International Small Business Series 5

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Informal Small Business in Rural Areas of Developing Countries

edited by:
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Contents

1. Introduction

Only twenty years ago, the subject of this paper would not have been taken particularly serious by development planners and theorists alike. The rural economy's role in national development was to provide resources needed for the expansion of other sectors, and for that purpose it seemed sufficient to treat it as a 'black box'. Non-agricultural activities in rural areas were either overlooked or dismissed as tradition-bound, backward and inefficient. As soon as possible, they were to be replaced by large, modern enterprises.

Seen against this background, the change in attitude towards rural informal small businesses (ISBs) appears rather profound. Rural development came to the forefront of research and project planning. At the same time, prejudices against small enterprises have gradually been overcome. The 'informal sector' discussion contributed to an improved understanding not only of the macroeconomic importance of hitherto neglected economic activities, but also of the micro-economic environment of small entrepreneurs and the specific difficulties they have to cope with.

The concept of 'informality' was introduced in the early 1970s. A widespread definition, first used by the ILO[1)], characterizes informal activities as follows:

- ease of entry,
- reliance on indigenous resources,
- family ownership of enterprises,
- small scale of operation,
- labor-intensive and adapted technology,
- skills acquired outside the formal school system, and
- unregulated and competitive markets.

The reasons for the formal/informal-dichotomy in Third World economies are usually seen in the discrimination against small businesses by public institutions and policies, and more specifically in the distorted factor price relations that result from public interventions in the factor markets.

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1) International Labour Office (1972), p. 503-504.

'Small is beautiful' has by now become a widely accepted notion. For a number of reasons, though, promotion of ISBs cannot follow a simple, clear-cut strategy. There is still a lack of empirical knowledge as to their properties. They also do not always display the conventional textbook-type of economic behavior. Finally, they are widely dispersed and hard to reach individually and so present administrative difficulties. This paper, then, aims at providing an overview of what is known about ISBs, their development potential and their possible place in development policy. Reviewing the research results of the 1980s, it confirms the positive view that was expressed in a World Bank publication of 1978: "Since rural non-farm activities seem to combine all those elements necessary for spreading the benefits of development to lower-income groups through growth in employment and wages, they deserve close attention in the formulation of development policies..."[2)]

2. Macroeconomic Aspects

2.1 Size and Structure

The importance of rural non-farm employment has long been underestimated. There are generally almost no enterprises with more than a handful of employees in rural areas, except for a few agro-industries; the overwhelming majority of enterprises is of the small, informal type. Inconspicuous as they are, they do not always appear in a country's statistics. These labor force statistics also often apply an overly narrow definition of 'rural', excluding small rural towns where many non-farm jobs are located. Another source of inaccuracy can be the emphasis on primary employment, when non-farm work frequently is a secondary source of income. Taking these limitations into account, census data on the share of non-farm employment in total rural employment (except small rural towns) show a range from 12% (Brazil, 1970) to 33% (Iran, 1974). If small rural towns are included, this share rises for example in India (1966-67) from 20% to 24%, in the Philippines (1970) from 28% to 40%[3)].

More reliable results can be obtained from detailed household surveys on la-

2) World Bank (1978), p. 36.

3) ibid, p. 17.

bor time allocation or income structure. The following table gives an impression of the importance of income from the non-farm sector in four selected countries:

TABLE 1: Share of non-farm income in rural households' total income[4)]

Country/Region	Year	Share (%)
Nigeria (3 villages)	1974	28
Korea	1980	34
Sierra Leone	1974	36
Thailand	1978	43

The non-farm share in cash income would still be higher, as subsistence production is more frequent in agriculture than in non-farm work. Aggregated data like these cannot show important distributional effects, though. The size of the land holding is usually considered to be the primary determinant of rural income. But non-farm income does have a strong equalizing influence and can even over-compensate the land size's influence.

TABLE 2: Effects of non-farm income on rural income distribution: Sierra Leone, 1974[5)]

Land holding(acres)	Share of non-farm income(%)	Total income(US-$)
0.00- 1.00	50	587
1.01- 5.00	23	404
5.01-10.00	14	546
10.01-15.00	12	720
15.01 +	15	927

4) Liedholm and Kilby (1989), p. 346.

5) Matlon et al. (1979).

