. These institutions attempt to combine, within a single agency, the tasks of promoting new small enterprises and providing the necessary technical and financial assistance for subproject implementation. Experience has shown, however, the promotional and development roles of these agencies almost inevitably become paramount and result in over-optimistic projections. In addition, promotional agencies generally suffer from poor financial management and are prone to political influence, both as regards staff appointments and loan approvals. Being dependent on continuous government budgetary injections to survive, promotional agencies become victims of abrupt government changes. In Jamaica, for example, discontinuity resulted from the sudden decision of a new government to dissolve the promotional agency in which the World Bank had invested considerable efforts. All evidence points to the conclusion that such promotional institutions face

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<sup>13/</sup> A new Bank project for \$10 million to assist in SSE development in Zimbabwe was approved in April 1985, using a newly created institution - SEDCO (Small Enterprise Development Corporation). The commercial banks were unwilling to act as intermediaries for this project.

considerable difficulties in becoming reliable financial intermediaries. Nevertheless, in certain countries (Kenya and Zimbabwe are examples) no other institutions are willing or suitable to assume the role of financial intermediaries for World Bank SSE lending and one is forced to decide between lending through a promotional or small enterprise development institution or not at all. Even in these situations all efforts should be made gradually to involve commercial banks and other financial institutions, possibly through a risk sharing or credit guarantee scheme or even, in a transitional phase, or possibly through having the banks manage the disbursement and collection of loans without taking the full risk where this is appropriate.

### Rediscounting Arrangements

The most successful arrangement in inducing commercial banks to become intermediaries is that of having an agency to rediscount the loans made by lending institutions.

In most of the earlier projects of this type, for example Philippines, Portugal and Bangladesh, the rediscounting agency was located in the central bank. Rediscounting was intended to encourage the commercial banks to make loans since they would not have to use their own funds. The rediscounting agency also supervised commercial bank lending to ensure that loans were made in keeping with the program objectives and eligibility criteria. Rediscounting programs seem to have been an attractive way for commercial banks to increase their loan portfolios without using their own resources. In economies subject to rigid credit control, such as in Portugal and Morocco, an additional attraction was undoubtedly the arrangements made for rediscounting to be outside the ceilings. Rediscounting did add to the cost of the programs as the agencies required a 1-2% fee.

In Sri Lanka, Morocco, Ecuador, Pakistan and later projects, the refinancing role was given to a publicly owned development bank instead of the central bank. Commercial banks sometimes found it unacceptable for such national development banks to monitor and supervise their lending decisions. Commercial banks in Portugal refused to take part in a program when it was suggested that a development bank assume the rediscounting role. Subsequently, the central bank performed the task with the assistance of a promotional institution. Only in Morocco did the development bank perform the role of rediscounting agency and use the funds itself in direct lending but despite early misgivings this aspect of the scheme worked well. In Mexico and Haiti, FOGAIN <sup>14/</sup> and the Industrial Development Fund, respectively, are special institutions which performed the rediscounting function. While proving costly, FOGAIN has managed to carry out this function well and commercial banks' participation has been high. Since FOGAIN is a trust fund linked to Nacional Financiera - the

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<sup>14/</sup> Fondo de Promocion y Garantia a Pequeñas y Medianas Empresas (FOGAIN) was actually set up in 1954, long before the first World Bank loan for SME in Mexico. FOGAIN, in a peculiar Mexican arrangement, is actually a trust fund of the Nacional Financiera (the National Development Bank). Although the word "guarantee" appears in its name FOGAIN has never operated a guarantee program as such.



major development finance institution in Mexico - this may be considered as a variation of using a DFC in the rediscounting role. DFC involvement as rediscounting agencies had had the added advantage in some cases of helping the commercial banks to build up subloan appraisal capability. Central banks, on the other hand, have by their very nature often shown a disinclination to become involved in the details of the programs and so have provided inadequate supervision to the onlending activities of the participating financial institutions.

In virtually all projects, development banks participated in these multi-institutional arrangements together with commercial banks. Sometimes, acting as a "lender of last resort", they financed more new enterprises and possibly "risky projects" where the commercial banks, following more conservative practices, were reluctant to approve loans. The proportion of the subprojects onlent by development banks varied from a few loans in the case of Morocco (BNDE) to a maximum of more than 40% by the Banco Nacional de Fomento in Ecuador.

A problem only beginning to emerge is whether a rediscounting agency, apart from the central bank, can ensure repayment of loans channelled through commercial banks when the final subborrowers are not repaying these institutions. A central bank, when it acts as such a rediscounting agency, has no such problem. All commercial banks have accounts with the central bank which can be appropriately debited or credited with disbursements or payments. Development banks which act as rediscounting agencies - such as in Sri Lanka (NDB), Pakistan (IDBP) and Morocco (BNDE) - have no such recourse. As repayments of subloans falter in the commercial banks it becomes a question of whether the development banks can ensure repayment even though the risk on loans is clearly with the lending institution. This is another reason for locating the rediscounting function in the central bank. Rediscounting schemes tend to create an overdependence by commercial banks on special funding of SSE lending and little use of the central bank's own resources for this purpose.

#### Credit Guarantee Schemes

To overcome the risk aversion of commercial banks some countries have tried to use a guarantee mechanism. It was hoped that through such a mechanism small enterprises could obtain loans even where they were unable to satisfy the collateral requirements of banks. The first project with a guarantee scheme was that in the Philippines. Here, the Industrial Guarantee Loan Fund (IGLF) guaranteed 60% of the loans refinanced through commercial banks and other financing institutions. Although the IGLF arrangement was quite successful in refinancing, the commercial banks continued to insist on collateral. Thus, the main aim of the guarantee scheme, which was to enable entrepreneurs with good projects but inadequate collateral to have access to loans, was thwarted.

Guarantee schemes were also tried in Bank projects in Jamaica, Cameroon, Sri Lanka, Morocco and Portugal. In Jamaica collateral requirements were still 100-130% despite a guarantee scheme and the banks were even reportedly insisting on compensatory deposits. In Cameroon, the credit guarantee fund did achieve partial success, but it appears to have adopted a very cautious approach and was criticized as being almost as risk

averse as the banks themselves. Since the project was through a government development bank, there was no increase in project lending as a result of the guarantee scheme. In Sri Lanka, SME loans were formally 60% guaranteed through a central bank fund but to a limit which was only 40% of the maximum loan size. The commercial banks again continued to demand collateral and here, as in Jamaica and Morocco, they seemed to lack confidence that claims for repayment would in fact be honored. In Indonesia a credit insurance corporation Askrindo guarantees 75% of World Bank subloans to small enterprises but the guarantee process has become automatic and Askrindo has been facing mounting claims. In Portugal a guarantee scheme did achieve some measure of success, probably because the guarantee scheme had been set up before the start of the World Bank lending program and had already gained confidence among banks. The guarantee in Portugal was up to 50% - higher in special cases - and was operated by the promotional agency IAPMEI.<sup>15/</sup> It seems to have been a factor in convincing banks to make subloans under the World Bank project, although the guarantee fund was used only as a last resort. It should also be pointed out that a relatively successful guarantee fund has been operating in Korea - Korea Credit Guarantee Fund (KCGF) - which played a significant role in the lending of the Small and Medium Industry Bank (SMIB) and the Citizen's National Bank (CNB), both recipients of World Bank loans for SME. Apart from Portugal and Korea, the banks were reluctant to get involved with the bureaucratic problems which they thought would be entailed in invoking the guarantee. Guarantee schemes of a limited nature have also been introduced more recently in Colombia, Peru and Mexico but there is little evidence that they have as yet produced any increase in commercial bank lending to SSE. In these cases they were intended to increase lending to very small enterprises.

For an effective guarantee scheme to be developed, governments and relevant public authorities must understand that the introduction of a scheme will result in claims that must be met efficiently and fully. Any attempt to avoid or delay meeting claims will inevitably result in an undermining of confidence in the scheme. It is therefore important in planning a guarantee scheme to make sure that enough funding and staff are available to handle claims in an efficient manner and that the authorities recognize that the scheme represents a binding commitment. At the same time it is necessary to maintain incentives for collection by the participating institutions and to have independent review of subprojects before providing guarantees. There is also need to establish clear procedures to avoid arguments as to the obligations of each institution, especially in pursuing defaulters.

#### Eligibility and Target Groups

One of the major issues in designing lending projects to small enterprises has been that of designating the target group and determining

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<sup>15/</sup> IAPMEI - Instituto de Apoio as Pequenas e Medias Empresas Industriais (Institute for Assistance for Small and Medium Industries) set up in 1975 to help SMI adapt to the changes brought on by the revolution of 1974.

who would be eligible to benefit. The policy paper of February 1978 followed the practice of most previous discussions on the subject by deciding that it should be left to the government of each country to determine the definition of the small enterprise sector in keeping with various factors peculiar to that country. The policy paper was accordingly reluctant to lay down rigid guidelines on this issue, but it did indicate that as a general rule enterprises should have fixed assets of less than the equivalent of US\$250,000 in 1976 prices. The paper advised against an employment limit as the major criterion on size, so as not to discourage enterprises from the earlier mentioned objective of job creation.

