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**The Case for a  
New Approach to  
Small Enterprise Promotion**

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## **Introduction**

This paper is concerned with some basic issues of small business promotion in Third World countries. It aims at introducing a new concept of promotion which is based on strengthening private sector organizations above company level. Such self help organizations should enable small enterprises to improve their political representation, and their economic performance at the same time.

The paper consists of three sections. First, the significance of small enterprises in low and medium income countries is examined. This requires a sensible delimitation of the sector, combined with an investigation of the reasons for differences in enterprise size. The contributions of small enterprises to national economic development are addressed. A second section deals with the related question of justification for promotional policies. Here it is important to go beyond the well-known properties of small enterprises that make them relevant for development, and to investigate possible market and government failures. It can be shown that market imperfections and specific problems on the business level as well as unfavorable framework conditions in terms of economic policy can justify special support for small enterprises. Against this background, the third section analyses several forms of small business promotion. The weaknesses of present approaches are identified, and the new concept of strengthening organizations above company level is outlined.

## **1. Economic Significance and Development Potential of Small Enterprises**

### **1.1 Definition and Characterization of Small Units**

The term 'small enterprise' stands for a highly heterogeneous assortment of business units. No clear-cut and universally valid definition can be found that would do justice to the sector's complexity. Any concrete classification must therefore remain variable, according to the sector to be analysed, the economy's level of development, and the purpose of classification. A big

enterprise by the standards of a developing country may be considered small in a developed one; a small enterprise in industry X may be big in industry Y. Obviously, the term 'small' acquires meaning only in the context of an analysis.

Fortunately, this paper can avoid the dilemma that arises when a specific definition has to be chosen. By presenting some different approaches to the delimitation of the small enterprise sector, it attempts to enable the reader to comprehend common characteristics of the whole spectrum of small scale economic activities.

Small business units can be found in all sectors of an economy. However, small agricultural units are generally excluded. The usual premise is that they have such special characteristics, and are confronted with such special problems that it does not make much sense to treat them jointly with other enterprises. This paper, too, sticks to the convention of excluding agrarian activities. It should be mentioned, however, that strong linkages exist between agriculture and small enterprises<sup>1</sup>. On one hand, in rural areas it is mainly agriculture that provides purchasing power for the products and services offered by small units. On the other hand agriculture provides raw materials that some small scale activities are based on. Last but not least, peasant families are a constant source of potential entrepreneurs, motivated by seasonal underemployment declining farm product prices, or disadvantageous succession.

If agriculture is excluded, the category 'small enterprises' comprises all economic activities on a small scale in manufacturing, services, trade and transport. Frequently, and especially in developing country studies, the category is restricted to manufacturing enterprises<sup>2</sup>. Such an approach may be justifiable for pragmatic reasons, as it simplifies corresponding research. But it may also represent an antiquated idea of economic development that ascribes to manufacturing an overwhelming importance. It has to be recognized that trade, transport, and services not only play an essential role

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<sup>1</sup> On the interdependency between small enterprises and agriculture, cf. Hartmann, J.; Peters, J., 1990

<sup>2</sup> See, for example, Corotez, M.; Berry, A.; Ishaq, A., 1987 or Little, Ian M. D.; Mazumdar, D., Page, J.M., 1987

for the provision of the population, but also create structural prerequisites for the smooth functioning of market processes. Consequently, these sectors will not be excluded here.

The discussion of small enterprises primarily attempts to identify their special features in comparison with larger units. The necessary delimitation may utilize quantitative or qualitative criteria. The purpose of quantitative criteria is operationalization. They serve to develop procedures that allow to classify individual enterprises. Such procedures are needed, for example, for data collection in scientific studies or for the selection of enterprises in promotion programs. The usual quantitative criteria and their problems shall only be briefly touched here. No concrete decisions on delimitation are necessary for the purposes of this paper.

The number of employees and the capital stock invested in an enterprise are two widespread quantitative criteria. The number of employees has, above all, the advantage of being easily established and verified. Furthermore, it offers a particularly graphic impression of enterprise size. A commonly used threshold is 50 employees, with enterprises employing less reckoned among the small enterprise sector<sup>3</sup>. Of course, other delimitations are possible and are being applied. In addition, a multitude of sub-categories, such as 'cottage industries' or 'micro enterprises' have been identified, resulting in further complexities of the difficult field of classification.

Both the quantitative criteria mentioned lose some of their appeal if cross industry studies are undertaken. Owing to diverse conditions of production, each industry is bound to display different labour and capital intensities, which hardly allows a uniform classification of enterprises. Some studies therefore restrict themselves to individual branches, and employ less conventional criteria. For example, sales can be used in trade studies, and energy input in studies of some manufacturing industries. Sometimes, a combination of several quantitative criteria is attempted. But here again, the basic dilemma of classifying and defining the small scale sector arises.

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<sup>3</sup> Cf. Bruch, M., 1983, p. 3.

While a single criterion cannot do justice to its heterogeneity, employing several criteria leads to results that can hardly be interpreted any more.

Qualitative criteria offer one way out of this impasse. However, because of their largely descriptive character they are not so much applicable to actual delimitation tasks<sup>4</sup>. Rather, they make it possible to identify the small enterprise sector as a field of research in its own right. Having postulated the concept of 'small enterprises', qualitative criteria enable the researcher to give it meaning. Therefore, in practice it is these criteria that justify the special treatment of small enterprises.

The qualitative criteria utilized for delimitation refer to quite diverse facets of an enterprise (see Table 1). It is evident that any criterion is more or less vague and does not allow sharp limits to be established. While this may be inconvenient for actual classification, it probably does more justice to the subject of small enterprises. Listing a number of different qualitative criteria makes it possible to arrive at the theoretical concept of the ideal-type small enterprise, and opens the view on its essential properties. Even more important is that the qualitative criteria allow to identify typical structural features of small business units, and that different intensities of the underlying criteria are revealed in identifiable differences between enterprises. Thus, depending on the research interest, the appropriate qualitative criterion may be chosen.