There are similar results for a number of other countries. If the Gini-coefficient is applied as an indicator for income inequality, a transition from the agricultural income distribution to the total income distribution will reduce it e.g. in Sierra Leone from 0.43 to 0.38, in Nigeria from 0.32 to 0.28, and in Thailand even from 0.58 to 0.38[6]. Obviously, non-farm employment is particularly important to the poor and landless segments of the rural population.

The informal non-farm sector includes a wide and diverse range of economic activities. From country to country and region to region, it widely differs in its composition. On the demand side, the nature of the markets being served and the prevailing income level are important determinants of this diversity. On the supply side, the following factors will determine the composition:

- availability of agricultural and other raw materials
- presence of specific skills (e.g. traditional artisans)
- local labor costs, respectively opportunity costs of labor
- availability of capital, local saving capacity
- level of infrastructure and competition from larger enterprises

If census data are used, the three branch groups manufacturing, trade and other services will typically have a similar share of employment in the sector (around 30% each); the rest will be in activities like construction or mining. Nevertheless, more detailed surveys, especially in less developed countries, do show a much higher proportion of manufacturing; these businesses are obviously most easily overlooked.

As an example for detailed descriptions of the rural ISB sector, the following table presents two surveys of African countries.

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6) See Liedholm and Kilby (1989), p. 347.

TABLE 3: Composition of the ISB sector in rural Zambia and the rural region Eastern Burkina Faso[7)]

Industrial Groupings	Number of Businesses		Average Number of Workers		Share of Total Employment (%)	
	BF	S	BF	S	BF	S
Garments	3526	8244	1.38	1.39	22.7	3.4
Leather	45	1222	1.55	1.19	0.3	0.4
Metals	421	7869	3.54	1.32	6.9	3.0
Forest-Based	35	52209	3.57	1.72	0.6	26.2
Ceramics	1126	4408	1.79	1.48	9.4	1.9
Beers	1581	86459	2.57	1.53	19.0	38.7
Foods	4373	6683	1.59	2.15	32.5	4.2
Repairs	103	2232	2.43	1.43	1.2	0.9
Manufacturing	11210	169526	1.77	1.59	92.5	90.0
Restaurants/ Bars	346	1589	2.45	3.12	4.0	1.7
Trading	290	6750	2.20	2.08	3.0	4.7
Other Services	99	3159	1.27	3.50	0.5	3.7
Services	735	11498	2.19	2.61	7.5	10.0
Total	11945	181024	1.79	1.66	100.0	100.0

The concurring predominance of manufacturing activities in both countries is remarkable. Among them, differences in the availability of inputs are reflected in the relative shares of 'forest-based activities' and 'foodstuff processing': In well-wooded Zambia, naturally forest-based activities like basket, mat, charcoal and firewood production are of importance, while in Burkina Faso the processing of agricultural raw materials (to 66% extraction of vegetable oils) is a dominating source of income. The weaving and dyeing of textiles in Burkina Faso is a good example for a traditional craft that depends on the regional spreading and passing-on of specific skills.

The average enterprise size is larger in the tertiary than in the secondary sec-

7) Adapted from Wilcock and Chuta (1982), p. 458; and Milimo and Fisseha (1986), p. 19. The surveys exclude businesses that do not operate from a permanent location.

tor in both countries. This may be an indication of services usually belonging to an expanding modern subsector, while many manufacturing enterprises can be said to belong to a stagnating or decreasing traditional subsector. The study from Burkina Faso classifies those branches as modern which benefit from the increasing integration of the region into the national and international division of labor. Traditional branches, on the other hand, have to deal with increasing competition from outside the region.

2.2 Dynamics

For a more systematic analysis of the ISB sector's development over time, one has to take into account a number of processes. Leaving aside for a moment the heterogeneity of the enterprises and treating the sector's output as one good, the two dominating processes are

- development of local demand, and
- development of competitive pressure from outside the region.

The dynamics of the rural economy could then be analysed in terms of a simple 2-sector, 3-goods model. The rural sector can produce two goods, F (food) and Z (denoting all non-farm goods and services). Z is a non-tradable, but F can be traded for M (manufactured good) with the urban sector. The production conditions for Z and F, the terms of trade between F and M and the rural consumers' preferences together determine the structure of the rural economy.

