International Small Business Series 3

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External Financing of Small-Scale Enterprises in Developing Countries

- Reforms and Innovations within the Commercial Credit Business in Colombia -

edited by:
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This paper is partly the result of field research conducted in Colombia in 1988 supported by the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH and the German Ministry for Economic Cooperation (BMZ).

CONTENTS

Fundamental Issues

1. Introduction

Developing countries are typically characterized by a highly imbalanced distribution of national income and consequently low standards of living. Broad parts of the population suffer from the pressure of partly or entirely unsatisfied basic needs like housing, clothing, and minimum working income. Poor living conditions often go along with low educational levels which in turn worsen employment opportunities and aggravate the difficult income situation in many families. In order to escape unemployment a great number of individuals open up their own small-scale enterprise (SSE) and work as shoemakers, blacksmiths, taxi drivers or independent manufacturers.

Small-scale entrepreneurs, however, frequently don't have any access to the tradititional banking system to satisfy their external financial needs. Therefore it is essential to set up specific promotional credit programs so as to enable SSEs to generate economic surplus and create new income and additional employment. The desgin of these programs necessarily has to incorporate the legitimate interest in profitability of the banking sector since the experience in the developing world shows that SSE loans cause substantial administrative and risk cost.

In aiming at gradually solving the apparent contradiction between formal banks' legitimate postulate of return on investment and the development objective of improving credit markets' efficiency by enlarging the small enterprises' share of credit through the provision of technical project-oriented assistance, the authors conducted field studies in Colombia. This research in 1987 and 1988 has been supported by the German Corporation for Technical Cooperation (Deutsche Gesellschaft für Technische Zusammenarbeit, GTZ GmbH) in connection with the German Ministry for Economic Development. Some of the results and conclusions elaborated will be presented in the following paper.

2. Capital Markets in Developing Countries

As opposed to the situation in the industrialized world, in developing countries there exist relatively high costs of investment capital for small firms than for larger enterprises. This segmentation of capital markets in Third World countries can be detected by the limited access for SSEs to loans and by higher costs of lending to these firms. Disadvantages as to receiving external financing, however, may in part reflect higher administrative and risk cost of borrowing to the SSE sector. Only if an additional, not cost-related creditary discrimination of small firms can be identified, there is a case to talk about adverse distortions in capital markets of developing countries[1].

Screening and administrative procedures necessitated by any credit contract are subject to significant economies of scale. This is why the administrative costs to banks - per unit of principal - rise with decreasing loan sizes[2]. If it is not feasible to standardize to a large degree the checks of creditworthiness for loans to small credit customers, SSEs will have to be charged higher interest rates and/or credit commissions. Collateral offered by the small entrepreneur improves the creditary risk and enables banks to charge a lower risk premium.

Lacking business experience that characterizes many ambitious entrepreneurs increases the risk of default and raises the cost of lending, especially in the case of newly established firms. Higher interest charges will in turn raise the expected value of a loan only up to a certain point, since a borrower will not be able or willing to repay his credit when facing highly increasing cost of borrowing. It is likely that there is some maximum rate of interest which has to assure that all expected costs and risks are covered, otherwise there will be no credit market at all[3].

It stands to reason that rising administrative and risk cost generate for higher costs of lending to SSEs and apply equally to industrialized as well as developing countries. However, financial institutions of the formal banking sector in developing countries are especially handicapped when they seek to reduce the risk of default by an intensive contact with their small-scale, often informal credit customers. Weak financial infrastructures in many Third World countries don't go as far as suburban or rural areas, and poor communication facilities make it even more difficult to keep in touch with customers. The resulting informational distance to SSEs allows for only an unclear picture of the economic situation of would-be borrowers, reduces the amount of pressure that can be exerted on the debtor and makes a credit contract less likely.

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1) See Koch (1988), pp. 12f

2) See Anderson/Khambata (1981), p. 4

3) See Anderson/Khambata (1981), p. 3, also Little (1987), pp. 218f

Because of these market-immanent reasons SSEs in developing countries often don't have any external capital from formal banks at their disposal when opening up their business. To a very large extent investment capital comes from personal savings, the sale of real estate or jewelry and from funds provided by relatives and friends[4]. Working capital is occasionally financed by professional moneylenders of the informal banking sector who charge very high rates of interest. Consequently, small-scale entrepreneurs try to minimize their loan volume from informal sources by keeping low stocks of working capital. Inputs are then purchased out of sales revenue which in turn increases the dependency of SSEs on the liquidity of their customers and renders them more vulnerable in the case of market fluctuations. Lack of working capital has also been considered as one of the major reasons for the incapacity of SSEs to keep standardized products in stock[5].

Many governments in developing countries try to improve access of SSEs to external capital by institutional interventions in capital marktes. Examples of such government action are legally fixed interest rate ceilings for SSE loans far below equilibrium levels, promotional rediscount arrangements for SSE loans, specialized credit intermediaries and development finance companies, and reserve requirements for commercial banks in order to generate funds for SSE loans. In practice these instruments frequently prove to be counter-productive since they tend to reduce the prospects of very small and informal enterprises to receive subsidized loans: Within a given range of business sizes credit intermediaries will prefer to allocate promotional loans to the largest legally possible enterprises and thereby reduce their risk and administrative cost given low levels of fixed maximum interest rates[6]. Therefore, the objective to reduce the cost of external capital for SSEs through government intervention has often not been achieved.