In attempting to follow these guidelines and to delineate target groups and eligibility, the following experience may be noted:

- (i) Projects have generally conformed to governments' policies of providing direct funding and other assistance to those enterprises which have previously had little or no access to finance or technical assistance.
- (ii) Because of the difficulties in using a fixed assets definition in practice, some countries keep an employment size definition, usually as a second criterion.
- (iii) Excessively stringent limits reduce demand and slow the movement of funds as well as discourage commercial banks from getting involved. Limits, set too low, can also discourage growth and development of SSEs.
- (iv) Finally, eligibility criterion should be applied before sub-project implementation to avoid discouraging the growth of firms.

To counteract the tendency to finance the largest permissible projects, which are often of high capital intensity, attempts have been made to control the eligibility of subprojects by using investment cost per job as an additional criterion. In certain cases, a subproject must meet a criterion of creating jobs at no more than US\$5,000 or some other figure often significantly lower than the investment cost per job in industry as a whole in the country. In practice, job cost has proved difficult to control. This type of limit has been found to be restrictive and has resulted in difficulties finding sufficient subprojects to finance. Also, one can only monitor the number of direct jobs created within the enterprise, not the number of indirect jobs generated, which can be significant. Furthermore, as mentioned earlier (see section on "Technology Transfer"), such limits sometimes act against the introduction of new, more efficient technologies and the financing of subprojects outside the usual labor intensive subsectors where SME predominate.

The above considerations have led to adoption of a more cautious approach in laying down limits of eligibility. In fact, most projects have found it too restrictive to designate small enterprises as the only beneficiaries and have attempted to design programs from which both small and

medium enterprises would benefit, even if to a differing extent. For example, in some projects medium enterprises have paid a higher interest rate or been required to put up a greater share of the subproject costs from their own resources. In some cases, limits have been imposed on the proportion of medium scale projects that could be financed from a World Bank loan. Where there are refinancing or guarantee provisions, further limits have been imposed on the extent to which medium enterprises can benefit. Commercial banks, where they are involved, are sometimes encouraged to lend more to small as against medium scale enterprises, by being allowed a wider margin from subloans to SSE.

Despite efforts to encourage lending to small scale enterprises, it must be admitted that World Bank lending has hardly benefitted the very small, informal, microenterprises. Subloan sizes would have to be US\$5,000 or below to benefit this group. Some IDF Bank projects in Nepal (cottage industries) and Sri Lanka, and some of the funds from projects in Indonesia, Bangladesh, Philippines, Kenya and Ecuador provided credits to very small units. In addition, some small components within urban projects have provided finance for microenterprises. It must be concluded that to channel substantially more funds to this sector would require rethinking as regards appropriate intermediaries, loan conditions and Bank procedures.

In small countries such as Haiti, Comoros, Cape Verde and even Barbados, Cyprus and Jamaica, it is hardly justified for the Bank to have separate small and medium enterprise lending programs as most industrial projects are well within the SME category. In fact, in the framework of a general industrial credit line, 90%, if not more, of all projects fall into the small and medium enterprise category. As it is administratively costly to handle a separate loan only for lending to SMEs, the Bank in such countries has approved a general industrial credit assuming that most of the beneficiaries will in reality be SMEs. This clearly is the most effective lending policy for industrial development in very small countries. This also applies to African countries with small populations and limited markets such as Botswana, Mauritius, Burundi, Rwanda, Niger, etc.

Ownership is another problem in defining target groups that has recently become evident. The original concept of a small scale entrepreneur was that of a struggling individual with limited resources, virtually identifiable with those of the business. In several cases, however, entrepreneurs who applied for small enterprise loans had already built up considerable businesses in trade, importing or other industries. The provision of too many special benefits for the small enterprise sector can lead to the creation of "mini-conglomerates" of small businesses in place of the development of larger enterprises. In one sense ownership may not be important, since these "mini-conglomerates" are still contributing to economic development and creating jobs, possibly in a geographical region where few employment opportunities exist. However, if SSE projects are intended for those who have been deprived of access to finance or other forms of assistance and if in fact the recipients are "wealthy businessmen", then presumably they could obtain the resources they need without special programs. In practice, it is almost impossible and

probably undesirable to deny eligibility to an entrepreneur solely on the basis of his personal resources, particularly if the enterprise for which he is seeking assistance is indeed within the SME definition.

A final issue - linked to the above - is whether a share of the subloans should be reserved for first time borrowers or those setting up new enterprises. Statistics show that while newly created enterprises generate more employment for a given fixed capital investment than expansion of existing enterprises, they are also more risky. It would probably be counterproductive to  earmark  a specific portion of the funds available for "start-ups" for the reason that those already in business, even if on a very small scale, would be those who can present track records in entrepreneurship to satisfy lending institutions and who can make best use of more resources. However, it should not be forgotten that expanding the entrepreneurship base is an important objective. This is especially the case in less industrialized countries, and lending to new entrepreneurs should be a part of most programs. It may be possible to monitor the distribution of subloans to ensure that "start-up" and first time borrowers are included as well as those with "track records" borrowing for expansion and modernization.

### Terms and Arrears on Subloans

#### The Interest Rate

In all the SME lending projects, the World Bank has tried hard to keep interest rates to the ultimate borrowers at a level that was positive in real terms in relation to the inflation rate and close to the prevailing commercial bank lending rates. Agreements were reached with a number of governments that the interest rates would be adjusted in accordance with changes in the commercial rates. Unfortunately, there have been cases where, due to a strong rise in inflation rates and/or government policies favoring subsidization, the interest rates did not remain positive in real terms over the duration of a project, on some occasions even falling below deposit rates.

The wisdom of the World Bank interest rate policy is supported by experience. In Indonesia, Jamaica and Colombia for example, there is some evidence that the subsidized rates of subprojects encouraged investment in equipment which subsequently had low utilization rates. There were also strong indications that heavily subsidized rates in Mexico and Indonesia led to distortions in the selection of beneficiaries and to loans replacing other sources of funds. Where the principle of lending at prevailing commercial rates was established early, factors such as the speed of loan disbursement, the duration of grace and repayment periods, and collateral requirements were at least as important for potential small subborrowers as the interest rate. In addition, there is some indication that these heavily subsidized interest rates tended to create poor repayment records and high arrears, because loans taken out at higher interest rates were paid off more quickly than those at subsidized rates.

Furthermore, subsidized interest rates at well below inflation levels has caused considerable erosion in the value of repayments as

related to the original value of the loan fund. This inevitably perpetuates a continuing dependence on outside sources of finance to carry on the lending schemes. The Bank has not succeeded in achieving positive real interest rates in all cases (it has been particularly difficult in countries with high inflation rates), but there has been success in narrowing the gap and reducing subsidies. World Bank policy should aim at eliminating these direct subsidies to the borrowers and maintaining pressure on this issue, recognizing that results will be obtained only gradually. At an absolute minimum, lending rates to SMEs should exceed the highest deposit rates.

#### Foreign Exchange Risk

In virtually all cases, with the important exception of Korea, the SME subloans are made in local currency. Following Bank policy in lending to SSE, the government takes the foreign exchange risk, usually in exchange for an exchange risk fee although in some cases that is largely symbolic. In fact, in this respect some governments have made distinctions between small and medium enterprises, requiring the latter to take the foreign exchange risk. All evidence points to the fact that small enterprises are neither able nor willing to assume the foreign exchange risk. While there are strong reasons for insisting that subloans to small scale beneficiaries carry a positive real interest rate, including the foreign exchange risk fee, such borrowers want to know the exact extent of the debt obligations and are not able to cope with a situation where these would increase suddenly due to exchange rate changes. At the same time this approach can cause significant problems for the government when the currency is clearly over-valued. As with regular DFC operations, SSE lending to countries' with over-valued currencies poses significant problems. However, if the onlending interest rate to the SSE borrowers is maintained positive in real terms, this should, over the longer term, account for exchange rate changes.

#### Maturities

Repayment Periods. The period for repayment of subloans has varied greatly from project to project, but the average was considerably shorter than was expected when the loans were designed and appraised. At that time it was hoped that loan repayment periods would be in the range of 7-15 years, but in the majority of cases they were actually between 4 and 6 years. In Jamaica, where the subloans were primarily for working capital, the average was only 1-2 years; in Morocco it was 3-4 years; in Colombia and Mexico 4-5; in Cameroon 5-7; and in Portugal about 6 years. Only in Bangladesh and Sri Lanka were the average subloans for periods of 10 years or more. In Jamaica and, to some extent, Colombia, Morocco and other countries, the short repayment periods of subloans probably contributed to arrears rising from cash flow problems. Short repayment periods may also have restricted the use of Bank loans for productive fixed capital investments which would have required longer pay back periods.

Grace Periods. It was originally intended that long term loans would have grace periods of 2-3 years; in reality the grace period given in

many cases was only 1 year and sometimes less. In a few cases some loans were without any grace period. In others, the grace periods were inadequate to cover the time needed to purchase, install, and put into operation equipment acquired by the borrower with the loan.

Clearly the tighter repayment schedules and the limited grace periods seriously affected the debt servicing capacity of the subborrowers. One can conclude that when preparing projects too much emphasis was placed on rates of return. At the same time, insufficient attention was paid to cash flow, business risk and entrepreneurial factors to ensure that repayment and grace periods were in conformance with the ability of the small subborrowers to repay their loan obligations.

#### Lender Margins

There have been great variations in the spread or margin allowed to financial intermediaries on their SME lending. This varied from 2% for BNDE and the commercial banks in Morocco, to 8% for KIE <sup>16/</sup> and smaller enterprises in Bangladesh, to 9% for SEDCO <sup>17/</sup> the promotional agency in Jamaica. This variation is affected by a number of factors, some of which are considered below.