The first model along these lines was presented in 1969[8]. The authors predicted a decline in Z-production over time. With the opening-up of rural areas, export demand for F would rise, the technology in F-production would improve and so the terms of trade for the rural sector would improve. This change would then lead to the substitution of Z by F in production and of Z by M in consumption. The result is a "... shift from inferior methods of home production to superior methods based on specialisation and exchange." In the

8) See Hymer and Resnick (1969).

course of the development process, i.e. increasing integration of the economy and intensifying division of labor, the rural economy will, according to its comparative advantage, specialise in the production of foodstuffs.

This interpretation appears plausible - yet development has taken a different course in rural areas. In all countries for which time series data are available, the share of non-agricultural employment in total rural employment has been rising: for example, in Mexico from 14% (1960) to 23% (1970), in Indonesia from 17% (1961) to 24% (1971), in Iran from 20% (1956) to 33% (1972). There is also a distinctly positive correlation of this share with per-capita-income and population density, if different countries are compared[9]. The reason is that locally produced goods and services are by no means 'inferior' goods, as Hymer and Resnick assumed. The income elasticity of demand for these products is usually well above 1 and can even surpass that for competing 'imported' manufactures.

The most important reasons for this discrepancy between prediction and reality, and the future tendencies that can be derived from them, are probably the following:

1) The model does not allow for the heterogeneity of the factor equipment of different rural households. The growing number of landless households cannot specialise in the production of F, and so there is a pressure for a growing division of labor within the rural sector.

2) With an increase of the income level, there is a growing demand for services that cannot be imported from the urban sector. Furthermore, exports of F and imports of M will provide jobs in local trade. Exports of F will cause demand for its processing, imports of M will cause demand for repair services. Indeed, these branches are among the fastest growing in rural areas.

3) The model presupposes a high elasticity of substitution between Z and M. Sometimes, though, the local artisanal product will be preferred to the

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9) See Chuta and Liedholm (1979), p. 18; Haggblade, Hazell and Brown (1989), p. 1183.

industrial substitute, if this does not meet traditional taste patterns. There can also be market segmentations where the ISB sector supplies low-income households with qualitatively simple but unbeatably cheap products.

The model's prediction holds relatively well, though, for traditional manufacturing micro-enterprises that operate in branches where industrial products are superior substitutes and can be produced under strongly increasing returns to scale. This heterogeneity of the ISB sector is of crucial consequence for an assessment of the development potential of different branches.

3. The Microeconomic Setting

3.1 Business Behaviour

The overwhelming majority of those employed in ISBs are the owners and helping family members. According to the surveys of Zambia and Burkina Faso (presented in 2.1.), for example, 90% respectively 95% of total employment in the ISB sector is family labor. Only a minority of rural ISBs employs wage workers or apprentices. Besides manpower, the family also supplies the necessary capital. A microeconomic analysis of ISBs thus has to specifically investigate the interaction between household and enterprise.

A rural household in a developing country may face a relatively complex economic situation when it has to design a livelihood strategy. The institutional environment, especially in terms of factor markets, is so imperfect that households have to internalize a number of allocation functions that the markets do not perform. A typical outcome, as will be shown, is a household/ISB-combination that is characterized by what has been called the 'family mode of production'[10]:

10) Lipton (1984), p. 190.

- the family controls the factors of production (capital, land) that it works with
- most of the family's resources are utilized in the ISB
- most of the work in the ISB is done by family members

If a household decides to run one (or more) ISBs as a component of its economic strategy, the primary objective is clearly not maximisation of profits to the enterprise but of expected utility to the household. The conventional micro-economic theory of the firm does not have much explanatory power in such a situation. There is, though, a branch of micro-economics called New Household Economics that can shed light on decision-making when production takes place in a household framework. In the context of poor rural societies, it has been applied to model small agricultural enterprises' decisions towards subsistence or market production; it could easily be extended to include non-agricultural activities[11].

What can these approaches say about the actual economic behavior that can be expected from a household/ISB-combination? Allocating the labor time of its members between reproduction, subsistence production, participation in the labor market and finally production in the ISB gives the family a fair degree of flexiblity. Additionally, the few capital goods that the household owns are often utilized for a number of different purposes. This flexibility of an ISB can be attributed to the 'fungibility' of the factors of production at the family's disposal. Fungibility means that the available resources are of an unspecific nature and can thus easily be reallocated. The family's house, for example, can be turned into a workshop; all the family members can be mobilized when a larger order comes in; or the ISB can be given up seasonally. The financial funds, too, are highly fungible as there is little separation between the financial structures of the household and the business.