Furthermore, most of developing countries' governments reserve special loan portfolios for large industrial firms - especially exporting enterprises - with the consequence that the available national volume of investment capital is further reduced. Scarcity of finance will raise the cost of capital and is going to worsen the probability for SSEs to receive loans from the formal banking sector at promotional interest rates[7].

The main source of finance for SSEs in developing countries are personal savings of the entrepreneur. This is why the actual cost of capital for small

4) See Lewin (1980), pp. 29f, and Page (1979), pp. 20f

5) See Page (1979), p. 22

6) See Little (1987), p. 220

7) See Child (1977)

firms should not be measured in terms of the interest cost of loans but rather by the private opportunity cost of savings capital[8]. This, however, implies that small-scale entrepreneurs are in a position to freely decide whether either to keep their savings and to look for work as an employee, or to undertake investments to build up their own enterprise. Given poor employment opportunities the latter alternative is often the only way to secure a family's income[9].

If an entrepreneur's savings were to be deposited in a savings account of the formal banking sector the investor could earn only little interest income (implying low opportunity cost of capital) since the combination of high inflation rates and low ceilings on interest rates leads to low or even negative real rates of return on savings capital in a great number of developing countries. An alternative choice could be the placement of funds as a deposit in informal capital markets. Because of missing competition, however, deposit rates in the unorganized private sector are also very low[10]. Finally the entrepreneur could open up his own informal lending business and receive rather high interest rates. Both an individual's lack of financial knowledge and high risk aversion, however, don't make this choice appear to be a realistic one[11] so that investment in the own productive enterprise - with low opportunity cost of capital - often remains the best and only choice to earn a living.

In summary, capital cost of self financing SSEs can be considered as rather low because of missing alternative investment opportunities in developing countries. As external financing becomes inevitable with growing business size the costs of credit and capital rise significantly. This is due to a lack of transparency and size with regard to informal capital markets: It is also due to distortions with regard to the formal sector credit business caused by inadequate promotional government intervention. It is only upon a massive growth in overall firm size that formerly small enterprises will experience diminishing cost of external financing - eventually down to interest levels for medium- and large-sized industrial companies.

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8) See Little (1987), p. 220

9) See Schmitz (1982), pp. 434f

10) See Steel/Tagaki (1983), pp. 426f, also Page (1979), p. 23

11) See Little (1987), p. 221

The Colombian Setting

3. The Role of Small-Scale Enterprises in Colombia's Development

As in the case of other middle income countries, Colombia has reached a level of industrialization where decreases in the manufacturing employment share of household activities go along with increases in that share of small workshops and factories. Large industry, however, does not yet play a major role in total manufacturing employment[12].

Colombia's National Planning Department estimates the number of small-scale enterprises to be 1 million by mid-1988 with half of these firms being located in urban areas[13]. DANE's definition of SSEs includes units with less than 10 employees, monthly sales up to Pesos 1.5 million (about US$ 5,000 in fall 1988) and total assets not exceeding Pesos 6 million. Total employment in such enterprises is about 4.6 million, equivalent to 40 % of the economically active population. This average employment share is significantly higher for rural areas (54 %) compared with urban regions (32 %). Focussing on the lowest income bracket with monthly earnings up to the legal mimimum wage, employment in SSEs rises to an impressive 67 % of total employment in rural and 36 % in urban areas.

Small-scale enterprises are to be found in all branches of the Colombian economy. They are assumed to make up 56 % of manufacturing firms, 81 % of the service industry and 35 % of the country's retailers. The majority of these small firms belongs to the informal sector[14] of the economy which is characterized, among other things, by the fact that firms concerned are not legalized - though officially tolerated and partly supported - and lack access to sources of commercial credit. Accordingly the level of self-financing out of savings and contributions by relatives and friends is relatively high, ranging from 73 % to 95 % of total investment in the Colombian SSEs sector[15].

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12) See Anderson (1982), pp. 914-918

13) See Departamento Nacional de Planeación (Dane) (1988)

14) The conception of the "informal sector" was first introduced by the ILO mission to Kenya in 1972. See International Labour Office (1972), p. 6

15) See Cortes, et al. (1987), p. 133

4. State-Financed Small-Scale Enterprise-Promotion in Colombia

Considering the important role of SSEs in Colombia's national employment and taking into account the general merits of the SSE-sector within Third World countries' development[16] it becomes very clear why there has been growing concern about adequate promotional measures on part of the country's government.