This paper proceeds from the premise that the small enterprises of a developing country constitute a subsector of the economy. Units of an even smaller scale are excluded by requiring that enterprises exceed the subsistence level. In other words, they should be able to accumulate capital and develop a self-supporting dynamics. In delimitating the sector as against larger enterprises, the entrepreneur's crucial role has to be emphasized. Small enterprises shall be identified as those where no differentiation of management is observable. Thus, the enterprise is highly dependent on the entrepreneur, and managers are not, as in medium-sized enterprises, more or less interchangeable<sup>5</sup>.

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<sup>4</sup> Cf. König, W.; Billand, K., 1992, p. 4 ff.

<sup>5</sup> Cf. Fahnel, H.; Hartmann, J., König, W.; Meier, R., 1993, p. 1.

In this delimitation, the small enterprise sector encompasses large shares of the so-called informal sector<sup>6</sup>, but is not at all identical with it, as many formally registered and established enterprises are covered by the above definition.

Table 1 : **A Systematics of Qualitative Criteria**

Criterion	Typical Features of Small Business Units
Mode of Production	- low degree of division of labour, craft-type production
Market Position	- no dominant market power on important sub-markets
Management Style	- no professional management, no division between productive and management functions
Workers	- high share of family members, low education requirements
Product Type	- low technology intensity, small production runs
Organizational Structure	- personal relations to employees, customers, and suppliers
Legal Position	- frequently no formal registration
Output Markets	- locally limited
Input Markets	- utilization of locally available resources

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<sup>6</sup> The informal sector generally includes all the economic activities that take place outside officially recognized markets. More frequently, however, the sector is defined by some qualitative characteristics. Cf. ILO, 1972, p. 503f.

## 1.2 Determinants and Trends of the Enterprise Size Structure

In this section, the reasons for enterprise size diversity shall be examined.

As a first approach to this problem, the linkages between a country's level of economic development and the enterprise size structure of its economy may be explored. Empirical studies over time as well as cross-country comparisons indicate that with growing incomes, the significance of larger enterprises (as measured by their share of value added or employment) rises while that of smaller enterprises falls<sup>7</sup>. This relation may increasingly be questioned for highly developed economies<sup>8</sup>, but for the purpose of an analysis of development processes in Third World countries it can generally be accepted. As an illustration, a phase model of trends in the enterprise size structure in the course of economic growth that was developed by Anderson is presented below<sup>9</sup>.

This model refers to manufacturing and distinguishes between three types of enterprises:

- (i) household and artisanal activities
- (ii) small workshops and factories
- (iii) large factories

Three phases of economic development are identified (cf. Diagram 1). In a first phase, at a low level of industrialization, household and artisanal activities dominate while the remaining two types of enterprises are insignificant. In a second phase, household and artisanal activities start to diminish, while large enterprises and, specifically, the 'small workshop and factories' type of enterprises are becoming more important. The final phase, with a high level of industrialization, is characterized by a shift from small workshops and factories to the large factories. These become, by all standards, the dominating size class in the manufacturing sector. Household

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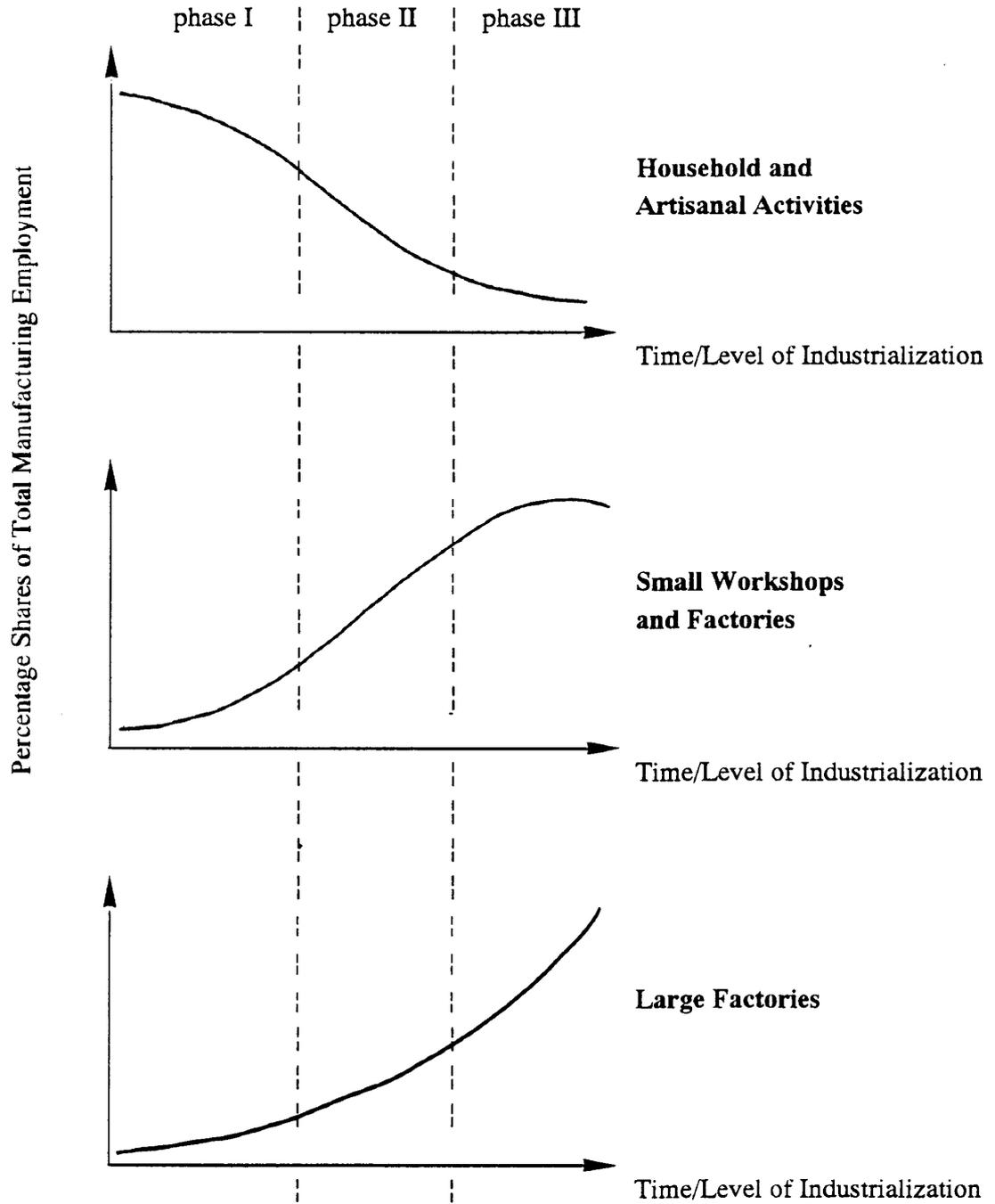
<sup>7</sup> Cf. Anderson, d., 1982, p.7 f. and Brock, W.A.; Evans, D.S., 1986, p. 15 ff.