ISBs may dispose of yet another opportunity to reach a collective flexibility: the operating in a network of small enterprises, where economies of scale can already be realized by the specialisation of each single enterprise. For this form of cooperation it is essential that the production process can be

11) For an overview, see Ellis (1988).

vertically disintegrated and that the extent of the market allows such division of labor. The cost advantages of ISBs and their 'economies of agglomeration' can then even enable them to take over market shares from the large-scale, formal sector. Such networks with their collective efficiency are quite possible even in small rural towns[12].

The owners of ISBs sometimes have distinct technical skills, especially a knack for improvisation. But they are no entrepreneurs in the classical sense of the term, i.e. looking for productive investment opportunities for their capital. The allocation of their capital is usually limited to a few alternatives. Instead, their primary objective is to secure the family's income through productive employment. Because of the often precarious economic situation, a high risk aversion is typical for their business behaviour. They establish long-term personal relations with suppliers and customers, preferably with their kinship, even if they loose some short-term benefits. Their innovativeness and flexibility are of a defensive nature: In an economic environment that is characterized by scarcity and insecurity, they have to permanently adapt and localize, if possible, new market niches.

They are able to do so because they can simultaneously adapt their production, consumption and reproduction behaviour to changing conditions - a task that would be impossible to a modern small business in a developed country.

3.2 Capital Markets

The following two sections will put the analysis into the context of the factor markets that ISBs are confronted with. For expository purposes, labor and capital markets are presented separately, even though, as will be shown, they are integrated by the household.

ISBs are generally equipped with only a few capital goods. They work in the open air or in the family's dwelling, use simple, hand-operated multi-purpose

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12) For the theory, see Schmitz (1989); for a case study, Child and Kaneda (1975) and Aftab and Rahim (1986,1989).

tools and do not maintain stocks of raw materials or finished products. The owners frequently declare a lack of capital to be their main problem.
An important reason for this lack is the distinctive structure of capital markets in developing countries, and more specifically their separation into formal and informal segments. The formal segment consists of commercial banks and public credit institutes that offer capital at relatively low interest rates. But these banks, if at all present in rural areas, are hardly accessible to ISBs so that they must have recourse to other sources of capital.

The informal segment of the capital market includes professional money lenders on the one hand and relatives and friends of ISB owners on the other hand. Interest rates charged by money lenders are considerably higher than those of formal institutions. This is often explained by their monopoly power in a fragmented money market where there is little information about prices in adjacent regions. When commenting on these interest rates, it should however be kept in mind that some of their cost components (opportunity cost of money, risk and administrative premiums) are quite high. In any case, for ISBs' borrowing money lenders are no attractive alternative; they are rather made use off for consumption credits in emergency situations[13].

ISBs therefore typically depend on household savings for 60%-90% of their investment needs, and the bulk of external financing consists of interest-free loans from relatives and friends. Working capital, which at a low stage of mechanization makes up a high share of total financial needs, is also financed out of household funds. Because especially the poorer families depend on ISB employment, and because under the given circumstances there is little scope for capital accumulation in the enterprise, the chances for productivity-improving investments are rather poor without external assistance.

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13) For empirical data on ISB financing, see Liedholm and Mead (1987).