It is difficult to understand the reason for the wide divergence of spreads at which commercial banks were ready to participate. The net effect of low spreads was usually an increased conservatism on the part of banks, which reduced the number of higher risk projects or first-time entrepreneurs that the banks were willing to finance. A reluctance to invest in subproject supervision was also evident when margins were low. On the other hand, low spreads may have been sufficient to induce commercial banks to participate, because it allowed them to attract new customers for their other services and to lend to their clients at a time when credit ceilings were restricting the growth of their business. This may have contributed to the participation of the commercial banks in Morocco <sup>18/</sup> and was certainly the case in Portugal.

In some projects, higher spreads were deliberately offered to commercial banks to encourage their participation in SME lending programs.

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<sup>16/</sup> KIE - Kenya Industrial Estates, a promotional agency. In the second KIE Project in addition to an 8% spread KIE will charge a 1% supervision fee and a commitment fee of 1% on undisbursed commitments and a fee of 1.5% for appraisal and feasibility studies.

<sup>17/</sup> SEDCO - Small Enterprise Development Corporation merging into SIFCO - Small Industries Finance Corporation, itself abolished in 1981.

<sup>18/</sup> There was some indication, after 1982 that the commercial banks found the margin too low, especially after arrears started to appear and they began losing interest in the scheme. After more than two years, less than US\$1.5 million had been disbursed of what was originally a US\$70 million loan, later reduced to US\$40 million.

There were also projects that introduced a spread variation between loans to small and to medium sized enterprises. In the Philippines, commercial banks received spreads of 8% for subloans made to small enterprises and 6% to medium enterprises. In Sri Lanka the spread for commercial banks ranged between 3% and 5% depending on the size of the enterprise, subloans to very small enterprises earning the highest spread. It is probable that this arrangement did influence lending in the Sri Lanka project as this project was, in fact, the most successful in providing finance for very small scale applicants.

DFCs and promotional agencies, such as those in Jamaica and Kenya, were allowed higher spreads because they are generally dependent on governmental sources of income. The two specialized DFCs that lent only to SMEs, the CFP and the SMIB, have differed widely in the spreads they received. In parts of Colombia the CFP received 7%, while in Korea the SMIB received only 3%. Part of the difference may be explained by the fact that the SMIB operated on a larger scale and mobilized its own local currency resources through deposits while CFP did not. In addition, in Korea the guarantee fund (KCGF), with over 1,200 staff, carried out much of the loan appraisal work and, of course, reduced the risk and need for provision for loan losses. On the other hand, in Colombia the spread varied according to the location of the project. For subprojects located in large metropolitan towns the spread was 5.5% for those located elsewhere it was 7.0%. This higher spread may explain why nearly half the subloans were outside the three main industrial centers, thus conforming to the Colombian government's policy of industrial decentralization.

Figures show that the transactional costs, i.e., the actual administrative costs, of handling the SME lending programs usually ranged from 3% to 4%, although it did reach 6.2% in CFP and was even higher in some lending institutions used as intermediaries in some Bank projects.

There is a conflict in some projects between pressing intermediaries to lower administrative costs and to operate more efficiently and at the same time urging better subloan appraisals, more subproject supervision and more effective debt collection. Administrative costs were considered to be unjustifiably high in some lending programs and institutions and efforts were made to reduce unnecessary management expenses. All evidence shows that commercial banks generally need a 5 to 6 percent spread for lending to SSEs in order to be profitable and avoid the need to subsidize such lending from other financial operations. If there is the objective of lending to very small enterprises or providing some technical assistance, then a spread of 8% may be justified.

The need for a higher spread for SSE lending to be a financial attraction for commercial banks, can be met in two ways. Either the banks will be allowed to onlend at higher interest rates than lending to large borrowers or they will be provided with funds for this purpose at lower cost. The second is the option usually adopted, as in most countries it is considered politically unacceptable and discriminatory to lend to SME at above prevailing rates. However, there has been some evidence that in



programs of lending to microenterprises, when banks are using their own resources to a greater extent, onlending at higher interest rates may be accepted.

The option of having the banks receive funds at lower than normal may create a situation where the commercial banks are unlikely to use their own funds for SME lending. One can only hope that as the banks become more proficient at SME lending they will be better able to screen out credit-worthy clients and thus reduce administrative costs. Hopefully, they will then be more prepared to blend lower cost funds with some of their own resources when making loans to SME borrowers. As already observed, it may also be necessary to provide additional direct subsidies for commercial banks to use their own funds for SSE lending. This has been considered in some countries for microenterprise lending.

#### Arrears on Subloans

Most projects were plagued to varying degrees by arrears on repayment of subloans. One project with a very high rate of arrears was that in Kenya. At the end of 1981, it was estimated that 81% of KIE's loan portfolio was affected by arrears, with an estimate that 55% of the portfolio might be irrevocably lost. As a result of World Bank pressure during 1984 KIE succeeded in improving its collection performance. Between the end of 1983 and the end of 1984 arrears of more than 3 months declined as a percentage of the portfolio from 23% to 19% and the percentage of projects affected by arrears dropped from 69% to 56%. Of even greater significance was the fact that whereas in the quarter ending September 1983 only 64% of new amounts coming due were actually collected, this figure had risen to 89% in the quarter ending March 31, 1985. In Sri Lanka, repayment of subloans under the first World Bank SME project experienced a serious deterioration as the economic situation worsened during 1982. As of March 31, 1983, over 40% of all subprojects were in default or arrears. While the global recession of the 80's severely exacerbated the problem, poor appraisals, over-optimistic market assessments, bad financial management and weak debt collection efforts are also to blame. In the case of Kenya, preferential treatment for influential borrowers may also have been a factor.

In many cases arrears differed significantly by type of institution. When DFCs and promotional agencies acted as intermediaries arrears were worse than when commercial banks performed this function. In the Philippines, loans onlent through the development bank (DBP) had higher arrears than the guarantee scheme (IGLF) where funds were onlent mainly through commercial banks or private financial institutions. In Jamaica, only one of 27 subloans made through commercial banks was in arrears, while 26 of 28 subprojects financed through SEDCO were in arrears. In Sri Lanka, there was a difference between private and public commercial banks. As of early 1983 the publicly owned People's Bank succeeded in collecting less than 60% of amounts due while the privately owned Hatton Bank collected 88%.

It was reported during supervision in early 1984 that the repayment record on subloans under the Second Bangladesh SSI project was poor and that only 25% of the amounts due had been collected. The collection performance was particularly bad in the case of the large state owned Janata Bank where 82% of the subloans under SSI II were affected by arrears. As of September 30, 1984, the collection ratios for the Janata, Sonali and Agrani banks were 16%, 41% and 31%, respectively.

In Morocco, at the end of 1983, it was found that only 57% of the subloans were being repaid on time. Arrears stood at 16% of the outstanding balance of the subloans and 7% of the subloans were under legal proceedings.

The unsatisfactory performance of subborrowers in repaying subloans suggests a need for more concern at appraisal with cash-flows than with rates of return on subprojects. More than a lower interest rate, realistic grace and repayment periods might have lowered the arrears levels and improved the debt servicing capacity of the subborrowers. Poor screening of loan applicants and over-optimistic projections at appraisal have compounded the repayment problem. Most lending institutions performed poorly in supervision and "follow-up" of subloans. Lack of effective technical assistance may also have contributed to the situation.

As indicated by most project reports, there is need for more vigorous debt collection and tougher handling of subborrowers whose operations are profitable but do not repay the subloans on time. A World Bank mission to Bangladesh in late 1984 undertook a sample survey of subloan repayment and concluded that in "... 25% of the subprojects, repayments are delayed because of the unwillingness of the owners to repay the loans for reasons ranging from unwillingness to repay Government loans ... to diversion of funds ...". Such delinquent cases seem to exist in virtually all of the projects. In Colombia during the 1976-81 period arrears were kept in check by CFP; in fact, arrears on loans outstanding were brought down from 6.8% in 1976 to 4% in 1981. The improvement was achieved by applying a substantial penalty rate on arrears, following up on all clients in arrears, and resolving cases speedily by restructuring, rescheduling or foreclosing loans. This experience suggests that the application of a substantial penalty can, if followed through, be an effective instrument for reducing arrears. Although arrears on CFP's portfolio did begin to rise in 1982-83, this probably reflected the sharp recession in Colombia.

The issue of arrears and defaults on subloans to small enterprises raises the question of what is an acceptable repayment level for this group. It has been repeatedly pointed out that small enterprises have high birth and mortality rates in all countries. Even in developed countries 30 to 50% of all new small businesses fail. Should one expect a substantially better rate of success in developing countries? Developing countries can ill afford the waste of human and financial resources in such high failure rates of small businesses. One assumes that in lending programs for SMEs, careful selection and appraisal of beneficiaries can reduce the number of defaults or complete failures. Nevertheless, one must expect that an SME lending program will have a higher arrears rate and risk

to intermediary institutions than a conventional DFC loan, especially if one is to encourage the development of more new enterprises. Collection rates of 80-85% could be considered acceptable. A default level of 10% may be reasonable in some circumstances, where a greater development orientation of SME lending is needed. In many cases where repayment difficulties arise out of genuine operating problems, it may be desirable to undertake subloan rescheduling. At the same time, it must be recognized that such default rates have important implications for the rates charged by the lending institutions, their financing, and their very survival. Hence, instead of subsidizing credits to SSEs below bank rates, it could be argued that financial institutions should be allowed to charge higher spreads and interest rates to reflect the higher risk of this activity. This has generally been found to be politically unacceptable. It therefore became necessary, in most cases, for the onlending institution to have access to subsidized funding. Such subsidies should be transparent and limited. For example, the government might pay back to the institution a small percentage of each loan to small scale enterprises made from the intermediary institution's own funds.