Offical credit to small and medium enterprises - provided mainly by the Corporación Financiera Popular, commercial banks, and development finance companies - has increased rapidly in the late 1960s and early 1970s. The ratio of formal banking sector loans given to small and medium enterprises in relation to the value added of these enterprises was less than 10 % in 1968; by 1978 this figure has risen close to 15 %[17]. Later, in 1984, the Colombian government set up the first "National Plan for the Development of the Microenterprise, 1984-1987", followed by a second such plan in 1988[18]. According to the latter plan Pesos 8.3 billion (about US$ 27.5 million) will be spent by the end of 1990 to provide basic business training as well as on-site advisory services for a total of 50,000 small-scale entrepreneurs. Participating agents are 42 private organizations, the chambers of commerce, various banks, some international organs and a variety of governmental agencies.

A key component of both national promotion plans is the provision of subsidized credit to microenterprises (total of Pesos 5 billion in the period 1988-1990). The major part of these funds stems from three multi-million US$-loans by the Interamerican Development Bank (IDB) to the Colombian government. Small enterprises are charged a 23 % interest rate, which is equivalent to a substantial negative real interest taking into account Colombia's average yearly inflation rates ranging from 25 % to 30 % over the past years. Repayment of the IDB loans in US$ at maturity is guaranteed by the government which covers all losses that arise out of devaluation of the Peso against the US$.

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16) For an overview of arguments in favour of SSE promotion see König/Peters (1985a), pp. 58f, also Koch (1988), pp. 7-27

17) See Cortes, et al. (1987), p. 217

18) See Departamento Nacional de Planeación (1984) and (1988)

Credits are given on the basis of the Cali-based CARVAJAL Foundation model, which during the past 12 years has been adopted by banks and private organizations of seven other Latin American countries. The major idea behind this model relates to the idea that there are two main obstacles which prevent SSEs from unfolding their important development potential: Firstly, inadequate organization of business and lack in entrepreneurial know-how, and secondly, lack of access to external sources of financing. Consequently, credit facilities as well as educational and consulting elements have been incorporated into this promotional conception.

In order to obtain external financing the entrepreneur must have been identified, motivated and qualified as eligible to participate in special training courses offered by one of the country's mainly private non-profit foundations. This education consists in mandatory accounting, cost and marketing classes of generally two-months duration, followed by a rigorous analysis as to whether credit is actually the bottleneck of the small firm's development. Given the real need for external financing, the foundation assists the small-scale entrepreneur to set up an investment project and to present his or her loan application to an affiliated bank. A joint bank-foundation committee finally has to approve the credit. The foundation's work, however, is not yet completed until it has provided continuous assistance in the small firm's daily operations during the repayment of the loan, although financial restrictions often force these institutions to cut back on that service.

Seemingly, this approach is a promising vehicle to improve the generally poor knowledge formal financial institutions possess about small-scale loan applicants without producing high administrative cost per unit of principal. Risk cost, however, remains on significantly higher levels than in the case of larger firms as credit customers: Empirical evidence shows that participating Colombian banks suffer average default rates of 15 % to 20 % on their SSE loan volume with more than 45 days of repayment delay. Poor legal norms and unsufficiently staffed legislative authorities dont't allow to take fast legal action against the borrower. Furthermore, low SSE credit volumes of US$ 1,500 on average would not justify the costly prosecution of bad loans.

Even if a bank does succeed to sue for repayment of a debt it often fails to collect the amount of the loan since collateral provided by the SSE does not have any significant commercial value. If there are no specialized guarantee funds for SSE loans available the bank will have to cover the entire loss which in turn reduces its willingness to engage further in SSE credit business. Therefore, in order to promote further lending to small-scale enterprises innovative reforms are necessary to solve the apparent conflict arising from Colombian banks' legitimate postulate of profitability and the development objective of enlarging the small enterprises' share of credit in that country.

Results of Empirical Research

5. Target Group-Oriented Analysis of Needs

5.1. Specification of the Survey Conducted

Analysing and possibly improving banks' performance in small-scale credit business requires a solid understanding of the typical needs and problems faced by their small-scale clientele. Therefore, surveys were initiated to interview a total of 52 SSEs in urban and suburban Bogotá as well as in its rural vicinity.

One of the survey's objectives was to answer questions about the creditworthiness and the financial standing of small enterprises, a central focus being the comparison of urban-based with rural small firms. Evidence had to be searched as to the hypothesis that in rural areas SSEs' demand for external financing exceeded by far the available supply of credit capital, but that at the same time rural SSEs did not constitute a worse creditary risk than their urban equivalents. Accordingly, 21 enterprises have been interviewed in urban regions, 12 in suburban areas, and another 19 firms in the very countryside.

The randomly chosen firms are all of rather young age with 60 % of them operating for less than four years. They rely heavily on family labour, the corresponding percentage share rising from 29 % in urban and 38 % in suburban to 56 % in rural areas. This reflects lower opportunity cost of labour in rural regions where employment opportunities outside the small-scale family firm ("famiempresa") are clearly more scarce than in urban regions.

Concerning the educational level of SSE owners there is a clear difference between urban and rural small firms: While 58 % of entrepreneurs in the countryside did only attend elementary school (with no one attending university at all) 55 % of urban small-scale entrepreneurs did receive secondary education and another 30 % went to university. Academic education, however, is no suitable indicator of entrepreneurial ability or technical knowledge. The latter depends mainly on the practical experience of a business owner which is not necessarily correlated with the location of the enterprise.