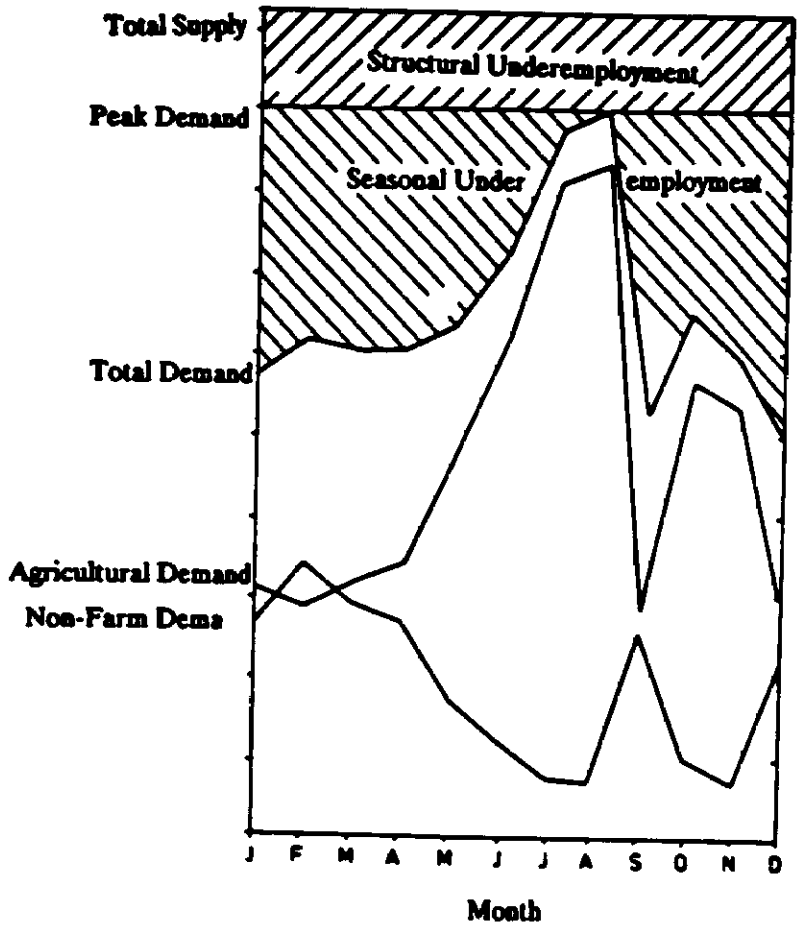
3.3 Labor Markets

Rural labor markets in developing countries are commonly in disequilibrium: There is only insufficient demand for in relation to the ever-increasing supply of labor. Some demand for labor comes from the larger enterprises in agriculture and the non-farm sector, but because of their rareness and relatively capital-intensive technology the absorptive capacity of this formal segment of the labor market is limited. One alternative for the unemployed is to migrate, at least temporarily, and look for employment elsewhere. In most cases, though, they will decide to remain in their region of origin and design, within the scope of the family's possibilities, an employment strategy that includes self-employment in agriculture and/or the own ISB. However, these strategies do not solve the problem of structural over-supply of labor; they just distribute it in a manner that avoids open unemployment. In a situation where productive employment is essential even for the satisfaction of basic needs, open unemployment is intolerable.

The family's possibilities depend on its resources of land, capital goods and human capital, but also on the solidarity of the extended family that allows to diversify the employment strategy and so minimize risks. Aditionally, seasonal and regional particularities of labor markets have their effects on decision-making.

The marked seasonality of rural labor markets can be explained by the special features of agricultural production. Using the model shown below, the employment structure in a typical rural region (or village, extended family) over the course of a year may be described.

DIAGRAM 1: Rural Labor Market. Seasonal Development of Supply and Demand[14)]



Underemployment as a result of a disequilibrated labor market can thus be analytically separated into two components: a structural (difference between supply and demand at the time of highest employment) and a seasonal component, which can only be partly compensated for by the anti-cyclical movement of non-agricultural employment. However, in some regions there may well be agricultural labor demand peaks that fully exhaust the available labor supply; in these cases there is no structural underemployment. Seasonal underemployment can be mitigated by seasonal migration, the labor supply then does not have to stay constant over the course of the year.

14) Adapted from Thorbecke (1982), p. 317.

Even if temporal underemployment is observed, however, it is no sufficient explanation for the very low level of income. The return on labor also depends on factors like technology, productivity, ownership of means of production, and exploitation. So especially the poorest families, and among them the female members, are frequently over-employed: They are forced to continue working even at very low marginal returns in order to survive. The main problem thus it not a lack of employment opportunities as such but a lack of productive employment. In India, for example, in spite of extremely long working hours, the average income in 'rural household industries' is "much less than half of the official poverty line"[15].

Regional economic structures as determinants of size and composition of the ISB sector were already mentioned in section 2.1. Their influence can lead to considerable differences in the employment structure even of adjacent and therefore relatively homogeneous regions. Local survey results should therefore be treated with caution, they are not necessarily representative of a larger region. This can be illustrated with the results of an inquiry into the labor markets of Western Guatemala[16]. The region was for this purpose divided into four zones that can be shortly characterized as follows:

1. Core zone: high population density, best marketing conditions
2. Central zone: fertile soils, good marketing conditions
3. Periphery: unfavorable soils and marketing conditions, frequently by middlemen; in bad years up to 50% of male workers looking for employment in the coastal plantations
4. Coastal zone: fertile soils, dominated by a plantation economy; unfavorable marketing conditions for non-farm products

The labor time allocation of rural households in these four zones, the features of which can be considered as typical for many developing regions, is given in the following table:

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15) Saha (1989), p. 136-137.