<sup>8</sup> Cf. Piore, M. J.; Sabel, C. F., 1984 and Brock, W. A.; Evans, D. S., 1989

<sup>9</sup> Cf. Anderson, D., 1982, p. 14 ff.

Diagram 1:

### Enterprise Size Structure in Economic Development



Source: Anderson, 1982, p. 15.

and artisanal activities continue to lose significance and, in the end, play only a minor role.

The model should not be misinterpreted. The trends surely do not represent deterministic relations. In particular, it has to be noted that structures and properties of small enterprises will change in the course of development, so that changes in the enterprise size structure are not to be equated with the development process itself. Modern, technology-intensive small enterprises can hardly be compared with traditional forms of small scale economic activity, and have entirely different consequences for the economy as a whole. Similarly, the clear linkage between a country's level of industrialization and its enterprise size structure should not be taken as an indication of inferior efficiency on the part of small enterprises.

Such interpretations have in many cases caused setbacks for those development strategies that attempted to skip transitional phases of industrialization, by overly emphasizing large scale development. Frequently, this only created dualistic structures without dynamism.

The fact is that small enterprises have an important role to play at any level of economic development, as witnessed by the co-existence of large and small enterprises in industrialized countries. Thus, a first step to solving the problem in this section is completed: there is no inherent advantage of one enterprise size over the other, but the proper size in each case is determined by the internal and external conditions of the enterprise.

This insight is, in the final analysis, based on the reflections of Coase in his 'theory of the firm'<sup>10</sup>. His crucial proposition was that firms exist because they constitute a transaction-cost saving way to organise economic activities<sup>11</sup>. Firms can organize and control the production in teams<sup>12</sup> and therefore mobilize the advantages of the division of labour. Following up on that proposition, small and large enterprises, respectively, exist because under certain conditions they are the types of organization that minimize transaction

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<sup>10</sup> Cf. Coase, R.H., 1937

<sup>11</sup> Transaction costs arise when individuals organize their economic activities and interact with other individuals. They represent the "operating expenses" of the economic system as a whole.

<sup>12</sup> Cf. Weise, P., 1979, p. 174 f.

costs. For example, the decision-making process in large enterprises is much more complicated than in small enterprises, where decisions are generally taken by the entrepreneur himself. Consequently, small enterprises have transaction cost advantages and will be the more efficient alternative in an economic environment that requires many and fast decisions, i.e. a high degree of flexibility.

In reality, the optimal enterprise size is determined by a multitude of factors. These internal and external conditions that cause the superiority of a small or a large enterprise shall be set forth shortly. Again, the question is for the determinants of a country's enterprise size structure. To proceed systematically, they are related to four different layers<sup>13</sup>:

- a) enterprise
- b) markets
- c) public regulations and activities
- d) social environment

On the level of the enterprise itself, three major fields of influence can be identified. First, there is the personality of the entrepreneur with its goals, attitudes, and capabilities, decisively affecting the enterprise's development. Secondly, there is the large area of production conditions. Here, it has to be ascertained whether large fixed investments are necessary, whether economies of scope or scale may be realized, and what type of goods or services is to be produced. Thirdly, the quality and flexibility of the firm's administration is crucial for answering questions such as, will further enterprise growth rather cause cost progression or degression.

On the market level, it must be differentiated between output, input and capital markets. The scale and homogeneity of demand, intensity of competition, developments of demand structure, and service intensity and transport requirements are major determinants on the output market. On the input markets, procurement conditions and availability of energy, transport and communication facilities, raw materials, and intermediate products are

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<sup>13</sup> Cf. Naujoks, W., 1975, p. 111 ff.

relevant. On the market for capital, the different conditions of access for small and large enterprises have to be recognized.

A country's government exerts major influence on the enterprise size structure through both its regulatory and its monetary and fiscal policies. Small enterprises may either be promoted or discriminated against; investments in infrastructure may be restricted to some key sectors or be more broadly distributed. Public procurement policies and the formulation and enforcement of property rights also have an important role to play.

Finally, at the level of the social environment, socio-cultural values and traditions as well as socio-economic structures become relevant. For example, a society's attitude towards entrepreneurship, technical progress etc. will influence the establishment, growth, and behavior of firms.

Space permits only to list the major determinants here, without addressing their relative weights. But even the specification of the relevant factors may give an indication of the complexity of the causal relations concerning the optimal enterprise size. In any case, it should be clear that small enterprises can be efficient under a number of constellations. The simplifying direct relationship between an economy's level of development and its enterprise size structure has to be modified. Small enterprises are particularly important in a dynamic view, especially when the continuing need for structural change is taken into account.