5.2. Basic Firm Characteristics

Production

In the productive area, urban microenterprises employ more modern machinery than their suburban and rural counterparts, the average equipment age ranging from 4 years in the former to 6 and 7 years in the latter two groups, respectively. However, the degree of capital utilization is remarkably high in all three subgroups, averaging 70 % of the technically feasible time of usage.

The older age of productive equipment in rural areas corresponds with the fact that in the countryside machines are up to 80 % used equipment acquired from other small enterprises compared to a low 33 % for urban small firms and 50 % for suburban enterprises. Accordingly, 17 % of the firms located in urban Bogotá bought imported new machines from the developed world with this percentage share decreasing to 14 % for suburban SSEs and even 0 % for rural small firms. A similar picture can be drawn for the kind of sources that raw materials and intermediate inputs are purchased from since rural small enterprises are buying exclusively from local and regional sources in their vicinity.

Personnel

On average, SSEs in the survey have between two and three permanent employees in addition to the owner of the firm. The majority of blue-collar workers in the productive area have been able to acquire specialized technical knowledge before entering the enterprise. Personnel is mostly employed on a permanent basis and comes from the very vicinity of the firm's location.

Firms outside urban Bogotá require lower educational levels than urban enterprises when they plan to hire new employees. Only 6 % of rural small enterprises expect their personnel having received more than primary education whereas this percentage amounts to 40 % in urban regions, accounting for the gap in scholastic infrastructure between urban and rural areas within Colombia. Training on the job takes about three months for unskilled new employees. There is a remarkably low rate of personnel fluctuation with an average time of affiliation to the enterprise of about 18 months.

Productivity and Profitability of Operation

It proved to be a difficult task to estimate reliable data on the profitability and income situation of the small enterprises in the survey. Since they generally don't keep explicit accounting records, small firm's financial transactions often cannot be separated from household's income flows[19]. This is especially true for those entrepreneurs that have not yet been trained by one of the specialized non-profit foundations mentioned above. Therefore, high values found for productivity and profitability should be handled with caution in their absolute terms.

There is, however, a clear positive tendency in favour of rural small-scale enterprises: Total capital productivity (commercial value of monthly production divided by value of total business capital) averaged 45 % per month compared to 24.5 % and 25 % in suburban and urban small firms, respectively. A similar picture results from comparing total capital profitabilities (net firm's income divided by value of total business capital) with rural SSEs reaching an average value of 17 % per month versus 8.5 % and 6.5 % for suburban and urban SSEs, respectively. Both observations reflect rather low capital/labour ratios in rural small-scale production and demonstrate that already low levels of external financing are likely to result in substantial increases in production, sales and profits in accordance with very favourable impacts to be expected on employment.

5.3. Financial Problems and Needs

Asked about the access to commercial credit, half of all SSEs in the survey answered to receive loans from the formal banking sector or thought to be in a favourable position to obtain external financing if necessary. This average, however, decreases to a low 20 % among the rural subgroup accounting for the above-mentioned reluctance by urban-based banks to provide credit to rural small-scale borrowers due to uncertainty and high transaction cost. The

19) On average 60 % of SSEs in the survey had only poor business records or didn't keep any books at all. This value was even higher among rural small firms (80 %) due to poor availability of adequate training opportunities for cost accounting.

issue of transaction cost is also a major complaint brought up by entrepreneurs themselves who consider banks' application procedures to be too complicated and time consuming.

Firms without access to commercial credit are generally characterized by a lack of collateral which seems to be the main obstacle to receiving loans. Hence, one objective of an innovative approach towards small-scale external financing has to be the design of collateral equivalents fully acceptable by commercial banks. A second important reason for failing to successfully apply for commercial loans is - again - the amount of bureaucractic action required by formal credit intermediaries. This point emphasizes the central role that non-profit foundations play in assisting SSEs to prepare and present their investment project to banks.

About 40 % of small-scale entrepreneurs have acquired additional experience with informal moneylenders and state that their effective average loan interest rate reached nominal values of 100 % per annum and above. In 96 % of these cases interest charges are considered to represent a very severe burden to the firm. Again, the rural percentage share of informal credit is significantly lower than the corresponding urban percentage share (32 % versus 53 %, respectively), a fact that highlights the sometimes poor - formal as well as informal - financial infrastructure in Colombia's rural areas.

On average, the loan size desired by all small-scale entrepreneurs equals Pesos 1.1 million (about US$ 3,700), which is substantially larger than the actual National Plan's average loan volume of Pesos 220,000. Therefore, increasing the IDB-loans' upper credit limit of US$ 3,000 (equivalent to Pesos 1 million in December 1988) to US$ 7,500 within a newly created additional IDB facility was an adequate measure.

