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Policy, Programmes and Priority Biases: A Hidden and Overt Agenda Against Small Scale Enterprises

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Contents

Page

1. Introduction	**1**
2. Policy Environment	**2**
3. Suggestions	**10**
References	**14**

1. Introduction

The recognition that small scale enterprises (SSE) form an integral segment of the economy presupposes that they should be treated on an equal basis with their large-scale counterparts. However, in many countries, economic development policies and strategies seem to favour large scale enterprises (LSE). More specifically, many macroeconomic policies, as well as fiscal and financial measures have a built-in bias towards LSE and the use of capital-intensive technology. The clearest example may be seen in the Republic of Korea which used to favour the chaebol at the expense of SSE. The chaebols were given a near monopoly control over a wide range of economic activities in Korea in addition to special fiscal incentives, low interest loans and other types of government assistance. For instance, selective export promotion measures in favour of existing large firms and business concentration (in order to be internationally competitive by all possible means) disadvantaged Korean SSE, which were structurally oriented towards the domestic market and neither equipped nor prepared for exports. High protection for implementing progressive import substitution forced most SSE to cope with high import prices for all kinds of products and equipment not available locally. Furthermore, initial scarcity of local capital (especially in the 1950s and early 1960s after the Korean War) and massive state borrowings overseas channelled priority loans to large business and left SSE alone to cope with high domestic banking rates while having insufficient collateral and guarantees to offer. Foreign direct investment and selective state clearance also tended to favour LSE, with 76 per cent of such investments going into firms of 300 employees and above for the period 1968-78. In addition, priority employment and social policy in favour of LSE were also detrimental to SSE which were unable to offer their employees good working conditions comparable to those in LSE. (According to P. Regnier [1992:108], the policy bias in favour of LSE and the consequent introduction of various distortions against SSE were already in evidence in the Republic of Korea during the colonial period.) As a result of unfair government policy, the growth of SSE was inhibited and Korean companies had to import large quantities from abroad, especially Japan. The revaluation of the yen in the 1980s was one of the factors which forced the government to adopt a more balanced policy towards SSE.

Fortunately, the deliberate bias in government policy towards LSE is an exception rather than the rule in many Asian countries. On the contrary, several countries in the Asian region generally favour SSE. For example, the retailing laws in Japan favour SSE at the expense of their large-scale counterparts; similarly, some industrial estates in India are set aside exclusively for SSE while the Reservations List reserves more than one thousand products for SSE production; in Indonesia, SSE was included as one of the four categories of priority industries to be promoted in the Fourth Plan (1984-1989). Nevertheless, an analysis of government policies in many countries indicates some biases against SSE, even though they may be unintentional. But whether they are unintentional or otherwise, the impact of government policies, if they are biased, have an adverse impact on SSE. Such policies prevent SSE from competing with their large-scale counterparts on a level playing field. Thus the focus of this paper is to examine the possible biases in government policies towards SSE and to suggest how such biases may be alleviated. (ZDH-Technonet Asia has started a project to study policy induced constraints on SSE development in Bangladesh, Nepal, Philippines and Indonesia. For details, see "Discrimination of Small-scale enterprises," Technonet Asia Newsletter, 1st Qtr/1993:10.)

2. Policy Environment

Since governments generally appreciate the multiple roles which SSE can play in overall development, they have implemented various policy measures to stimulate the growth of SSE. (There is no common definition of SSE among the developing countries in Asia. However SSE generally refer to manufacturing enterprises employing up to 50 workers each [For details, see Chee Peng Lim 1992]). Sometimes however, such policies even when they are intended to favour SSE have a deleterious effect. Consider for instance, some SSE policies in India, Indonesia and Malaysia. These policies, while attempting to promote SSE, end up hindering their development. For example, is it really necessary to have a "product reservation" policy for SSE in India? Such a policy implies that SSE are non-competitive and need to be protected from competition with their large-scale counterparts. According to I. Little(1987: 314), India's policy of reserving a great many products for SSE tends to segment product markets and reduce the element of competition not only for the protected sector but also for large firms. It tends also to freeze the structure of the industry and inhibit the organic growth of firms beyond the protected size. It also inhibits exports in that larger firms have economies of scale in foreign markets, as evidenced by the fact that SSE typically export a much lower portion off their production than larger firms. These effects are unquantifiable but may be serious in the long run.