### **1.3 The Small Enterprises' Contribution to Development**

Since the 'discovery' of small enterprises for development economics in the beginning of the 1970s, there has been a lively debate over their advantages in the development process. In particular, it was emphasized that production in small enterprises is more labour intensive, and therefore offers more employment at a given level of capital input. Consequently, small enterprises were seen as contributing to a solution of the employment problems of Third World countries<sup>14</sup>.

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<sup>14</sup> Cf. World Bank, 1978

As a result of this discussion, the impacts of the small enterprise sector were more generally analysed, and further characteristics of the enterprises and their advantages for an acceleration of the development process were worked out<sup>15</sup>. For example, it was shown that small enterprises primarily rely on local resources and exert little pressure on foreign exchange reserves for imports. They were described as rather flexible, opening up new markets, and contributing to the development of rural areas. It was also pointed out that small enterprises support a decentralisation of economic structures and improve market conditions by intensifying competition.

As it is difficult to keep track of such arguments, they need to be systematically ordered. Three areas can be differentiated: first, the area of accumulation, where income and employment effects are listed; secondly, the area of allocation with an emphasis on resource utilization by small enterprises; and thirdly, a structural area where dynamic effects of small enterprises are considered. The following arguments, in particular, have been frequently mentioned:<sup>16</sup>

#### 1. Creation and distribution of income and employment

- \* Small enterprises produce in a labor-intensive way and need little capital to create employment opportunities.
- \* Small enterprises discover and occupy market niches that would not be utilized otherwise.
- \* Small enterprises are present in remote and rural areas, and create much-needed additional income there.
- \* Small enterprises offer employment and income opportunities to less qualified workers.

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<sup>15</sup> Cf. Bruch, M., 1983 or Harper, M., 1984 or Neck, P.A.; Nelson, R. E., 1987

<sup>16</sup> Cf. Meier, R.; Pilgrim, M. 1992, p. 4 f, or Nanjundan, S., 1987, p. 9 f.

- \* Small enterprises contribute to a more equal distribution of opportunities and of income.

## 2. Utilization and development of national resources

- \* Small enterprises utilize resources that would otherwise be lost for the development process:
  - savings of the entrepreneur and his/her family, relatives, and friends
  - workers that are not educated formally and without employment chances in the formal sector
  - local raw and recycled materials
- \* Small enterprises offer multiple possibilities for business training and entrepreneurship development.
- \* Small enterprises contribute to the qualification and training of workers.
- \* Small enterprises need few imported inputs and therefore save foreign exchange.

## 3. Structural and dynamic factors

- \* Small enterprises are less concentrated in urban areas than large industries. They have stronger linkages to agriculture, alleviate migratory pressures, and contribute to a regionally balanced pattern of development.
- \* Small enterprises show flexible supply responses, are important links between different economic sectors and indispensable suppliers to other companies.
- \* Small enterprises employ, develop and disseminate appropriate technologies.
- \* Small enterprises intensify competitive pressures and so prevent monopolistic and oligopolistic market structures.

It should be noted that this list contains typical characteristics of small economic units that have very often been mentioned in the literature. However, the real world is not as uniform. As a synopsis, the list necessarily starts from the premise of an ideal-type small enterprise, while the sector as a

whole is characterized by its complexity. Thus, in reality not every argument will apply to every small enterprise.

As a preliminary result it may be concluded that small businesses constitute a worthwhile independent field of research. The sector cannot easily be delimited, spanning from informal activities to modern industrial production on a small scale. The central role of the entrepreneur and his/her personality as well as the ability to create a self-supporting dynamics were seen as decisive factors. It could be shown that no general superiority of large enterprises exists. Small enterprises can adapt to many different market conditions in a flexible and efficient way. Their typical characteristics give them a considerable role for the process of economic development. However, this does not yet answer the question whether there is a need and a necessity to promote small enterprises.

## **2. The Reasons for and the Justification of Small Enterprise Promotion**

### **2.1 Market-Oriented Development and Public Interventions**

The developmental advantages of small enterprises that were considered in section 1.3. are frequently used to justify promotion programs for the sector. Such an approach, however, is misleading. A similar argumentation could be made, for example, with respect to the advantages of large enterprises (introduction of new technologies, overcoming of threshold effects etc.) that would similarly justify a special promotion effort for this sector. The result of such an approach can only be selective and unsystematic measures with uncertain, at best neutral effects.

Instead, effective promotion has to be integrated into a wider strategic concept of sectoral development, brought into line with the country's economic policy. At least verbally, most Third World countries endorse market-economic principles by now, and pursue market-oriented development. Therefore, the reasons for and the justification of small enterprise promotion should be given within that context.

Any promotion represents an intervention into market processes, regardless whether it originates from a developing country's public agencies or from external donors. Economists argue that to justify such interventions, two conditions must be fulfilled. First, as a necessary condition it has to be shown that the market does not yield satisfactory results; secondly, a sufficient condition would be that intervention can indeed improve the results. In the design of promotion programs, such categories of market and government failure have frequently been neglected. Any decision on interventions into economic processes, however, must be based on an assessment of their relevance.

A first step, as mentioned, is to identify possible market failures. An important distinction with respect to the causes has to be made. These can be inherent to the market, or else the market may not function properly due to public intervention or insufficient or unsuitable regulation. The latter causes, which are external to the market, and which cannot be clearly separated from government or bureaucratic failures, are bound to play a major role in many developing countries<sup>17</sup>.

According to the analysis of the reasons for unsatisfactory market results, different conclusions can be drawn for economic policy. While causes inherent to the market can justify public regulation, external causes would rather call for the establishment of institutional requirements for market processes to unfold. Relating this understanding to the area of small enterprise promotion, it becomes obvious that promotion cannot only mean a narrow concept of direct business support, but also a change of the framework conditions in which these units operate.