In most of the cases, small-scale entrepreneurs aim to make a joint investment in fixed assets and working capital, the ratio of volumes being around 1:2. 30 % of SSEs with creditary needs of up to Pesos 500,000 (mainly to purchase raw materials) believe that they were in a position to repay such loans within one year. Another 40 % of this subgroup could arrange repayment within a two-years period. Firms with credit volumes as far as Pesos 500,000 desire mostly more than 2 years for complete repayment of loans. These needs and estimations correspond to a large degree with the actual credit conditions postulated by government for promotional loans approved inside the National Plan.

42 % of SSEs don't have any significant collateral at their disposal. On the other hand, small firms with larger amounts of assets seem to be unusually well equipped with would-be collateral averaging around Pesos 2 million. The corresponding values for the rural, suburban and urban subsamples are Pesos 1.2 million, 2.2 million, and 2.6 million, respectively. Such an inhomogeneous picture requires a great deal of flexibility on the part of financial intermediaries when dealing with small-scale clientele.

Questioned about firm-specific strengths that could have positive impact on SSE's creditworthiness entrepreneurs mentioned mainly three factors: Product quality, entrepreneurial skills, and high growth potential due to strong market demand for the products offered. Weak points with an unfavourable influence on the firm's creditary standing - according to the firm's owners' point of view - are poor organizational structures, low technical standards of production and insufficient maintenance of equipment. Consequently there is strong interest among practically all small-scale entrepreneurs (91 %) as to receiving on-site consulting services provided by non-profit foundations.

Faced with the option to participate in any kind of innovative credit guarantee scheme, only 20 % of the firms knew about the very existence of such schemes, but 78 % expressed their interest to become member of a local solidarity group. This interest is strongest among urban SSEs (95 % versus 67 % and 64 % among suburban and rural SSEs, respectively). The main motive for unwillingness to join guarantee groups with mutual liability is difficult or even hostile business relations with local competitors.

Monthly contributions to an additional group-based guarantee fund could average as much as Pesos 4,000 (about US$ 17), which would easily result in group savings volumes of 10 % of total group credit within one year's time. These savings could serve as additional collateral for financial institutions, increasing the creditworthiness of solidarity group members and reducing the perceived riskiness of loans to small-scale firms. Thereby, banks could be induced to raise their respective credit share in the small-scale sector.

5.4. Other Problems

Besides their internal financial needs and the desire to receive consulting assistance about 70 % of SSEs in the sample assign high priority to an improvement of the country's overall economic situation (i.e. reduction of inflation) and to reforms of regulations concerning the private sector (i.e.

making it easier and less costly to register a SSE with formal legal status). Another 53 % mention poor solvency among their clients as an important constraint to their business. Lack of SSE self-help organizations (49 %), strong market competition (40 %) and insufficient demand for products (36 %) are further obstacles which prevent SSEs from growing further.

Finally, about 25 % of SSEs in the survey complain that there are only little sources of information about the financial and consulting assistance available to small firms in the country. Another 25 % understand that their accounting records are not sufficiently well kept and should be improved; 23 % criticize their own efforts in planing production and selling their products and beleive that there is a lack of know-how in marketing. No major problems are seen in the areas of product quality, personnel training and skills, and in personnel costs which tend to be particularly low in rural areas[20].

5.5. Summary of Problems and Needs

On the basis of the interviews held with the target group it is possible to identify the set of relevant problems and needs faced by Colombian small-scale enterprises in general and, more specifically, faced by rural small firms. As a result of empirical research two key areas of possible assistance have been defined.

The first area covers the financial problems of SSEs. Credit conditions of formal credit intermediaries permit only rather short maturities of loans and low maximum loan volumes. An important obstacle to receiving commercial loans is the lack of collateral in a great number of rural small firms. Alternative external financing from informal moneylenders - with lower collateral requirements - leads to very substantial interest charges. To some SSEs the bureaucratic requirements of loan applications are very high and discouraging. Finally the rather centralized financial infrastructure in Colombia is not able to reach SSEs located in rural and suburban areas.

The second area of possible assistance includes non-financial deficits and needs of small firms. Organization of business is often inefficient, there are deficits in the fields of book-keeping and cost accounting, efforts and general knowledge of how to use marketing instruments are rather poor, and many entrepreneurs lack technical know-how to correctly use and maintain their equipment. SSEs would like to be better informed about possible training

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20) For a more general discussion of growth constraints on SSEs and their typical problems in the developing world see Schmitz (1982)

and on-site assistance provided by the country's non-profit foundations. There is strong interest to participate in self-help organizations of the SSE sector - apparently without being in a position to set up corresponding organizational structures.

Problems and needs of financial nature can be tackled through reforms and innovations of the commercial credit system in Colombia. Other problems of the kind described above are mainly subject to the efforts of non-profit foundations in that country.

Reform and Innovation of Commercial Credits

6. Ten-Points-Catalogue

Based on the experience that participating Colombian banks have made during the past six years of the National Plan's operation, and taking into account the small-scale firms' financial needs and constraints revealed through means of the survey conducted, a catalogue of innovative recommendations is elaborated for the future conduct of the National Plan's small-scale credit program. The following ten measures could result in a situation in which the banks are assured of their profitability on small-scale loans while at the same time improving SSEs' creditworthiness and increasing their share of credit in the national capital market.