In Malaysia, some SSE have been provided with so much assistance that they may never develop any self-reliance. This is a tragedy since the vital entrepreneurial role of the individual will be smothered by assistance programmes which are too comprehensive or generous. Consequently the SSE will become over-dependent and will be incapable of responding to any challenge. External assistance should try to reinforce and supplement private sector initiatives rather than supplant them. Similarly, SSE assistance programmes which are too generous may become counterproductive. An example of a policy which tries to assist SSE but ends up being counterproductive relates to financial assistance. In both India and Malaysia, as well as several other countries, financial institutions, especially commercial banks are directed to set aside a minimum percentage of their loans at a subsidised interest rate to SSE. As a result, deserving SSE may not have adequate access to commercial bank credit which may be monopolised by certain highly favoured SSE.

The paper' s major concern, however, is with government policies in general, which do not appear to favour either SSE or LSE. But these policies are not really neutral, since government policies generally tend to have an impact on firms according to their size. This is true not only of policies implemented at the local but also at the national level.

Consider for example, the zoning policies applied by local authorities in many countries. The basic aim of these policies is to separate residential from industrial areas. While the aim is laudable and does not discriminate against enterprises in terms of size, in practice, it is generally SSE which suffer most from the zoning regulationsf Such regulations have the most severe impact on SSE because of their inadequate capital and the limited geographic nature of their markets. Due to inadequate capital, a number of SSE often first set up shop in a residential area. Initially, local authorities tolerated their existence but as the town developed, regulations were subsequently tightened up and more strictly enforced. At the .same time, the local authority failed to appreciate the locational problems of SSE and failed to provide alternative sites before evicting those enterprises. As a result, a number of SSE, particularly in the larger towns in many Asian countries have seen their business disrupted, and in some cases, forced to close shop. In those rare instances where the local authorities were considerate enough to provide alternative sites, such locations were either too far from the SSE's major customers or they were too expensive. In fact, the locations offered may even do more harm than good for the affected SSE because they may entice SSE away from their market. (In many cases, it has been found that industrial estates, generally subsidised by public funds, are occupied by a larger proportion of large, rather than small enterprises. For example, an analysis of industrial estates developed with government assistance in Shah Alam and Senawang in Malaysia showed that SSE in those two towns were allocated only 22 percent and 19 percent of the total available sites in the two towns respectively [Chee Peng Lim 1986]).

At the national level, biases against SSE are most evident in the areas of fiscal, monetary, trade, government regulations and procurement policies. Firstly, fiscal incentives to encourage the development of industries often attempt to link the value of. such incentives to the level of investment. This implies that larger enterprises (in terms of investment) would receive greater benefits (Krongkaew 1988). Apart from fiscal incentives, the tax structure in several Asian countries also imposes a penalty on the operation of SSE. For example, the sales tax favours vertical integration in the pro-duction process, and hence, larger enterprises. (For details, see Sanguaruang, et. al. 1978). Similarly, in Singapore, some SSE complain that increases in the foreign worker levy are affecting the viability of their operations. (The levy which was imposed to discourage the employment of foreign workers was raised from S$250 to S$300 in August 1990).

Apart from the fiscal burden, which is the amount of tax that SSE actually pay, B. Levy (1993:74) observes that SSE also have to bear the bureaucratic burden, which is the cost to SSE of dealing with government agencies. A major part of this burden consists of the opportunity cost of entrepreneurial effort diverted away from wealth-generating activities. The size of the bureaucratic burden is inversely proportional to the agencies' efficiency. Since governments presumably do not impose bureaucratic tasks only to torment entrepreneurs, the bureaucratic burden is produced jointly with the fiscal burden - or jointly with some other public task. It is likely to be disproportionately large for the smallest enterprises - in part because its fixed-cost elements are invariant with firm size, and in part because large, but not small, enterprises can hire managers to handle dealings with government officials. Even as a fixed cost, the bureaucratic burden can inhibit the operation of enterprises that are too small to hire a manager. With entrepreneurship complementary to other inputs in production, a reduction of bureaucratic costs would free up the entrepreneur's time and lead to a downward shift of both fixed and variable cost schedules.

Secondly, SSE also suffer from the trade policies in several countries. Protectionist policies adopted by several developing countries have led to the introduction of high import taxes and over-valued exchange rates to support the growth of their local industries. This has led to higher prices for imported goods and improved the competitive position of local suppliers - especially large firms since the local production substituting for the capital-intensive imports also requires a relatively high amount of capital and a corresponding firm size. This means that SSE with its relatively labour-intensive production is discriminated by the above mentioned trade regime.