It should become clear that the demands for promotion and the level of intervention are not laid down rigidly, but determined by the dynamics of the sector's environment in any specific case. While in an early phase of development it may be particularly necessary to change framework conditions and reduce discrimination against small enterprises, it may later become a priority to directly compensate small enterprises for disadvantages related to

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<sup>17</sup> Cf. Kimenyi, M.S., 1991, p. 199 ff.

their size. The measures required, and with them the approach to promotion, depend on the concrete economic and political situation of the country<sup>18</sup>. In any case, promotion should be specified on the basis of an analysis of the reasons for dissatisfaction with present results. It has to be differentiated between causes internal and external to the market, and the direct and indirect costs of any public regulation and subsidisation must be taken into account.

## **2.2 Bottleneck Factors of the Small Enterprise Sector**

Small enterprises obviously do not contribute to economic development of most countries in the Third World to the extent they would be able to. They are restrained in their dynamics. An analysis of the reasons requires, first of all, an identification of respective bottleneck factors. Basically, in the context of small enterprise development one has to differentiate between bottlenecks that are internal or external to the enterprise<sup>19</sup>.

Internal bottleneck factors are all those that appear directly within the small enterprise, or in other words, for which the firm itself is responsible. Here the problems of organization, technology, qualification of labour, methods of marketing, procurement, and financing, as well as entrepreneurial competence have to be mentioned. Shortcomings in these areas prevent an autonomous improvement in the small enterprise's performance.

External bottlenecks are all those that hamper the enterprise's development, but on which it can hardly exercise any influence and, consequently, for which it cannot be held responsible. They are part of a given environment within which the small enterprise has to move. Two areas can be differentiated: bottlenecks in market relations, and bottlenecks induced by economic policy. The former might be lack of demand, lack of access to capital, know-how, intermediate products, or qualified labour. The latter stem from the wide area of public regulation.

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<sup>18</sup> Cf. Shapiro, H., Taylor, L., 1990, p. 861 ff.

<sup>19</sup> Cf. Schmitz, H., 1982, p. 430 ff.

In this context, it is crucial that small enterprises in the Third World are generally, economically as well as politically, marginalized. They have but a few possibilities to influence political decisions, and are therefore frequently subject to open or concealed discrimination. This may be brought about by conscious public intervention into economic processes, e.g. by import regulation disadvantageous to small enterprises, as well as through an insufficient care for public order on the part of the state. Legal and contractual insecurity, a lack of property titles, and bureaucratic arbitrariness are recurring problems. Finally, even the state's behavior as an economic subject may lead to discrimination against small enterprises. This is particularly evident in public procurement procedures.

The specific bottlenecks of a small enterprise always depend on its specific characteristics, its branch, its socio-cultural environment and its country's politics and economy. It would be possible to identify common bottlenecks and to attempt a ranking; however, this would not be generally applicable, and would have to be drawn up anew in every situation. Furthermore, a definite identification of bottlenecks is often impossible as mutual overlapping and dependencies prevail. For example, the problem of financing which is put in first place in most bottleneck analyses may be understood as expression and upshot of a number of different deficits in the enterprise and its environment.

The major point to be made here is that the identification of bottlenecks does not substitute for difficult decisions on solution approaches. Following the above principles of promotion in the context of market-oriented development, the underlying causes of bottlenecks must be found out first. Internal bottlenecks do not necessarily result from causes inherent to the market, just as external bottlenecks do not necessarily result from causes external to the market. Causal dependencies are hard to establish. The problem of insufficient access to capital, for example, may either be due to high costs in small scale credit operations, or to administrative impediments and discriminating credit policies. Depending on the results of the analysis, to overcome one bottleneck, totally different recommendations for the support of small enterprises may be given.

This does not render an analysis of the small enterprise sector's bottlenecks useless. It will primarily help to identify promotion priorities. This requires an assessment, on the one hand, of the development goals and needs of the country, and on the other hand, of the constraints of the small enterprises' development. Successful small enterprise promotion will have positive impacts on the society's objective function and will be oriented on the essential constraints of small enterprises. A further application of bottleneck analyses is that by repeating them over time, failure or success of promotion can be established. Thus, bottleneck analyses primarily have the function of indicators. They show the need and the priorities for action without necessarily indicating the appropriate solution.

### **2.3 Market Distortions and Positive External Effects**

It was shown that support for small enterprises not only means direct help for selected firms but just as well an improvement of the environment for small enterprise development. The approach taken will, in any individual case, be determined by the results of the causal analysis which, at the same time, will also provide the necessary justification of small enterprise promotion. The causal analysis has to be conducted in the context of the premises on market-oriented development that were established above.

Consequently, the arguments that can justify small enterprise promotion may be systematized with the help of two categories. First, there are market distortions that block a dynamic development of the small enterprise sector. Secondly, there are positive external effects generated by the small enterprise sector which are useful for the country's economic and social development.

Positive external effects are generated by certain economic activities, the market incomes of which are too low compared with their contribution to social welfare. Costs and benefits do not accrue to the same agents<sup>20</sup>. As a result of this divergence, there is little private incentive for such activities.

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<sup>20</sup> Cf. Frey, B.S., 1981, p. 75.

Economic agents will prefer those activities that strongly increase their private utility, while neglecting activities with positive external effects.

An extreme case of positive external effects is represented by so-called public goods. Nobody can be excluded from the consumption of these goods, and their consumption is non-rival. A public good can be used by anyone without diminishing any other persons access. A favorite example is the lighthouse that helps any ship with its navigation. Because of non-excludability, no price can be charged for the public good. Therefore, no private economic agent will be willing to provide it. Public activities are necessary to ensure the provision of public goods.

Consequently, positive external effects will even in a generally market oriented strategy justify interventions into market processes. If small enterprises have positive socio-economic effects that are not rewarded through the market, their special treatment can be justified. Promotion will then serve to create the necessary incentives to expand activities with positive external effects.