6.1. Separate Credit Conditions for the Commerce Sector

Analysing the structure of bad loans shows a nearly twice as high default rate among small retail firms as compared to manufacturing and service microenterprises. Unlike the latter two branches, retailers in Third World countries typically don't have any significant amount of fixed assets which could serve as collateral. In addition, the structure of their financial needs is different from other industries since their business involves short-term financing of working capital with instant loan availability and daily or weekly repayment.

These observations stress the importance to design specific credit conditions for small-scale retail customers that include an extensive on-site monitoring component in order to respond to the highly fluctuating and vulnerable nature of their business. In addition to personal visits by bank or foundation staff it is also necessary to redesign and intensify loan repayment control for the commerce sector. Finally further studies should be undertaken to evaluate possible factors and indicators that might have an influence on the specific risk of default when loans are approved to small-scale retailers.

6.2. Less Loan Approvals for Newly Established Firms

From a development economics point of view, establishing new small enterprises is highly valuable since employment generation in new firms requires relatively less capital input than in already existing enterprises.

Banks, however, are facing a larger degree of uncertainty about expected returns on investment when financing new firms than in the case of established small-scale enterprises. The latter are in a position to present a history of business activity whereas new firms only possess an investment project based on estimations and possibly unrealistic assumptions about market demand and expected sales. Furthermore, there are no specific credit conditions that would match the financial needs and possibilities of newly established enterprises. Examples of such needs are enlarged maturities and grace periods, reduced collateral requirements, increased maximum loan volumes, and an intensified follow-up consulting after loan approval.

It is indispensable, therefore, that banks seek for an association with Colombian foundations specialized on the promotion and education of new entrepreneurs, thereby reducing uncertainty without an increase in transaction cost. Until there exist a sufficiently large number of qualified non-profit foundations[21)], Colombian formal banks should leave the small-scale credit business with new firms mainly to informal moneylenders.

6.3. Extension of Loan Application Evaluation Criteria

Colombian banks tend to rely heavily on credit evaluation criteria that focus primariliy on the financial situation of the small-scale borrower. Most important is the amount of real estate and other assets available as would-be collateral. In summary, the following five evaluation criteria are typically applied when banks judge whether a SSE loan applicant should be considered as creditworthy or not:

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21) Some of the few existing examples in Colombia are the Fundaempresa foundation with offices in Bogotá and Cali and the Cartagena-based foundation Funcop.

- Past year's income and profit
- Commercial value of plant, equipment and real estate
- Amount and maturity of loans from other banks
- Solvency of guarantors
- Quality of existing past business relation with the SSE

Given the poor financial accounting records of many small-scale enterprises in Colombia, however, other than financial criteria should receive greater attention by bankers. A future-oriented project evaluation requires in the first place detailed information about the quality of the SSE owner's entrepreneurial skills. There is a whole set of additional non-financial evaluation criteria that should be considered in the decision process:

- *Managerial qualification of the entrepreneur*

  (educational level, technical know-how, entrepreneurial skills, knowledge of the SSE's product market situation, agility, integrity of character)

- *Succession of entrepreneur* (secure/ uncertain)

- *Structure of personnel*

  (educational level of staff, geographical origin)

- *Stability of personnel*

  (fluctuation of personnel is rather high/ low)

- *Production process*

  (degree of utilization of equipment, technological level)

- *Product characteristics*

  (quality of products, stage that has been reached in the product cycle)

- *Market standing of products*
  - Since when are products sold in the market?
  - How strong is the position of competitors?
  - How did market demand fluctuate in recent years?
  - Has there any market research been done?

- *Hidden risks on input side*

  (dependency on specialized inputs, reliability on punctual supplying, quality and priceworthiness of raw materials and intermediate inputs)

- *Hidden risks on output side*

  (existence of monopolistic buyers, dependency on fashion trends, share of production on order of single clients)

- *Utilization of profits in the past years*

  (complete distribution of profits or partial retaining of earnings for the purpose of reinvestment into the SSE)

Applying these credit evaluation criteria will necessarily go along with a rise in administrative costs faced by banking institutions. At the same time, however, banks will be able to select more efficiently those SSE investment projects that are worth it to be financed. On balance, reductions in the amount of losses due to bad loans - brought about by improvements in creditary risk - will very likely more than compensate for the rise in loan evaluation cost. To keep banks' transaction cost on lowest levels possible the provision of additional information of the kind described above should become part of the foundations' work when setting up the investment project.

6.4. Gradually Growing Loan Sizes

Credits to new, historically unknown small-scale borrowers are more risky than revolving loans. This is especially true if the small-scale entrepreneur has no preceding experience with external financing out of formal sources since he is not yet used to monthly and punctual repayments. He also underestimates the financial consequences of late payments (penality interests, legal action) and he does not fully understand how banks usually proceed to enforce repayment of loans. Financial intermediaries, on the other hand, have a hard time to evaluate the ex-ante reliability and integrity of a new and unknown loan customer.