#### Delivering Non-Financial Assistance

When the early SSE lending projects were designed by the World Bank it was agreed that help for small enterprises should not be confined strictly to the provision of finance. It was believed that small enterprises suffered not only from a lack of access to finance, but also the ability to utilize any finance effectively should it be made available. They needed suitable technical and managerial assistance to prepare projects for investment and overcome operating problems. Therefore, it was recommended that all SME projects include a component for the provision of technical assistance.

#### Foreign Advisers

Since the World Bank principally provides foreign exchange the help offered usually consisted of financing a number of foreign advisers to provide technical assistance to small enterprises. However, there is clearly a limit to the amount of assistance that such expatriate advisers can deliver in a cost effective manner and the absorptive capacity of recipient institutions. There is also a dilemma if advisers confine themselves to an advisory role and insist on working through their local counterparts, then their effectiveness will depend on the quality of the counterparts. On the other hand, if the advisers operate independently, they may achieve more effective results in transferring their knowledge and experience to a limited number of small enterprises, but after they leave, little remains other than improvements in the small number of enterprises they helped directly. Yet another problem is a tendency for expatriates to overstay. This preempts possibilities for local staff who could have the capacity to take over, and the most capable of these people may become frustrated and leave. In some cases, it becomes difficult for the local personnel to attain credibility from the banks and local business community. The record also shows that the World Bank has found recruitment of consultants for longer assignments difficult and time consuming. Finally,

expatriates are both expensive and sometimes have difficulty in adapting to local conditions quickly, which makes their use very expensive for SSE programs, which by their nature should be low cost operations. It is clear that the World Bank, as it is currently organized, does not have any comparative advantage in providing foreign advisers to help SME.

#### Specialized Service Centers and Industrial Estates

In Bangladesh, Sri Lanka and Pakistan, the technical assistance arrangements went further and involved the setting up of service centers in different subsectors. These centers were expected to train and upgrade the small enterprises in the subsector by providing technical assistance and helping with the development of new products. However, in all these cases, the process of obtaining local government funding to set up the centers, the recruitment of foreign and local technical staff, and the ordering and installation of the equipment, all took much longer than the time involved in disbursing the credit. As a result, five years after the agreement to establish these centers, it was generally still too early to judge whether they have fulfilled expectations. Moreover, all evidence of other multilateral and bilateral funded service centers (in Pakistan, Thailand, Kenya and Turkey) shows many of them to be costly investments that are underutilized. There has been somewhat similar experience in the financing of industrial estates. Components of small enterprise loans in Kenya, Portugal and Mexico intended to finance industrial estates, have all encountered problems.

#### Extension Services

There were a few cases where technical assistance arrangements achieved greater success. In Mexico, the institution involved in refinancing the lending to small enterprises, FOGAIN, established an extension service, PAI <sup>19/</sup>, in part on the advice (not expert assistance) <sup>20/</sup> from the Bank. The regional offices of PAI (26 in number in 1982) achieved some success as referral centers for directing small enterprises with problems to various specialized and financial institutions. A second case that might be mentioned is that of IAPMEI in Portugal. This promotional and technical assistance agency of the government successfully took on the task of helping entrepreneurs to prepare their projects in a manner acceptable to the commercial banks. Even though the commercial banks did not always accept IAPMEI-assisted projects at their face value and generally reviewed and appraised them carefully, a relatively good working relationship did develop between these banks and IAPMEI.<sup>21/</sup>

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<sup>19/</sup> Programa Apoyo Integral.

<sup>20/</sup> Some limited funds - US\$2 millions - were given in the Mexican SMI project for technical assistance, which was used for some equipment for training and information dissemination.

<sup>21/</sup> However, in the first Portugal SMI project no technical assistance was provided by the Bank for IAPMEI, only for other government technical institutions who played no role in the credit part of the project.

### Public Institutions

For the most part, the proposed technical assistance arrangements used public institutions as delivery agents. The institutions were staffed with inexperienced personnel and suffered from management and staff turnover and political pressures regarding appointments. The Bank's project officers repeatedly pointed out these problems. They pressed for more autonomy for these institutions and greater authority for the management to select staff, set improved salaries and motivate employees through promotion and advancement policies. In a few exceptional cases, such as in Mexico and Venezuela, the government briefly offered salaries for public servants at a level competitive with the private sector. Most often it proved unrealistic to expect such countries as Bangladesh, Pakistan, Sri Lanka, the Philippines, Egypt, etc., to be able to staff these public institutions at levels of remuneration equivalent to those in the private sector. Other forms of incentives, such as opportunities to study abroad, acquire experience and use these agencies as a springboard into the private sector or more senior government appointments may increase the appeal of these institutions. In this way, the agencies have the benefit of competent - even if inexperienced - persons for periods of 3 to 5 years. The conclusion is inevitable, however, that larger centralized public agencies have not proved very effective in the delivery of technical assistance.

### Financial Institutions

There have been cases where some limited technical assistance was provided by the financial institutions. Small industry divisions were set up within commercial banks in Bangladesh, Sri Lanka and Morocco. In Mexico, apart from the creation of PAI, the major commercial banks established their own small units for providing limited technical assistance. Although this type of assistance is usually confined to follow-up and supervision activities of clients of the banks, it is to be viewed positively. Small industry units within banks cannot hope to cover all the needs for technical assistance, but they can supplement such operations. Considering the limited lending margin, commercial finance institutions cannot be expected to provide broad based technical assistance. Attempts were made in earlier projects in Korea (SMIB) and Colombia (CFP), to have these institutions develop wider technical extension services. Later, it became clear that these services were too costly for financial institutions and ways were sought to provide technical assistance from other government-financed agencies.

### Some General Conclusions on Technical Assistance

There is some evidence that small, independent, local or sub-sectoral organizations are a more effective way of providing technical assistance. Similar organizations have been successful even in countries such as Jamaica <sup>22/</sup>, where the experience with a variety of publicly financed institutions has been otherwise poor. In addition, there have

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22/ A small unit helped the garment industry in Jamaica apparently with some success.

been suggestions that technical assistance concentrate more on "outreach" programs with closer formal and informal links, first and foremost with the banks and financial institutions, but also with industrialists, professional associations, technical institutions, non-governmental organizations (NGOs), private foundations and local consultants. It has been proposed that if ways could be found to create institutions which obtain some assistance from the public budget yet, closely follow the patterns of private institutions in their management and staffing, and are able to establish links with larger industries and the groups mentioned above, they could be more effective in providing technical assistance, extension services, to the small enterprise sector. It is also important that technical assistance, extension services, and promotional agencies view themselves as referral centers, able to bring in all the available talent in the country without seeking to handle all problems directly. They must also find ways to attain credibility and cooperate effectively with the financial institutions.

Most of the Bank's technical assistance arrangements took much longer to implement than the credit programs they were supposed to support. Therefore a significant lag developed between the two elements of the program that were intended to complement each other. In these cases, it proved difficult to achieve any coordination between the lending and technical assistance aspects of the program. Even where assistance was confined to bringing in a few specialized technical advisers, actual placement was a lengthy process.

Experience with these projects clearly shows that there is no single design suitable for providing technical assistance to SME in all countries. Each project must look for its own solution based on the size of the country; its degree of industrial development; the availability of suitable experienced staff; and the extent of the commitment, on behalf of the country and its institutions, to invest in support services for SME. Another factor may be the degree of development of the private sector and the extent to which it is prepared and able to become involved in helping in SSE development. An interesting example comes from Mexico where it became clear after 1982 that the costs of the extension service of the PAI program had to be reduced. Efforts were made to work with groups of small industries rather than with each enterprise individually. Groups were formed in the same product lines to discuss better design and improved productivity and quality. Common services for procurement of materials and marketing of products were also developed. Quality control circles along Japanese lines were formed as well as centres for machine maintenance. Training courses were arranged to supplement extension work. The results of these collective approaches were very positive in making better use of extension staff.

## V. CONCLUSIONS AND LESSONS FOR FUTURE PROJECTS

As regards the speed of disbursements and the performance of loan portfolios, projects involving World Bank lending for small enterprises have fared no worse and, in a few cases, better than the conventional loans to development finance institutions. Over-optimism on financial targets in project preparation is evident but usually this has been in relation to the time frame for reaching profitability rather than with respect to the basic viability of the subprojects. World Bank supported SME projects have provided institutional finance to enterprises that previously had limited or no access to such funds, thereby helping to redress a distortion in the financial system. The creation of employment at lower costs (often less than half the investment cost per job prevailing in a country's industrial sector) is another positive aspect of the World Bank's SME lending.