A large share of small enterprise promotion is, more or less implicitly, based on the assumption that positive external effects are present. And indeed, arguments such as professional qualification, rural development, improvement of the structure of competition, reduction of migration, or diffusion of technologies do hold in this context. The small entrepreneur who trains workers in remote and under-developed regions and so lowers incentives to move to the big city may save society more costs than he himself is able to earn. In addition to these economic arguments, socio-political arguments such as a decentralisation of power structures or political stability should also be mentioned in the context of positive external effects.

It has to be taken care, however, that economic costs of promotion should always be covered by respective successes. They include not only direct but also indirect costs of measures, such as bureaucratic expansion or dynamic inefficiency. Even if positive external effects can be shown, which should not prove easy in reality, the justification of promotion still depends on a cost benefit comparison.

With a positive external effect, the market will fail and promotion can be justified with the specific properties of the good to which the external effect relates. In the second category that was established above, market distortions, the market could well perform its functions, were it not for certain internal or external impediments. Results are misallocation and an inferior utilization of the economy's production and development opportunities.

There are some indications that small enterprises are particularly prone to be affected by malfunctioning markets. While large enterprises, for example, can get over not or badly functioning markets through vertical integration, or may have the resources that are required to establish markets in the first place, small enterprises are dependant upon working markets for their outputs and inputs. Thus, while imperfect markets generally cut back the development opportunities of the economy as a whole, they particularly restrict those of small enterprises.

Besides the structural causes for distorted markets that are important in Third World countries, such as infrastructure and communications deficits, the behavior of the state plays an important role. Political discriminations of the small enterprise sector, whether consciously as a result of large enterprise-based development strategies or unconsciously as a result of missing information about sectoral interdependencies, can be decisive impediments of small enterprise development. Examples for such discriminations are overvalued currencies that reduce prices of imported inputs and place small enterprises, which primarily use local inputs, at a disadvantage. Widespread bureaucratic requirements that are extensive and hardly comprehensible also primarily fall on small enterprises, which generally have lower administrative capacities<sup>21</sup>. Finally, the frequent exclusion of small enterprises from public credit programs must be noted. Development banks prefer larger units that appear to be easier to deal with, so that small enterprises cannot obtain subsidised credits and pay higher prices for their capital.

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<sup>21</sup> De Soto presents an impressive example for the difficulty of overcoming informality in Peru. Cf. De Soto, H., 1989, p. 131 ff.

A removal of these and other market distortions will not only support the small enterprises' development but will improve economic allocation and accelerate the country's development process. This is the real justification for promotion measures in favour of small enterprises, not only with market distortions but also in the case of positive external effects.

A differentiation between the two categories makes sense because the analyses of causes gives important insights for the choice of approaches in small enterprise support. In the case of positive external effects the market cannot by definition, lead to a satisfying result. An intervention from the outside, to give the necessary incentives, is therefore warranted. The case of market distortions is different. Here, the first step should be to look for methods and measures that may improve the markets' functioning. These could be structural improvements to create market preconditions or less discriminating economic policies. Only if such possibilities cannot be found or lead to insufficient results, direct interventions such as regulations are justified.

In any case, promotion measures in favour of small enterprises should conform to the basic commitment of market orientation, i.e. utilize the possibilities of existing markets, and support, in a dynamic view, the long-term development of efficient markets. When promotion measures are considered, the possibility of government failures has to be acknowledged and a comparison of economic costs and benefits should be attempted. No assertion that one measure is the best possible can be reasonably made in advance. Sometimes, of all the possible second-best solutions it is most appropriate not to intervene at all.

### **3. Major Approaches to Small Enterprise Development**

#### **3.1 The Traditional Approach**

Having shown the relevance of small enterprises for economic development and a general justification for their promotion, some different approaches to small enterprise promotion can now be discussed and evaluated. In order to demonstrate general problems, two rather extreme positions as to small enterprise development, the traditional and the deregulation approach, have been selected. Finally, the new approach of including organizations above company level into small enterprise promotion shall be presented.

A natural starting point is to discuss the traditional approach to small enterprise promotion. This approach identifies the problem as insufficient market participation and unsatisfactory performance of small enterprises in general. It does not differentiate between internal and external causes of these deficits, but takes the need for promotion as a sufficient condition. One of its essential characteristics is the assumption that framework conditions of small enterprises' activities are given and cannot be influenced. For these reasons, the traditional promotion approach regularly consists of measures that apply directly to the enterprise<sup>22</sup>.

Typical projects and programs of this kind proceed from a bottleneck analysis of the small enterprise sector and attempt to remove bottlenecks by offering carefully directed support measures. Usually, the areas of procurement, production, marketing, and management are examined and it is tried to identify the crucial impediments to enterprise development. Promotion measures address the whole array of an enterprise's functions<sup>23</sup>:

- instruction and training of apprentices, workers, and the entrepreneur
- technical and business consultancy
- credit programs (subsidized interest, credit guarantee schemes, etc.)
- assistance with procurement
- assistance with marketing

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<sup>22</sup> Cf. Bruch, M., 1983, p. 197 ff.

<sup>23</sup> Cf. Schneider-Barthold, W., 1984, p. 39 ff.

- provision of infrastructure and workshops

It is remarkable that these measures are very much supply-oriented and directly aim at the performance of the supported enterprises. Frequently, not only individual functions of the enterprises are addressed, but whole packages of measures are put together that are supposed to attack all the enterprises' weaknesses at the same time. With respect to the actual implementation of measures, it is attempted to set up so-called 'one-stop-agencies' for the small entrepreneurs. These (usually public) agencies are meant to hold ready and carry out the entire service offers<sup>24</sup>.

Many experiences with this kind of small enterprise promotion have been negative, the reasons being either fundamental shortcomings of the approach or concrete problems in implementation.

One basic deficit of the approach is certainly that it does not recognize positive or negative impacts of the economic policy framework. It has become evident that traditional small enterprise promotion can hardly be successful as long as small enterprises are discriminated against by general economic policies. Even if successful, however, the economic efficiency of promotion measures must be doubted. Measures that directly address individual enterprises entail very high financial and personal costs. With limited resources, only a few firms of the target group can be promoted.