Hence, banks should more than in the past show a risk averse behaviour concerning new small-scale customers applying for commercial loans. That is, credits to new customers should start out with low maximum loan amounts and rather short terms up to one year of maturity. This implies an initial concentration on working capital financing. SSEs are then in a position to learn how to use external capital in a profitable way and how to reserve funds in order to assure punctual repayment of principal and interest. Banks, in turn, are given the opportunity to closely observe their new small-scale customers without taking significant risks due to low initial loan sizes.

Upon successful investment and punctual repayment of the first loan, banks can revolve credit and allow for a longer maturity. With each further repetition loan volumes will then be increased stepwise until banks might grant up to the largest loan possible within the Colombian National Plan. Due to the accumulation of information and knowledge on behalf of both the firm and the bank during that process, there is a good chance that long-lasting debtor-creditor relations will emerge. SSEs' creditworthiness increases steadily since they are building up a successful record of loan repayment that can also serve for loan applications with other financial intermediaries. Banks are able to immediately cut off the process of growing loan sizes whenever it seems necessary for reasons of risk limitation.

6.5. Formation of Mutual Guarantee Associations

A key component towards strengthening the weak collateral position of Colombian SSEs is the formation of solidarity groups among small-scale borrowers. The development potential of such mutual guarantee associations has been elaborated extensively in the literature on SSE promotion[22]. Furthermore, it is the strong interest of entrepreneurs in the survey to become part of local solidarity groups that justifies the high priority assigned to this specific topic.

From a *development economics point of view* promoting a single small-scale firm by means of individual creditary assistance through commercial banks or development finance companies does not constitute a promising approach as to removing SSEs out of their isolated position in a development country's society. Only if small-scale entrepreneurs join together to form any kind of interest group, association or cooperative they are given the possibility to increase their social and economic weight in society. Besides pure access to credit, associations may for example serve as a vehicle for cheaper joint purchase of rawmaterials and intermediate inputs. Members will also profit from an association's ability to satisfy larger volumes of demand that could not be served by a single SSE. Under ideal circumstances, partly or entirely joint production can also be part of a close cooperation among small firms.

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22) For an overview of different group-based credit schemes see International Labour Office (1984), also Levitsky/Prasad (1987)

Most important, however, the joint unlimited liability principle implied by group lending will effectively facilitate each member's access to commercial financing. For stability reasons group size should not exceed 15 members with a miminum size of 3 or 4 member firms. Group formation should be promoted by Colombia's non-profit foundations the main obstacle probably being as to convincing competing SSEs to collaborate for reasons of mutual benefit.

From the *banks' profitability point of view* the joint liability principle will prove to serve as an effective substitute for conventional collateral, mainly due to strong peer pressure and collective responsibility of repayment in case one member fails to repay his loan in time. It is the vital interest of member firms to assure punctual repayment in order to keep association's creditworthiness on high levels. This will be motivating enough to assist a specific fellow member with technical or even financial aid whenever this member is in danger of defaulting on a loan. Consequently, banks' creditary risk of bad loans is reduced, and expected profitability on SSE loans is improved.

Furthermore, guarantee associations can contribute to a cut back on banks' transaction costs by providing information about group members' financial standing and by assisting within the process of loan evaluation, control and repayment - again with a positive impact on expected earnings of financial intermediaries.

Loans given for the purchase of *working* capital should be assigned to the guarantee association as a whole and not to a specific group member for reasons of administrative costs to banks. It is then within the solidarity groups' responsibility to set credit conditions and selection criteria through some kind of elected group committee. Loans to acquire *fixed* capital assets, however, should be kept within direct supervision and control of the financial intermediary and be given to single association members due to the larger credit volumes involved.

6.6. Group-Based Savings as a Collateral to Banks

Associations' creditworthiness can be increased even further by mobilizing savings inside groups of small-scale enterprises which will serve as additional collateral to formal sector banking institutions[23]. Again, survey results

23) For African examples of successful savings mobilization within savings and credit associations see Seibel (1984)

indicate strong interest among entrepreneurs to participate in such an innovative approach.

The major argument in favor of improving creditworthiness through group-based savings is the incentive effect that underlies the group liability principle which is now being extendend on group savings. In case of delayed loan repayment giving rise to a critical total loss banks are entitled to charge groups' savings accounts which will do harm to each member firm in addition to the defaulting SSE. Technical and financial assistance by fellow SSEs will therefore be provided in order to assure in-time repayment of each loan given to group members. If joint savings are not sufficient to cover banks' losses further payments by each group member are to be made according to the above-mentioned mutual guarantee commitment.

The ratio between total group borrow and group saving should be a dynamical one, that is, minimum group savings requirements should decrease from an initial 20 % of total group loan volume to 10 % or less depending on the association members' repayment performance. Given a savings volume this procedure will guarantee a steady growth of external financing volume. At the same time an incentive to accumulate additional savings is provided since larger group savings will entitle to larger group borrowing.

6.7. Modified Procedures to Enforce Repayment

Colombian banks usually allow their borrowers a three months period of overdue payments before they take any legal action against the debtor. However, after the accumulation of three quotas including substantial penalty interests only few small-scale enterprises are in a position to pay back their debt, given for instance that the firm's owner was unable to work during several months on account of reasons as to his health. That is why repayment enforcement should be modified such that banks will take legal action after any delay of payment of more than 30 or 45 days. It is essential that these procedures be explained to the borrowing firm very clearly once a loan is granted.