### Policy Factors

The most important lesson of past experience is that most early World Bank small enterprise lending projects did not recognize the importance of the policy framework. As some of these projects were being implemented, it became increasingly evident that policies toward economic development, such as those related to incentives, trade, labor and fiscal matters, discriminated in favor of larger enterprises. These policies, therefore, impeded the attainment of SME objectives and development in general. Specifically, discriminatory policies include the direct exclusion of SME as beneficiaries of investment privileges, as in the case of the investment codes of several French speaking African countries; and the introduction of complex bureaucratic procedures for obtaining benefits such that SME are unable to comply with the requirements. There is need to ensure that licensing procedures, import controls, taxation, export benefits or other regulatory measures do not discriminate against SME either directly or because these enterprises are unable to cope with the onerous bureaucratic processes involved. Simplification of regulatory procedures related to formalizing enterprises and to obtaining benefits offered by the government in the form of tariff relief for imported equipment and materials, is essential if these measures are to have a positive impact on small enterprise development. Examples of measures which tend to discriminate against SME's are:

Trade and Pricing Policies. Relief from duties on imported equipment and favorable depreciation treatment, tend to encourage excessive capital intensity, which in turn usually means the establishment of larger enterprises. The negative aspects of these measures is further exacerbated when the currency is over-valued and/or interest rates are subsidized. Price controls, while in theory operating equally as a disincentive against both large and small enterprises, in practice discriminate against SME, mainly because smaller enterprises have less potential to push for price changes.

Labor Legislation. Minimum wage, social security or statutory requirements regarding the hiring and firing of workers, is often mentioned as burdensome and restrictive for SME. In actual fact, there is little

evidence that this legislation has a negative effect on SME development. Experience seems to indicate that governments lack the administrative machinery to enforce these regulations. However, they do force large numbers of SSEs to live at the margin of the law in the clandestine segment of the economy often referred to as the informal sector. Relaxing compliance with labor (and tax) laws for small enterprises would ease the graduation of very small informal enterprises into the formal economy and enable them to benefit from assistance programs and gain access to institutional finance.

Capital Formation. Inheritance laws that limit capital accumulation, and financial policies that discourage savings tend to make it extremely difficult to accumulate the equity needed to become an entrepreneur. In less developed countries, including most of Africa, the difficulties in accumulating funds for equity is a major constraint to entrepreneurial development. There are also few incentives for savings. These problems may partly explain why so many Bank subloans go to entrepreneurs already engaged in other businesses and also the very high debt burden assumed by small enterprises. Policy reform on the macroeconomic level is necessary to bring about change in these areas.

Subcontracting. Linkages between large and small enterprises through subcontracting are an essential element of the industrial structure of all developed countries. Yet in developing countries the volume of such relationships is small. This is due, in part, to government policies which provide incentives to larger firms to produce themselves, most of the items they need. Investment and export incentives are offered to large firms but they are rarely extended to the smaller subcontractors even though their contribution to the final product may be significant. In some countries, the structure of business taxes on inputs and exoneration from various duties may encourage larger firms to import or produce the items they require. In very few cases is there any incentive to subcontract, even though it may benefit the country economically. As regards procurement by public agencies, few governments have measures to ensure that SME are given an equal chance to compete as suppliers or act as subcontractors.

Banking Regulations and Financial Policies. In some developing countries certain regulations and legal aspects of banking transactions limit the access of SME to loans from financial institutions. Among these is the requirement - statutory in some countries - to obtain collateral of up to 150% of the loan amount or higher and even specifying, in some cases, that this has to be in the form of certain properties, e.g., land. There are also cases of taxes, stamp charges or commissions which often bear heavily on smaller loan transactions. In addition to the above difficulties created for small borrowers from commercial banks, other regulations such as credit ceilings, legal limits on personal guarantees and on foreclosing on certain types of properties, and even the high costs of litigation against small defaulters, all make the banks even more reluctant to lend to small enterprises. Again, policy changes are necessary to reduce discrimination against SMEs. Control of loan interest rates for political reasons tends to create a scarcity in loans made available by commercial banks, making it more, rather than less, difficult for SME's to obtain credit.



Bureaucratic Constraints. As already pointed out, many government policies, such as the overvalued exchange rates, protection against imports, investment incentives, industrial regulations, taxation, price controls, and labor legislation, tend to work against SME development to varying degrees. The extent of the distortion depends on the manner in which the regulations are enforced. There are also a number of less obvious more indirect ways in which the actions of government through its bureaucracy create difficulties for small enterprises, despite the declared intention of most governments to support the sector.

Affirmative Measures. Some countries have taken legislative measures of an affirmative action nature, to try to redress the factors that work against SME in their quest for institutional finance and markets for their products. Among these measures are:

- (a) Specific regulations imposing on commercial banks mandatory quotas of lending for SSE (sometimes within priority sectors which include small scale farmers or indigenous borrowers).
- (b) Requirements for those obtaining large government orders to sub-contract a certain portion to small scale enterprises.
- (c) Fixing a specific percentage of public procurement to be made directly from SME suppliers.
- (d) Reserving certain services or products only for small scale firms and barring large scale enterprises from engaging in their production.
- (e) Exempting SME from the payment of certain taxes and levies, or from observance of specific factory laws in relation to employee safety, environmental controls or labor regulation (usually only for very small enterprises).

Such measures, together with special lines of credit offered at subsidized interest rates and other favorable features, have resulted in an increased growth of the small enterprise sector (as in India). At the same time, these measures need to be assessed as to how they affect all parts of the economy. In some cases they go beyond the mere redress of biases and market distortions which discriminate against smaller enterprises and actually result in giving favored treatment to a section of the economy based on size consideration alone. In some circumstances these measures can negatively affect the growth of other important parts of the economy in that they may provide unfair competition to larger enterprises which may not be in the broader national interest.

### Conclusions on Policy Issues

Policies which have hindered economic development in general have typically hindered the growth of small scale enterprises, in some cases more than large scale enterprises. Experience has shown that in countries such as Jamaica, Mexico, Sri Lanka, Portugal, and Colombia, until realistic exchange rate regimes were established and changes in trade investment and

financial policies implemented, it was difficult to effect a substantial development of SSEs along healthy economic lines. It is hardly feasible to press for the use of appropriate technologies and maximum employment creation in a situation where subsidized finance is available for equipment purchase and the domestic market is protected such that profits are high enough to justify equipment with low utilization rates. Using subsidized finance to counteract the impact of policy induced distortions on SSEs has usually not been successful. While the World Bank should be fully aware of these policy factors related to SME development, it cannot be expected that Bank loans for such development, usually of modest size, will provide the leverage needed to effect major policy changes. Evidence also shows that decisions on matters as far reaching as trade and exchange rate policies are not likely to be made in the context of negotiating an SME loan. In practice it has proved difficult to negotiate on such matters as tax policies, investment codes, and possible export subsidy schemes, largely because those who are involved in the negotiation of an SME loan are not the proper authorities for taking stands on the wider policy issues, even as they affect the SME sector. Major policy reforms and issues on finance, trade and incentives are best negotiated through SALs or industrial or financial sector support projects. Thus, it is important for those who represent the World Bank in negotiations on the major policy related loans to be fully conversant with the history and problems of SME lending projects.

#### Other Operational Lessons

##### Intermediaries

Over-reliance on single intermediaries may prove counterproductive. More effort is needed to broaden the range of such intermediaries by bringing in commercial banks and other financial institutions, either for the first time or in increasing numbers. Commercial banks have proved more effective than DFCs or promotional agencies as financial intermediaries for channelling funds to wider groups of SME. This has been especially so when the funds have been channelled through rediscounting arrangements. Guarantee schemes should be considered, in suitable circumstances, to reduce the "risk-aversion" of commercial banks but only if carefully planned and with the strong public commitment needed to generate the necessary confidence.

The World Bank, commercial banks and governments must all recognize that SME lending is risky. Much better data needs to be gathered on the costs of SME lending, including the costs of potential arrears. At the same time, it must be recognized that a higher rate of defaults and arrears may be a price of development. If this is accepted, and if more realistic estimates can be made of the true costs of SME lending then a rational decision can be made regarding the funding of these losses, in order to maintain the viability of the lending enterprises. As regards subprojects, intermediaries and promotional agencies need to adopt a more realistic (less optimistic) view when projecting markets, sales, profits and duration of subproject implementation, as well as make more allowances for contingencies. Wider and flexible lending margins should be allowed on subloans to cover administrative costs and risks in lending to SSEs. These wider margins should be used to encourage improved screening of sub-borrowers, better loan appraisals, more effective supervision and the

provision of technical assistance. Greater provision must be made for improved supervision of subproject implementation by the lending institution, even if this requires a larger spread.

Despite the earlier mentioned deficiencies of DFCs acting as intermediaries for lending to SSEs, if brought in as intermediaries alongside commercial banks they may be able to provide a more development oriented view of what is needed (e.g., lending to new enterprises, less developed areas, longer repayment periods, etc.). It will also be necessary to use DFCs in some countries where the commercial banking system is too weak for the banks to be made the sole intermediaries of an SSE lending program. Such situations exist in some African countries where the commercial banking system is primarily in the hands of conservative foreign owned banks and the few national commercial banks, usually state controlled, are either too weak or unwilling to fulfill this role. Experience shows that competition between commercial banks themselves and with DFCs has been healthy and has, in some cases, resulted in wider use of funds than might have been the case otherwise. For this reason, the principle of not earmarking specific sums for particular institutions should be followed.