16) See Smith (1989).

TABLE 4: Rural employment structure in western Guatemala (1976-1978), by employment and zone

Branch	1	2	3	4
Agriculture	22.4	35.9	42.7	67.9
own farm	16.8	25.9	25.1	32.2
local wage labor	4.6	6.0	7.5	12.8
plantation	1.0	4.0	10.1	22.9
Trade	18.5	17.4	12.3	8.3
Craft	6.4	5.7	8.3	19.7
Artisanry	42.7	25.0	21.3	0.7
own enterprise	21.0	10.5	11.3	0.4
wage labor	21.7	14.5	10.0	0.3
Others	10.0	16.0	15.4	3.4

The share of agriculture obviously decreases with growing population density and pressure on the land. For the non-farm sector, though, a high density is advantageous because market centers and effective demand are to be found in the producer's vicinity. Among the manufacturing ISBs, there is a clear distinction: the relatively traditional 'craft' activities provide more employment in the more remote zones, while the comparatively modern 'artisanry' activities are concentrated in the densely populated areas. Craft ISBs, working with rudimentary technologies and providing little income to their owners, are distinguished from artisanry ISBs by producing all the necessary inputs in the household. Comparing zones 1 and 4, it becomes clear which branches are operating most successfully under the given circumstances and provide most income to the local economy: in zone 1, it is the artisan ISBs which, with 42% of total employment, make 55% of total income and can offer wage labor for 22% of the local workers. In zone 4, however, agriculture is dominating. With 68% of total employment, it makes 73% of income and provides wage labor for 35% of local workers, to which one has to add migrating workers.

Evidently, regional differences in the employment structure can be traced back to the relative returns to different activities. Besides that, rural households have to take into account the different risks of the activities available for them. For this reason, agriculture should frequently be preferred to alternative activities with higher returns: if demand fails to appear, the output is at least edible.

3.4 Goods and service markets

The primary role of ISBs is to offer their owners an opportunity to make their income on goods and service markets instead of trying to get into the organized labor market. The importance of demand was already emphasized in the last section and will now be explored more systematically.

Demand can be broken down into three components. First, there is a demand of local rural households for simple goods and services. Secondly, there is demand arising from the production linkages with local agriculture; from backward linkages (processing and distribution of agricultural products) as well as forward linkages (production and distribution of simple inputs for agricultural production). Thirdly, there may be demand from outside the region for certain ISB sector products.

Rural consumers use most of their income for foodstuffs. Some of this demand goes to ISBs engaged in processing and distribution of these products. For the rest of their income, the ISB sector and the formal sector are competing, but even demand for formal products does create demand for certain ISBs' services (e.g. in trade). The following table shows the demand behavior in two rural regions, with the Malaysian region having about twice the per-capita-income as the Nigerian region:

TABLE 5: Budget allocation of rural households in Muda (Malaysia) and Gusau (Nigeria)[17]

Product	Average budget share (%)		Income elasticity of demand	
	Muda	Gusau	Muda	Gusau
Food	66.7	80.7	0.57	0.94
Non-food				
locally produced	18.0	8.4	2.05	1.34
imported	15.3	10.9	1.66	1.46

In this context, terms like 'imported' and 'exported' again refer to a rural region's trade with the rest of the world, regardless of national frontiers. The imported goods in table 5 have probably to a great part been produced in the industrial enterprises of the urban centers in the respective country. It appears unlikely that the urban informal sector or the ISB sector in other rural areas of the country would produce goods attractive enough for importing. Informal products are qualitatively too homogeneous and transport costs are too high for such an exchange.

This has, of course, important consequences for the sales prospects of rural ISBs. If in the urban economy there is demand for informally produced goods, urban informal enterprises will generally get the contracts. The export marketing chances of rural ISBs are therefore minimal, frequently their products are explicitly termed 'non-tradables'. Exceptions to the rule are to be found where highly qualified artisans are known beyond the region or where a 'cottage industry' or subcontracting system reaches into the villages as is frequently the case in South Asia.

On the other hand, the ISBs do import a large share of their inputs from the urban-formal sector. This is evident for retailers who distribute industrial products. But other branches like bakers (imported wheaten flour), construc-

17) Hazell and Röell (1983), p. 28.

tion ISBs (corrugated roofing) or tailors (industrial fabrics) also need imported inputs; moreover, most craftsmen use tools and (frequently second-hand) machines that cannot be produced in the region. To pursue the analogy to international trade further, the ideal-type rural sector could be said to have to pay for the imports of certain capital and consumer goods with exports of food.