Entrepreneurs who are able to foresee that they won't be able to fulfill their upcoming payment commitment are required to notify their lending institution accordingly and in advance. Banks will then decide whether or not the justification for payment delay is acceptable, possibly resulting in postponing the deadline of the next payment until the underlying circumstances within the firm will have changed.

6.8. Intensive Follow-up Consulting after Loan Approval

The proven cooperation between non-profit foundations and the formal banking sector should be continued in the future. As in the past banks will concentrate on evaluating and approving loans and will also be responsible for repayment control and enforcement. Foundations, in turn, are assigned the task of identifying and selecting small-scale entrepreneurs and to motivate business owners to participate in training courses of the various types described above. Before applying for commercial financing on-site advisory services have to be provided in order to clearly differentiate those SSEs with the lack of loans as a binding constraint for the firm's growth from other enterprises without urgent financial needs.

As an important factor for determining default rates and banks' profitability many foundations lay high emphasis on follow-up assistance after loans have been given to SSEs. Most Colombian foundations have to reduce this service due to their limited financial ressources. The CARVAJAL foundation in Cali estimated the total cost of a complete 2-years on-site assistance to sum up to an average of US$ 250. However, at best only 30 % of this amount can realistically be borne by the small-scale enterprise.

The central role of consulting services upon credit approval cannot be overestimated. First, establishing a close relation between SSE and foundation enables the latter to verify the correct use of the loan amount according to the mutually agreed-on purpose. Second, assistance provided during the process of acquiring equipment and putting it into operation will assure fast and smooth integration of new machines into production. This is, thirdly, the prerequisite for punctual repayment of principal and interest. Finally, monthly consultations with the SSE up until maturity of the loan will give the business owner the impression to be under permanent joint observation by the foundation and the financial intermediary in that any attempts of fraud incorporate a high risk of being detected instantaneously.

All these arguments point out the importance of follow-up assistance in order to reduce default rates on SSE loans and, consequently, to improve expected profitability of commerical credits to the small-scale sector in Colombia.

6.9. Provision of Technical and Organizational Support

In interviews held with foundations, interestingly enough these organisations pointed out two areas of strong self-criticism. Pre-credit education provided by Colombian foundations generally does not include any *technical* instruction or assistance. Given the importance of technological skills for maximum use of capacity and maintenance of equipment it should be considered as a central goal for the future performance of the National Plan to build up technical knowledge and competence among foundation staff.

The same criticism applies to deficits in the area of *organizational* support which has been underestimated in the past. Besides questions about the organizational structure of single SSEs such support would include assistance to build up solidarity groups and mutual guarantee associations among local small firms. Finally, special efforts should be incorporated within SSE consulting that would promote the formation of self-help organizations in order to strengthen the economic and political role that small entrepreneurs play in the Colombian society. A central element of economic cooperation between SSEs on local and regional levels should be the promotion of joint sales through specialized marketing corporations.

6.10. Formation of Guarantee Funds by Banks

As a final security that would cover losses incurred when small-scale credit customer default on loans, banks should consider to establish their own guarantee funds. These could be designed as independent guarantee organizations that are supported financially by a large number of national commercial banks and international contributors like the IDB or developed countries' governments. Guarantees given would involve the payment of a premium with the amount depending on the size of the loan.

In 1983, the Colombian government set up the National Guarantee Fund (Fondo Nacional de Garantía, FNG) that charges a 2 % per annum guarantee fee based on the guaranteed portion of the loan. Those small and medium firms are eligible which employ less than 150 employees and meet certain restrictions on fixed assets and the volume of sales. Although the FNG is available to all institutions in the banking system its impact on guaranteeing small-scale loans in Colombia has been rather small[24)].

24) See Levitsky/Prasad (1987), pp. 81f

In addition any single bank or group of local banks can build up individual funds for risk reduction. It is essential that such internal guarantee funds are not made public to would-be borrowers: In knowing that losses due to default will eventually be covered by an anonymous guarantee institution, debtors might count on the existence of only very small incentives for banks to rigorously sue late payments and bad loans. Although such line of thought would represent a complete misjudgement the sole knowledge of guarantee funds could reduce a customer's willingness to correctly repay his or her loan.

7. Concluding Remarks

In summing up, increasing small-scale enterprises' share of external financing in Colombia requires that those parameters which are the cause of imperfections in domestic capital markets and the reason for sub-optimal credit allocation in the developing world be effectively influenced. The corresponding parameters addressed in this study are, first, formal financial institutions' high transaction costs when dealing with small-scale credit customers, and second, poor creditworthiness of the SSE clientele due to a lack of collateral available and deficits in various fields of business management. These issues serve as a basis for the elaboration of ten innovative recommendations which can be seen as general guidelines to gradually solve the apparent contradiction between banks' legitimate postulate of return on investment and the development objective of enlarging small enterprises' share of credit.

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