#### Subproject Considerations

Greater care needs to be taken in the choice of subprojects to achieve greater positive economic impact. One should avoid directing too much finance to subsectors where supply is already outstripping domestic demand, capacity utilization is low, where industries are overprotected and export possibilities hardly exist. Ways should be found to assess demand for SME credits with the aim of avoiding loans with excessive disbursement periods or which have to be cancelled in part. Subprojects should also be less dependent on imported inputs, make more use of local resources and generate linkages with larger industries.

The terms on subloans should be based on realistic repayment schedules, reasonable grace periods and interest rates close to those prevailing in the financial market. Foreign exchange risk should be borne by the government as is now the practice in virtually all cases, but more realistic fees should be charged for bearing this risk. While continuing to press for positive real interest rates the World Bank may have to accept in some cases that this can only be achieved gradually. However, lending rates should always include a realistic margin above the rates offered on deposits. Unless this is achieved, then there is too much incentive for diversion of lending into deposits and there is no incentive for intermediaries to use their own funds for SME lending.

All credit schemes must ensure the availability of working capital from some source (not necessarily the same source as the loan for fixed capital). Even though it is correct for control purposes to observe the principle that working capital should only be available from World Bank funds. Where lending is associated with fixed asset investment, a more flexible approach on providing working capital within this limitation seems desirable. This is especially true when the Bank loan is being made in difficult economic conditions, such as low capacity utilization and high unemployment.

Lending to small enterprises involves higher risks, defaults and arrears than lending to large enterprises. These problems will become acute if lending is also used to on an attempt to offset economic distortions; thus SME lending projects should concentrate on subprojects with adequate financial returns that have been unable to get funding due to credit market failures. Further, lending institutions must be pressed to introduce financial discipline in collecting subloan repayments. Evidence shows that in all countries an intensified collection drive and rescheduling effort is justified. Penalty rates, foreclosures and litigation for willful default are effective means of improving portfolio performance. Penalty rates for arrears are particularly important when the subloans have been made at subsidized interest rates, deterring the subborrower from repaying more expensive loans first or using the funds for other purposes.

#### Technical Assistance

Projects to assist SME should include a technical assistance component, despite poor experience so far with such efforts. An effective technical assistance component could raise the degree of success of subprojects, introduce new technologies and increase the number of first time entrepreneurs. When designing a technical assistance component these factors should be taken into consideration: (a) the technical assistance component often takes longer to implement than the credit portion of a project; (b) greater reliance should be placed on local experts than on expatriates; and (c) small, local, independent agencies with strong links to large industry, financial institutions and universities are more effective than large, public institutions in delivering such assistance. No single pattern exists for successful delivery of technical assistance to small enterprises. Arrangements must be tailored to a particular country taking into account size, technical and human infrastructure, economic and industrial development and the real needs of the small enterprises in the country. Physical facilities such as industrial estates and common service centers rarely are cost-effective and are usually underutilized, therefore they should be included in projects only under very special circumstances, where demand for such services is clearly identified.

#### Microenterprises

In most cases Bank lending to SMEs has not benefitted the very smallest enterprises although in a few cases a limited amount of lending has been oriented to these "microenterprises" (Nepal, Sri Lanka, etc.). In order to channel more funds to subloans of less than US\$5,000, to units with less than US\$10,000 in assets, changes would need to take place in World Bank procedures, choice of intermediaries, conditions of lending and project preparation. Closer collaboration with private voluntary organizations may be necessary to achieve this. In all regions there is increasing demand to assist these very small microenterprises.

### Size of Future Projects

In some countries--Cameroon, Sri Lanka, Portugal, Morocco, and to a lesser extent, Ecuador and Bangladesh--relatively quick commitment of first projects together with other factors encouraged an optimistic view of the SME demand for investment finance. On this basis, considerably larger second (or third) SME projects were prepared and approved. Later, it was found that the real demand was much less than envisaged, resulting in a much slower movement of funds. In Ecuador and Bangladesh demand for loans picked up after a slow start but in Cameroon and Morocco demand for sub-loans remained low or non-existent. Worse still, in some cases (Morocco and Sri Lanka for instance) there were substantial cancellations of commitments for subprojects in the earlier Bank SME loan. An important factor was undoubtedly the severe economic recession that hit most countries during 1981-83. In some cases other bilateral and multilateral funding became available, often at more advantageous terms than that being offered by the World Bank. Despite these exogenous factors, one must conclude that there was also a failure to recognize that the first SME projects in a country often benefitted from pent-up demand and that those projects are not always indicative of the future level of demand for investment finance. Furthermore, a real perspective on the results of an SME lending program can only be seen after at least five years, when one can assess the real performance of the subloan portfolios. There are some indications that, as repayment problems increased, some commercial banks became less enthusiastic about SME lending.

There is need for more work to be done in determining loan size in small enterprise support projects. Viewed in perspective it has become apparent that there are great difficulties in forecasting prospective demand of the SSE sector for financial resources. This applies to the total demand which could determine the overall size of a loan for SSE and also the size distribution of the subloans likely to be requested. Both from the point of view of time spent and methods used, assessment of demand for finance from the SME sector needs improvement.

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## ANNEX. REVIEW OF SUBPROJECTS

Clearly the ultimate determination of the success or failure of a World Bank project assisting small enterprise development is made through an evaluation of the subprojects financed. Only if those enterprises that received financial or technical assistance are able, as a result, to operate successfully can a positive impact be concluded. In addition, a real evaluation of a subproject performance review must, generally, be made at least 2 or 3 years after implementation.

Unfortunately, an "ex-post" review of subprojects presents many technical difficulties. In most of the loans the number of subprojects is high, sometimes in the thousands. The intermediary institutions often have poor supervision and follow-up procedures. If the loan is being repaid and in some cases even if it is in arrears, there often is little effort to determine the real situation of the sub borrower. "Ex-post" reviews of subprojects have been conducted in a few completed SME projects and only at the insistence of the World Bank. These reviews also took place in a few other cases, when the institution itself wished to ascertain what had been achieved with the credits disbursed. Some information is available on the actual performance of subprojects in the World Bank's SSE lending projects in Mexico, the Philippines, Colombia, Korea, Cameroon, Cote d'Ivoire and, to a more limited extent, in Morocco, Kenya and Bangladesh. Samples of subprojects are currently being analyzed in Ecuador but the results were not available at the time of the publication of this report.

### A. Bangladesh

Some effort was made to look at the performance of the 875 subprojects financed under the IDA second and third small scale industry credits, US\$7 million approved in 1978 and US\$35 million approved in 1981, respectively. The second project consisted of 175 subprojects and the third 700. The average subloan size increased from approximately US\$21,000 to US\$35,000 between the second and the third credits. Fifty percent of the subprojects, 46.3% of the credit made available under the second loan went to food and allied enterprises, as against 36.1% of the projects and 25.1% of the amount in the third loan.

A sample of subprojects was analyzed. The average "ex-ante" financial rate of return (FRR) on these projects was 29% and the economic rate of return (ERR) 33%. However, the "ex-post" FRR and ERR were lower, 20% and 25%, due to less output than expected the result of market constraints and poor efficiency of operations.

As a result of poor supervision and a benign toleration of non-payment of loans, the credit given in Bangladesh by a number of participating commercial banks has a poor collection record. The collection ratio of one of the main onlending banks has been as low as 16% (September 1984). An analysis was made of 35 sample subborrowers with the conclusion that there was no relationship between the repayment performance and the location of the subproject. There was, however, a clear indication that the arrears were highly concentrated in four subsectors - food, transport, textile, and jute.

Based on the sample analysis it is reported that the most common cause of default was simply a decision by the loan recipients to avoid payment. The reluctance to pay appears to have been justified in 20% of the cases because of "start-up" delays. At the same time, depending on the lending bank being considered, estimates show that between 25% and 55% of the defaults are due to poor supervision and a "willful attitude of the subborrowers not to pay." As stated by the World Bank mission that reviewed a sample of development subborrowers; "in 25% of subprojects repayments are delayed because of the unwillingness of the owner to repay the loan for reasons ranging from reluctance to repay 'government loans', to temporary delays due to diversion of funds..."

Of the subloan beneficiaries, 20% were subprojects oriented towards exports. Nearly 32% of the third World Bank loan went to textiles, primarily ready made garments manufacturers. This explains the low average investment cost - US\$1,100 for each of the 35,000 jobs claimed to have been created.

#### B. Cameroon

By 1982, 35 projects had been approved for the 1975, US\$3 million, IDA credit for Cameroon SME. These consisted of 14 SSE and 21 SME projects. The original World Bank project appraisal had projected 65 SSE and 17 SME to be financed from the IDA credit. However, by mid-1982 10 of these 35 subprojects had either ceased activities or never started, and 5 others were still in various stages of construction. In a study undertaken by a consultant in November 1981, a report was given of the status of 31 of the subprojects approved. The consultant reported that of these, 9 could be said to be trading profitably or close to the break even point; 11 were trading at a significant loss; 2 had ceased operations; 3 were in various stages of starting up; 3 had never actually operated and were waiting for some relocation; and 3 were designated as having "aborted with misuse of funds." Of the 9 trading profitably in mid-1982, 4 were bakeries, 3 garment and textile manufacturers, 1 furniture, and another producing food items. Those that were trading at significant losses or had ceased were actually engaged, 4 in the food sector, 3 in the wood sector, 1 in clothing and footwear, 2 in metal works, and 4 in various other activities.