A highly interesting source of demand for ISB products, from the point of view of development policy, consists of the linkages with local agriculture. Following the interest in rural-led development strategies in the 1970s, research on the demand relations within the rural economy and the regional growth linkages from a promotion of agriculture covered a lot of new ground. It was shown that 60-80% of an increase in income from agriculture is spent on consumption goods. The effects of rising income on demand for ISB products depend on a number of factors. If, for example, a rural development program does especially support the poorer households' income, a relatively large share of incremental purchasing power will be spent on foodstuffs and not much on non-farm products; on the other hand, of this non-farm rest a relatively large share goes to locally producing ISBs. The consumption of better-off households is more strongly directed at imported, formal products. This has been mentioned as a reason why the strategy of rural-led development is less effective in Latin America, with its extremely skewed income distribution, than in other areas[18].

The production linkages with agriculture have to be examined more closely. Backward linkages of ISBs to agriculture are an important source of demand for agricultural raw materials. Some of these can only be produced if there are efficient local capacities for processing and distribution. The marketing of agricultural products is frequently regulated by the state; but the public marketing boards and licensed traders do not always perform efficiently. In these cases, the legalization of ISBs participation in marketing can improve the distribution system.

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18) See Mellor (1989), p. 309.

Forward linkages, that is the supply of inputs to agriculture, are particularly important because the productivity of agricultural enterprises is a function of the availabilty and quality of these inputs. ISBs can certainly not supply chemical fertilizers, improved seeds, or tractors. But in most cases they will offer the lowest-priced simple tools (e.g. hoes), that can be produced by the local blacksmith, or intermediary products (e.g. irrigation pumps) that originate in the workshops of small rural towns, and they are able to adapt them to local conditions. They also frequently have to repair imported devices and agricultural machinery, because the service network of formal enterprises in developing countries is not close enough.

Consequently, the presence of efficient metal-working ISBs is a precondition for productivity increases in agriculture. But equally, it is a result of the mechanisation of agriculture, just as those businesses that process and market agricultural products are benefitting from the intensification and diversification of agriculture. For a successful implementation of any rural development programme, it is imperative to understand these mechanisms. Positive interventions as well as negative external shocks can spread very fastly through these channels.

4. Informal Small Business and Development Policy in Rural Areas

4.1 Development Potential

It was shown that the demand situation for most branches of the ISB sector can develop rather positively. Now it remains to be seen whether the supply reaction is sufficiently elastic, which factors have influence upon the supply elasticity of ISBs, and if bottlenecks can be identified where carefully directed promotion measures can be applied.

At a glance, the supply elasticity of ISBs appears to be very high: They will 'mushroom' if there are favorable demand conditions. The main reason for this is the high elasticity of supply of the main factor of production, labor. In connection with the low market entry barriers and the high flexibility of

households in their production decisions, this will lead to fast quantitative growth, that is an increase in the number of businesses.

Even more desirable, though, is qualitative growth. This should be understood as the ISB's ability to expand, to increase the owner's income, and to improve the quality of its consumption products and inputs for other enterprises. However, most rural ISBs do encounter their limitations relatively fast in this respect, and the reasons are to be found just in their very informality. From the individual ISB's point of view, an internal and an external dimension have to be distinguished.

Internal growth problems can often be attributed to a lack of formal qualification of the work force. An improvement of the ISB's production methods may for example require the ability to read technical drawings; with the enterprises' growth and the employment of wage workers arises the need for regular accounting. If an ISB's expansion is not adequately accompanied by productivity increases, there will soon be competitive disadvantages as against smaller enterprises. To begin with, the owners are frequently not able to handle the organizational requirements after the 'managerial slack' is used up. Secondly, the need arises to replace production in the backyard with the utilization of separate buildings. Thirdly, wage costs will rise from a certain point on as the wage rate approaches that of the formal segment of the labor market. Thus, the internal problems in combination with the intense competition from enterprises with a comparable technology, but lower unit costs, limit the individual ISB's elasticity of supply[19].