Therefore, the problem of selection arises. First there may be unwanted distortions within the small enterprise sector, with some units receiving preferential treatment and others falling behind. Secondly, the discretionary power of the, usually public, agency that is authorized to select will rise. The dangers and negative effects of government and bureaucracy failure are well known, and an increase in rent-seeking activities can be expected. It has to be questioned whether it is sensible to delegate all the responsibilities of small enterprise promotion to a single institution, let alone a public one.

A second major critique of the traditional approach is that its supply orientation is carried too far. Basically, any development of the small

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<sup>24</sup> Cf. UNIDO, 1989, p. 7

enterprise sector is limited by profitable investment opportunities<sup>25</sup>. In the final analysis these are determined by the development of the demand for the sector's products. An effective promotion of small enterprises, many observers conclude, may therefore be most easily reached through an increase in rural incomes. It has to be noted, however, that a major part of rural incomes stems from the activities of small entrepreneurs. Thus, these two areas are interdependent.

A further critique of the traditional approach identifies it with paternalism and little regard for the real needs of small entrepreneurs. The firms' bottlenecks are ascertained by external experts with their own value systems. The support services that are established and subsidized may overwhelm the small entrepreneur and restrict his freedom of choice. The small enterprise becomes dependent on promotion and its direction of expansion.

This leads to a fundamental problem of the traditional approach, the question of how to terminate promotion. If small enterprises were able to improve their performance and market position with the help of subsidised assistance, discontinuing these promotion services may mean a reversion to an earlier state. In practice, programs and projects accordingly always aim at strengthening the independence of the target group in the medium to long run, and proceed from the assumption that promotion is necessary to overcome certain threshold, beyond which no further specific promotion is necessary. Whether this can indeed be achieved and whether this kind of promotion indeed has sustainable results, remains doubtful.

To summarize, the traditional approach to promotion has not delivered the expected results. The reasons are probably not only to be found in poor implementation; instead, they are of a more general nature, having to do with fundamental aspects of the approach.

### **3.2 The Deregulation Approach**

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<sup>25</sup> Cf. Schneider-Barthold, W., p. 75.

This approach, which is also sometimes termed 'neoliberal', may be seen as a reaction to the unsatisfying results of traditional promotion. The point of departure, however, is identical: the perception that the development potential of small enterprises is not fully utilized. The deregulation approach identifies political discrimination and regulated markets of small enterprises as the underlying reasons. The basic hypothesis is that liberalised markets, free price fixing, and undistorted price structures are a sufficient condition for the realization of the development potential of small enterprises<sup>26</sup>.

In accordance with this hypothesis, the advocates of the deregulation approach argue for changing the economic policy framework, and for the state to refrain from intervening into economic processes as far as possible. This is supposed to allow an efficient allocation of resources, within which also small enterprises will have their place and will be able to prevail.

Promotion measures as in the traditional approach are rejected. It is reasoned that while these may be able to help some selected enterprises, they will mainly lead to additional distortions and disturb the optimal allocation of factors.

The deregulation approach must be credited with clarifying the role of the economic policy framework which decisively influences the market conditions for small enterprises. Its critique of traditional promotion measures compels to exactly define the goals of small enterprise promotion, and to question any measures taken. The approach further emphasizes that small enterprise promotion is no end in itself and that the replacement of small by large enterprise structures can be advantageous. "*where labour, capital and total factor productivity are higher in large-scale production, and large firms can produce at a profit without protection or special inducements, there is no case for discriminating against them.*"<sup>27</sup> By clarifying these simple but important insights, the deregulation approach has contributed to a rationalization of the discussion on effective small enterprise promotion.

The strengths of the approach are certainly to be found in the theoretical interpretation of the subject. Its influence on the practical implementation of small enterprise promotion, however, remains modest. On the one hand, this

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<sup>26</sup> Cf. Bruch, M., 1983, p. 198 ff.

<sup>27</sup> Elkan, W., 1989, p. 254

may be explained with political economy arguments: the interests of external donors as well as the recipient governments frequently cause an adherence to traditional, directly enterprise-oriented measures. The deregulation approach expects the developing countries' governments to markedly change their economic policies. As this endangers political rents and influence potentials developed over the years, the attempt to alter economic policies will lead to considerable internal resistance. Most governments, in order not to endanger their own position, therefore prefer the retention of the status quo with the politically less sensitive direct approaches to promotion.

On the part of external donors, it is particularly the institutional structure of promotion activities that may lead to an adherence to traditional measures<sup>28</sup>. The public agencies that administer development aid have already fulfilled their political task when they can report that the resources have flown off. Private consultancies are frequently the intermediaries that are responsible for the design and implementation of promotion, and they are interested in maximizing sales. Thus, they will argue for prolonging projects and for the implementation of similar projects in other places where they can again become project managers. This means that traditional project approaches that may have been outdated for a long time are perpetuated.

However, one reason for the missing practical significance of the deregulation approach must also be seen in its distance from reality. The idealized free market economy can neither be found in any industrialized nor in any developing country. Instead, reality is characterized by a large number of types of market economy, differing from country to country. As undistorted structures exist in no country, and should in fact hardly be attainable, it becomes an irrelevant question whether a free market economy is sufficient for the development of the small enterprise sector. Striving for total liberalisation without accepting existing rigidities cannot be taken as a concrete recommendation for economic policy.

Every deregulation measure has to be judged within the complete framework of economic policy. There is no guarantee that market imperfections will automatically be removed by deregulation. In developing countries in particular, the missing institutional and infrastructural preconditions make a functioning of the market mechanism unlikely. Market imperfections not

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<sup>28</sup> Cf. Feldsieper, M., 1988, p. 280 ff.

only result from public interventions, as the deregulation approach alleges, but also from institutional deficits. This implies, on the one hand, that the state should create the necessary conditions; on the other hand, it cannot be expected that a sufficient adaptation can be reached in the short to medium run, as some of the deficits are related to the general level of development. The conclusion is inevitable that deregulation measures, just as other promotion measures, are only second best and therefore no unequivocal solutions.