According to the subproject appraisals, 31 of the projects approved were supposed to generate 463 jobs, considerably less than the amount forecast in the World Bank's loan appraisal. In November 1981 the consultant could only identify 153 jobs actually created. The appraisals had originally shown that these projects should create approximately 200 jobs. The average investment cost per job was approximately US\$14,000 equivalent.

The problems encountered by the various subprojects in Cameroon were diverse. It is significant that only about a third of the subprojects were single enterprises unconnected with other businesses through some common ownership. We may therefore assume that the financial problems encountered, such as shortage of working capital which prevented implementation of some of the subprojects, may have been due to problems in other businesses owned by the entrepreneurs. There is no doubt that the

financial appraisal of the subprojects was carried out with over-optimism by the promoting agency and the BCD (the National Development Bank) and the absence of any follow-up on the disbursed funds may also have contributed to the situation. There were a number of cases where the expenditure on buildings exceeded the forecasts leaving a shortage of working capital for trading, machinery purchase and operational expenses. It was also reported that some funds were used on residential accommodation or in the acquisition of private cars rather than commercial vehicles.

### C. Colombia

Some data on the performance of subprojects under the first and second loans to the Corporacion Financiera Popular (CFP) are available. The first loan for US\$5.5 million became effective in May 1975 and was disbursed by 1978. In early 1979 a survey was undertaken of a sample of 76 subloans financed. While the total sales generated by the 76 subloans was close to that projected, 29 managed sales higher than projected and 47 lower. Forty four firms projected higher than actual profits as against 28 lower while 45 projected 20% higher profits than actually took place. Forty two projected lower project costs than was actually the case, as against 14 who projected higher costs. Thirty nine of the 76 firms projected increased sales of 20% above the actual.

The second CFP loan for US\$15 million approved in 1979, assisted 696 subprojects which were expected to generate 3,300 direct jobs at an investment cost of US\$13,500. To assess the performance of the subprojects two surveys were conducted, one of 183 subprojects carried out by the CFP and a survey carried out by a World Bank consultant of 31 subprojects. These two surveys together accounted for about one-third the total subprojects.

As a result of subproject implementation, the average sub-borrower's sales grew by 24% in real terms, but there were wide fluctuations. The subprojects gross incremental capital/output ratio (ICOR) was 1.27 which may be considered satisfactory. Labor productivity, measured as sales per worker for an average subborrower, increased by approximately 9% with some higher productivity growth for larger sub-borrowers than for smaller firms. In fact, some of the larger subborrowers increased their labor productivity by reducing their work force through the modernization of their plant equipment. Capital productivity, on the other hand, experienced a 16% decrease (20% for larger subborrowers and 8% for smaller) which means that the rate of capacity utilization probably decreased over the period covered, as a result of the purchase of new equipment. This seems to indicate that entrepreneurs used World Bank funds to purchase equipment with low expected utilization.

In both Colombia projects few new enterprises were financed. In the first CFP project, less than 4% of the 305 subprojects financed were new enterprises. In the second loan 70 enterprises, approximately 10% of the total number and 7.5% of the total loan amount, were for new enterprises. Generally the new enterprises were smaller, but had higher labor productivity and lower investment costs (US\$11,250). On the average, the new enterprises created more jobs per loan (9.6) than the existing ones (4.7).



One point of interest in the case of the Colombia CFP projects is that the average subloan size in the first two loans was US\$22,000, proving that the beneficiaries were in reality overwhelming small industries.<sup>1/</sup>

#### D. Cote d'Ivoire

This loan to the Credit Cote d'Ivoire (CCI) was approved in August 1975, implemented in February 1976, and finally disbursed in June 1982 after several extensions. The loan financed 84 new small scale enterprises. Fifty one of these were above the free limit of US\$50,000 and accounted for US\$3.8 million or 83% of the total US\$4.5 million credit. The remaining US\$700,000 financed the other 33 smaller subprojects.

This project was originally designed to finance small scale repair shops, bakeries, garages and furniture factories. In the end, the 84 subprojects were broken down as follows: 9 garages, 29 bakeries, 7 wood-working units, 3 printing shops, 33 poultry farms and 3 others. According to subproject loan applications 844 jobs were to be created at an investment cost per job of US\$9,371, compared to an original World Bank appraisal projection of 1,600 new jobs at US\$5,700 each. In general, the financial rates of return were to be as follows: bakeries 14-34% with an average of 25%, woodworking in the range of 16-37% with an average of 25%, garages ranged from 12-32% with an average of 26%.

The Project Completion Report related that CCI did not have the capability to carry out the systematic supervision of these subprojects, so it was not possible to get information on the actual performance of all 84 subprojects. CCI did issue a questionnaire, but 3 years after start of operations received response and actual data from only 11 subprojects, a sample too small to be considered fully representative. The sample of 11 showed that the actual investment costs were about 40% higher than those in the CCI appraisals. Employment creation was 121 against an appraisal estimate of 111, the investment cost per job was US\$9,775 as against US\$8,502, and the returns on investments were as follows: garages actual 0-12% (estimated 58-71%); bakeries 4-68% (estimated 39-66%); woodworking 13-19% (estimated 37-40%); poultry farming 30-35% (estimated 22%); and ice-making 3% (estimated 22%).

Of the 11 subprojects, 7 had actual investment costs higher than estimated. Six of the subprojects created fewer jobs while four created more. One subproject, a garage, had an actual investment two and a half times higher than the estimate, but it was also built to a higher capacity. In most cases, the actual returns on investment were substantially lower than estimated, the only exception being poultry farms. It should be noted that poultry farms were not originally included in the sectors to be financed from the loan, and that a number of these subborrowers were reported to have been officials of CCI.

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<sup>1/</sup> Statistics show that two-thirds of the beneficiaries had total assets below US\$85,000.

## E. Kenya

In early 1985, as part of the appraisal for a second small scale industry credit to Kenya Industrial Estates (KIE), a representative sample of 232 enterprises financed between 1977 and 1985 by KIE (not only from IDA funding) was analyzed in terms of sector, capital intensity, relative size and geographical location. This represented about 40% of all KIE projects. The analysis showed that 82% of the projects, representing about 68% of funds committed, were in the food, clothing, leather, wood and furniture industries. The remaining 18% were distributed among more capital intensive chemical and engineering industries. Twenty five percent of the enterprises receiving loans were located in the major urban centers of Nairobi and Mombasa, another 25% in four medium sized cities, while the remaining 50% were disbursed in the rural areas and minor urban centers.

Projects involving KIE loans of more than KSh 3 million (about US\$200,000) came to only 6% of the total projects financed, accounting for 40% of the commitments. Projects of less than KSh 0.5 million (under US\$30,000) represented more than 70% of all projects, accounting for less than 20% of commitments. As a group the enterprises in the sample imported only 9% of their raw material requirements, confirming the view that small enterprises were primarily using locally produced inputs. The analysis also showed that the larger projects (those costing more than US\$200,000) tended to import a higher proportion of their raw material needs. The average cost per job for the small enterprises assisted was US\$5,600, although it was US\$8,000 for the projects in the relatively capital intensive sectors. Some 60% of all the jobs created were in projects costing less than US\$30,000 at an average cost per job of about US\$1,700. Similarly the cost per job created in the major urban areas averaged US\$9,200 compared to an average cost of US\$2,800 for jobs created in rural areas.

A post evaluation was made of 109 subprojects financed under the first IDA credit. The results seem to show that the IDA subprojects fared better than KIE's portfolio in general. Of the IDA subprojects, 73% of them were rated successful and 16% of them unsuccessful compared to 55% and 33% respectively for the rest of KIE's portfolio. Some 800 jobs were created by 65 IDA projects for which information was available at a cost of about US\$3,600 per job compared to the US\$5,600 for the entire KIE portfolio. About 75% of the IDA supported subprojects were for loans below US\$30,000. Some 64% of the subprojects were owner managed and 50% of these IDA small subprojects were located in small towns or rural areas.

As a further indication on the performance of KIE's operations the following figures are relevant. KIE's loan portfolio, as of June 10, 1984, consisted of 692 loans. Of these, 58 borrowers had failed completely and were not operating. This represented 8.4% of the loans and 7.6% of the loan portfolio. A further 151 or 21.8% of the loans given, representing 24.3% of the portfolio, were experiencing major problems. On the other hand, 405 loans representing 58.5% of those granted and 38, 9.5% of the loan portfolio, were operating either without problems or with very minor ones. The overwhelming majority of this latter group - 96.5% - were repaying their loans on time.

F. Republic of Korea

In general one may say that the subprojects financed under the four loans given to the Small and Medium Industry Bank (SMIB) of Korea up to the end of 1984 have performed well. These were among the few projects where efforts were made to supervise the use of funds and to obtain data on actual performance. In the first loan provided by the World Bank to SMIB, which became effective in 1975, data was collected on the 141 subprojects actually financed. It was calculated that the total sales generated by the 141 subprojects amounted to US\$250.8 million in 1977 and US\$314.6 million in 1978. In both of these years the actual sales outperformed the SMIB's estimates - by 3.4% in 1977 and by 24.1% in 1978. These were years of very buoyant economic development in Korea in both domestic and foreign markets. However, as regards profits, SMIB's appraisals were overoptimistic. In the appraisals it was forecast that only one of the firms would sustain a loss in the first year of operation, but in actual fact, 28 of the 141 sustained losses during the first year.