In addition to the intensity of competition, a number of other external factors constrain the growth potential of ISBs. The most important problems have to be faced on the markets for financing, raw materials, and technology. The financing problems, caused by the segmentation of the capital market and the general scarcity of capital, have been mentioned. Closely connected are bottlenecks in the supply of raw materials, spare parts etc. that are frequently cited as a major problem of ISBs. They can also be caused by direct discrimination on the part on public institutions in the allotment of inputs. Finally, in

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19) For a case study, see Aftab and Rahim (1989).

their efforts to expand ISBs may not be able to get over a technological gap, when intermediary technologies are not available and modern methods, frequently based on imported technology, are without their reach.

The interplay of these factors results in growth constraints that can be surmounted by only a few ISBs. The relative weight of single factors will be different from branch to branch; this has to be considered when designing supply-oriented promotion policy.

4.2 Policy options

A whole range of reasons has been presented in the paper that argue for a strong representation of the rural ISB sector in development programs. Before giving an outlook on appropriate promotion measures, these merits shall be recapitulated.

Informal activities provide income especially for the most important target group of rural development, the poorer landless households, and they stabilize this income in course of time. They supply rural areas with goods and services at low prices and so increase the rural population's standard of living. They mobilize capital (the owners' savings) that would otherwise be left idle, and they exert very little pressure on a country's foreign exchange. They contribute to the spread of technical skills, for example through the training of apprentices, and they mobilize entrepreneurial potentials. They decentralise the economic structure and reduce the migration pressure on the urban centers. They are finally indispensible for the development of local agriculture, and particularly of the smaller farmers.

If the ISB sector is capable of delivering these contributions even under public discrimination, it can be expected that adequate promotion measures will have very positive effects on the development of the rural economy. However, it should be avoided to selectively assist some conspicuous enterprises and so turn them into 'rent-seekers' that spend more time and energy

on negotiating with public institutions than with customers, a behaviour that is characteristic for many entrepreneurs in the formal sector.

Instead, promotion policy should be broadly designed and concentrate on the bringing about of equal chances for enterprises of different sectors. If 'urban bias' and 'large-scale bias' in the economic policy of developing countries can be redressed, it will show that under conditions of undistorted factor prices ISBs with their labor-intensive technology will frequently be the more efficient alternative. In any case, this holds for the branches with a choice of technology, i.e. where substitution of capital by labor is possible.

As was shown in the discussion of growth barriers, directly supply-oriented promotion can also be useful. The financing problems of ISBs are often regarded as the critical bottleneck that should be mitigated by institutional credit. Agricultural development banks might extend their credit offers to non-farm enterprises, for example. But it has to be taken care that additional financing programs improve the functioning of the capital market rather than further fragmenting it: Interest rates should reflect the real capital costs to give incentives to the financial institutions to place credits, and to mobilize the rural households' savings.

Another priority should be management consulting for ISBs. Even the introduction of most rudimentary accounting techniques can detect organizational inefficiencies and so improve the success rate of the businesses. As with financing, the experiences with technical and organizational consulting of small agricultural enterprises may be helpful for the design of consulting services.

Of crucial importance for the future development of the rural non-farm sector is the interplay of supply- and demand-oriented promotion. Without an increase in the purchasing power of the rural population, ISBs cannot sensibly use available credit for investments. Above all, production and income increases in agriculture are necessary, and this in the framework of a strategy that attempts to maximize the multipliers between regional agricultural and non-agricultural growth.

5. Outlook

Future development policies should not attempt to solve the problems of informal businesses by introducing a whole array of new programs, institutions and policies - e.g., in business promotion by creating a "cocoon of training and subsidy from which no free-choosing entrepreneurial butterfly would ever rationally emerge"[20]. This would only further complicate a situation that is already characterized by distortions. Instead, technological and regional dualisms should be reduced and the gap between informal and formal activities should gradually be closed. Of course, economic policy in developing countries is not the result of a theoretical optimization process but the expression of the interests of certain groups in the society: 'urban bias' and 'large-scale bias' are the result of the political power of urban industrial and bureaucratic elites. However, the chances for a more rational allocation of resources in the development process may be rising with an improved perception of the possible contribution of ISBs.

More research along the lines of 'rural household economics' will be necessary to better understand the microeconomics of family enterprises, their specific needs for assistance and their reaction to different policies. More empirical data from different rural regions of the developing world will also be required. But in the final analysis, ISBs have the potential to become a very worthwhile focus of development policy.

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20) Lipton (1984), p. 241.

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