The neoliberal reasoning of the deregulation approach has at least led to more attention to commercial aspects of promotion. In order to avoid an even stronger distortion of markets and to facilitate the selection of enterprises to be promoted, the so-called 'commercial promotion' attempts to charge market-clearing or at least cost-covering prices. The main advantage is that the enterprises have to decide which one of the services offered is needed most urgently, and the promotion agency is made to behave according to this demand.

Commercial promotion can be a component of the deregulation approach, but it does not address framework conditions and can therefore not fulfill the expectations of the approach. In addition, it does not deal with enterprises in specific situations, such as the foundation or innovation phase, and consequently leaves the question of whether to subsidise learning costs unanswered. In the final analysis, commercial promotion must be seen as an (rather promising) attempt to make traditional promotion measures more efficient.

Even if its practical significance is still low, the deregulation approach has spread the insight that frequently market position and discriminating economic policy are responsible for the unsatisfactory development of the small enterprise sector. Thus, it has shown priorities and guiding principles of promotion. It should equally have become clear, however, that deregulation measures also constitute interventions into economic structures, can cause distortions, and do not automatically remove crucial problems of small enterprises. Experience has shown, for example, that a liberalised capital market not automatically improves the conditions of access for small enterprises if the social, legal, and monetary environment is not also put right. Deregulation therefore has to proceed in an iterative and synchronized manner. Any measure, be it traditional or deregulating, must be judged

individually with respect to its impacts on the small enterprise sector and the economy as a whole.

### **3.3 Integrating Organisations Above Company Level**

The discussion of the approaches to small enterprise promotion has demonstrated that no panacea can be hoped for. Designing successful concepts requires more sophisticated considerations. In the first place, it has to be borne in mind that the decision for one approach to promotion always has to be related to the country's economic and institutional starting position. To a large part, this will determine goals and methods of promotion.

In a country at a relatively low level of development and with fragmented and regulated markets, the promotion of small enterprise development should primarily require creating the institutional preconditions for an improved functioning of markets. In a country at a more advanced level of development, on the other hand, where market processes already dominate in large areas, interventions to compensate for certain disadvantages or to promote a certain behavior of small enterprises are probably necessary.

Small enterprise promotion apparently is subject to a dynamic that varies contents and methods in accordance with country specific conditions.

The complexity of small enterprise promotion is even further increased by the fact that in no country, there is a homogeneous and uniform small enterprise sector. The units that are conveniently termed small enterprises differ with respect to size, branch, and mode of production. It is obvious that family enterprise from the informal sector has different needs for promotion than a small producer with modern technology. An effective and efficient support for small enterprise development has to take all these particularities into account. An enormous demand for information arises.

This raises the question of the appropriate body responsible for small enterprise promotion. Neither the state nor external donors have the information necessary to carry out such a differentiated and dynamic promotion. Both are aiming at the development process at large, while small enterprise promotion can only represent one part of it. They will therefore lack capacity as well as interest to thoroughly deal with small enterprise promotion. Thus, a delegation of responsibilities to decentralized institutions that are closer to the small enterprise sector appears to be a solution.

This is where the approach of integrating organisations above company level into small enterprise promotion comes in. Its point of departure is the understanding that contents as well as methods of small enterprise promotion need to remain variable in a dynamic view, and that neither state nor external donors have the motivation and the information to identify and implement appropriate promotion measures.

The target groups of the new approach are, consequently, the small enterprise sector's organisations above company level, such as chambers and associations. They can not only offer traditional promotion, i.e., direct services for the small enterprises, but are also suited to represent the sector's interests in improved framework conditions vis-à-vis the government. In most developing countries, organisations of small enterprises above company level have only moderately developed and do not yet have the strength of the respective organizations in industrialized countries. It is expected that by strengthening them, important weaknesses of present promotion can be overcome and the positive components of the approaches discussed above can be brought in. On the one hand, the indirect proceeding of the approach is hoped to contribute to reaching all the diverse small-scale activities. On the other hand, a more problem oriented and efficient promotion is expected from the self-administration organisations, as they are responsible for selecting and executing concrete promotion measures.

Depending on the specific conditions in any country, the most urgent task can be either seen in inducing changes of the economic policy framework or in offering services to remove bottlenecks internal to the enterprises. Chambers and associations are able to become active in both areas. This flexibility makes them appropriate for supporting small enterprises in the long run, i.e. in a changing economic environment. With respect to the sustainability of successes in promotion, it is therefore reckoned that

strengthening self administration organisations is superior to present approaches.

The following concrete advantages are generally expected from an integration of organisations above company level into small enterprise promotion:<sup>29</sup>

- \* proximity to the target group and its problems
- \* strengthening of an indigenous political influence against discriminatory economic policies
- \* problem- and practice-oriented support measures
- \* cost efficient promotion
- \* less red tape and more flexible decision making
- \* participation and control of promotion measures by small enterprise members of chambers and associations
- \* relief of public administrations
- \* improved balancing of interests between public policies and the needs of small enterprises
- \* advancement of the small enterprises' self help capabilities

The fundamental considerations that have led to the development of this new approach to promotion determine that it is to be an indirect approach. It is not the small enterprises themselves but rather the private sector's organisations above company level that become the center of attention. In practice, this implies that institution building must be emphasized. Here, the experience with institution analyses in development cooperation may prove helpful<sup>30</sup>, but there has been a lack of research as to the overall development potential of organisations above company level and the possibilities of supporting them in small enterprise promotion. There is clearly need for corresponding action.

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<sup>29</sup> Cf. Meier, R., Pilgrim, M., 1992, p. 14 ff.

<sup>30</sup> Cf., e.g., Israel, A., 1987

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