As regards exports, the performance in line with the development of Korean exports was very impressive. In general, SMI contributed 40% of the exports achieved by Korea in the four years 1977-81. Of the 141 firms financed under the first SMIB loan, 92 firms actually exported an average of 50% of their sales. Data available on 88 firms show that in 1977 they exported the equivalent of US\$19.5 million which was 53% of the total sales.

It is significant that the average subloan was relatively high, US\$212,000, which indicates that most of the firms financed were in the medium-sized category. Only 34 of them were new and 107 represented expansions or modernizations. World Bank funds financed 47% of the total costs of the subprojects.

It should be understood that the World Bank loans to SMIB have been used only to finance the purchase of foreign equipment for which the sub borrowers have had to take the foreign exchange risk. There was a distinct fall-off in the use of these funds after the large devaluation of 1979. Foreign currency loans never represented more than 10% of the total lending of SMIB. In recent years (1983-84) this has dropped to 7% of which the World Bank's lending is not more than about 3-4% of SMIB loans. Over the last ten years, Korea has been able to satisfy an increasing proportion of the equipment needed by SMI from its own manufacture and therefore foreign currency loans are used by enterprises only to purchase technologically advanced equipment which explains the relatively high average subloan size. Recently the foreign exchange risk has meant an additional annual 5% on average costs of the loans, which themselves are at a higher interest rate than domestic currency loans. The sophistication of the equipment financed is also borne out by the increased capital intensity of the subprojects. In the first World Bank loan to SMIB, it was forecast in the Bank's appraisal that 18,000 jobs would be created at an average of US\$3,540 investment in each. In actual fact, only 6,222 jobs were created at an investment cost of US\$9,611 each, which should be compared with the expectation at the time of the subloan appraisal that these subprojects would create 6,768 jobs at a cost of US\$9,410 each.

The capital intensity of projects under SMIB loans has continued to increase. In the second World Bank loan to SMIB, (approved in 1978), the investment cost per job averaged US\$11,130; in the third loan (approved in 1980), the investment costs had risen to US\$17,460 and by 1983 it was reported that the average investment cost per job of these foreign currency loans was US\$25,400. These figures clearly suggest that SMIB has been using World Bank funds to introduce higher and more efficient technologies into existing medium-sized enterprises. An indication of the low level of incremental employment in some of these expansions and modernizations is given by the fact that in 26 of the projects financed under the first loan there was actually a loss of employment due to the substitution of workers by machines.

As regards capacity utilization, the actual situation that emerged did not fall far short of the estimates at appraisal of the subprojects. At the end of the second year of operation, the average capacity utilization was 77.2% as against a projected figure of 83.2%. Only a few firms were operating below 50% capacity, and over 80% of the firms were operating at over 80% capacity.

Economic Rates of Return (ERRs) were not calculated on most projects. They were only calculated for the four largest projects (in the first loan), i.e., those above US\$500,000 with an average result of 38.6%. The average financial rate of return (FRR) for the same subprojects were 18.9%.

#### G. Mexico

Mexico was one of the countries where an independent study of a sample of subprojects was performed. A random sample of 43 enterprises (33 small and 10 medium-sized according to the definitions of the country) that received credits from the first World Bank SMI loan for US\$47 million, approved in 1978, were analyzed during 1980-81. The sample shows that the average "ex-post" economic rate of return (ERR) for investments made from the credits of the World Bank loan was 51.17%, with one case below 10% and nine below 40%. Thirty four of the sample, or 37.79%, had ERRs of more than 40%. The minimum ERR in the group was 8.60% and the maximum 72.79%. From a country point of view, this seems to indicate that virtually all the subprojects studied can be said to have been of economic benefit. The financial rates of return (FRR) ranged from a low of 7.8% to a high of 59.72% with an average of 37.77%. Ten of the subprojects had "ex-post" FRRs below 30%. It is clear that at that particular period in Mexico return on investments was high.

Some indication of the productivity improvement in the firms of the sample can be shown by the fact that there was an increased capacity utilization from before and after the credit of 61% to 69%.

The average size of the World Bank subloans provided to 33 SSI projects within the sample was Ps 21.765 millions (about US\$30,000) in 1980. The total average subproject investment was around US\$56,000, thus the World Bank credit financed about 54% of the subproject costs. In the ten medium-sized subprojects investments were of the order of US\$230,000

with the World Bank subloans averaging approximately US\$120,000. In all, the 43 subprojects generated MX \$179.3 million (US\$8.2 million) of additional sales of which only 4.4% or around US\$350,000 went to exports. It should be recalled that the (1979-81) period was one of very high domestic demand in Mexico and low manufacturing exports.

For the total sample of 43 firms, the average value added was "ex-ante" MX \$63.65 million and "ex-post" MX \$64.574.<sup>2/</sup> Average profits went up from 22.85 million pesos to 25.86 million. An interesting point was that the interest payments went down from MX \$11.95 million to MX \$9.49 million, a clear indication that the World Bank loans were subsidized and at lower interest than the prevailing rate on other loans. The figures seem to indicate that there was no great increase in the overall value added in the firm, which might be considered a gauge of general output, although there was approximately a 14% increase in profits. The profit rate was high, as evidenced also by the high level of FRRs.

In the Mexico case there were few unsuccessful subborrowers - only two reported out of 857 financed to the time of the sample - primarily because the economy at the time was in a boom situation.

#### H. Morocco

A survey was carried out of 143 subprojects financed by commercial banks through the funds provided under the first small scale industry project approved by the World Bank in 1979. Of the 143 subprojects surveyed in mid-1983, 121 were completed and in operation. Of these, 7 had been completed ahead of schedule, 28 within the expected timeframe, and 86 with delays which averaged 8 months. The delays were due to a variety of reasons, some beyond the powers of the promoters, and in other cases due to poor design and management. Of the subprojects surveyed, 15% were implemented within the original cost estimates, 25% managed some savings, but the remaining 60% suffered cost overruns, these were most frequent in the subprojects in the chemical, food, and beverage sectors. One feature of cost overruns was that these were the result of delays in implementation which were often caused by lack of working capital. In past, because of the long delays in implementing the subprojects - of which were new enterprises - no detailed information on operations was available by mid-1984.

#### I. Philippines

In the Philippines some figures are available for subprojects financed under the first SMI loan approved in 1975. These figures were collected in 1980 and were part of a post disbursement review made on a randomly selected sample. In reality, there were two samples, one of 89 of the original 445 subprojects financed through the DBP (Development Bank of the Philippines) and another sample of 81 of the 391 subprojects financed through the IGLF (Industrial Guarantee and Loan Fund).

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<sup>2/</sup> All the samples consisted of firms already in operation when they received the credits.

Financial data is only available for 66 of the 89 sample subprojects financed by the DBP. Of the 53 subprojects for which the current ratio is calculated, 14 had ratios of less than one indicating subprojects facing liquidity problems. For the same 53 subprojects debt-equity ratio calculations showed that 11 of them were in excess of 4 to 1 which was supposed to have been a level above which loans should not have been made. Sales performance of the sample was much below expectation. Over 70% of the 89 firms in the sample failed to realize the sales originally estimated in submitting the loan applications. Actual net profits were less than a third of the projected profits. Actual incremental employment generated by the 85 sample subprojects for which data was available amounted to 1,702 or 31% more than estimated at the time of the DBP's appraisal, resulting in a cost per job of US\$4,491 as against the estimated US\$5,946.

Actual costs of the subprojects for over 15% of the sample were close to that projected but there were 70 projects with cost overruns exceeding 15%. As regards repayment, of the 89 in the sample, by December 31, 1980, two thirds of the group were in arrears of over 6 months and 19 projects had already been rescheduled, 4 were foreclosed, and 1 was acquired by DBP, with another one at that time still under litigation.

As regards the IGLF subprojects, although the initial sample had comprised 128, finally only 81 firms provided data. The sample was not entirely representative since 19% of the firms in the sample were from Metro Manila but 47% of the total investment costs had actually gone to that area. As regards projects cost, these were underestimated in 41% of the sample and overestimated in 31%. The remaining 28% were approximately in line with projections. The 81 firms surveyed generated 2,240 jobs which was 83 more than at subloan appraisal estimates. Sales were overestimated in 75% of the sample projects and in 40% of the cases the projected sales figure was over 50% higher than the actual figure. Virtually the entire sample suffered from an overestimation of export sales.

As to financial performance, the current ratio computed for 71 projects showed that 27% of these had a current ratio of less than one, signifying liquidity problems. Twenty three percent of the sample had debt-equity ratios above four, with a few having debt-equity ratios in excess of 20:1. According to the data available from the sample of 81 firms, 68 subprojects showed a profit, but 29 reported their net profit as a percentage of total assets to be less than 5%. Fifteen percent had net profits ranging from 5-10% of total assets, and 17 had net profits between 10-20% of total assets. Twelve showed net profits in excess of 20%. Of the remaining 13 projects, 10 stated they were operating at a loss, while 3 failed to report their actual net profit. It should be noted that in

matters of profitability there is a distinct tendency on the part of the businesses to underestimate profits for fear of taxation. 3/

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3/ It should be noted that these data were collected early 1981 and refer to operations to the end of 1980. Thereafter a severe deterioration in economic conditions occurred in the Philippines and, judging by the considerable increase in arrears and defaults, the financial situation of the subborrowers worsened substantially.





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ISSN 0256-2235  
ISBN 0-8213-0814-9