For example, according to Bruch and Heimenz (1984), a comparison of the structure of effective protective rates and the size distribution of enterprises in ASEAN countries reveals that effective protection tends to be particularly high in industries where SSE shares in production are relatively low. Their findings also show that the structure of effective protection in the ASEAN countries, except for Singapore, is biased against not only against certain industries, but also against SSE within individual industries. The authors explain that in most cases, the present system of protection is not so much a reflection of deliberated policies in accordance with clear objectives, but rather the result of a case-by-case approach to the setting of tariff rates. Due to their relative importance and easier access to influential administrators, LSE are likely to be more successful than SSE in arranging government protection against external competition. Since protection is granted against imports of specific products and since manufacturing industries produce a number of different products, LSE may be able to arrange protection but SSE in the same industry may not, if LSE and SSE differ with respect to their production mix.

Another example of fiscal discrimination against SSE are tax concessions granted for the import of new technology and machinery. For SSE, used machinery is often better suited and more cost-efficient, but tax concessions are often not granted for the import of such machinery. Generally, high tariffs on machinery, spare parts and accessories deprive SSE of the opportunity to expand, modernise and learn new technology.

Thirdly, in many countries, intensive purchasing makes the government a major or dominant buyer of a wide range of goods and services. The government's purchasing activities inevitably discriminate, albeit unwittingly, against SSE. Usually, governments do not buy or give out tenders to any particular group of firms; still its policy tends to favour LSE. The reason is that in the interests of administrative efficiency, and in the search for economies in purchasing, government purchasing agencies tend to place their orders in relatively large amounts at a time, and often by selective tender. Bulk purchasing and selective tender favours LSE, so SSE are generally left out of the lucrative government purchasing business.

Finally, SSE suffer most at the hands of government regulations and bureaucracy. SSE with their limited information base and management capacities suffer from bureaucratic procedures in public administration and a complex legal environment (registration and licensing requirements, business regulations, tax schemes, etc.) For example, up to the mid-1980s, SSE found that starting a business in the Rep. of Korea was not only financially but also administratively difficult: the local legislation required at least 300 documents (P. Regnier 1992:114).

Usually, LSE find it much easier to deal with government red tape because they have the capability of employing staff specialised in these matters. With their know-how on administrative regulations and procedures, LSE are able to work more efficiently than SSE busy with all the management tasks of their firms. In this context, one can speak of "administrative economies of scale." Therefore, as a ZDH-Technonet Asia study (1992) rightly points out, a complicated bureaucratic and time-consuming public administration will cause additional problems for SSE. In fact, excessive paper requirements for securing business licenses, registration and permits are the bane of all SSE since they generally have a very small administrative staff. In addition, cumbersome licensing requirements and ubiquitous enforcement create substantial opportunities for offficials to extract side payments from even the smallest SSE. For example, in Tanzania, licenses must be renewed annually. Although the fee is modest and is calculated on a sliding scale according to the size of the enterprise, each renewal is dependant on a host of prior clearances. In the best of circumstance, obtaining clearances and renewals eats into the scarce time of the proprietor. In circumstances in which not all clearances have been obtained, the proprietor is at the mercy of the licensing official. Although incomplete compliance has not been used to obstruct entry or to shut down enterprises, it is a vehicle for officials to extract side payments. According to B. Levy (1993:75), 7 of 13 interviewees reported that "lubrication" is needed to complete license formalities each year.

Certain government regulations which may have a laudable objective such as employment or product quality regulations may have an adverse impact on SSE. For example, in some countries all employers are required to grant maternity leave to their female workers. If an SSE employs six female workers, and three go on maternity leave, the enterprise will lose half its operating capacity. Similarly, product quality standards which may be relevant to an export-oriented economy, when also applied to goods meant for local consumption may drive some SSE out of business. This may be seen in the Malaysian pineapple canning industry where regulations discourage the entry of small, less capital-intensive enterprises.

SSE suffer not only from the bias of government policies but are also discriminated against in the private sector. The clearest example is in the financial sector where many commercial banks are reluctant to lend to SSE because of the high risk and cost of extending loans to SSE. Denied institutional credit, many SSE are forced to finance their operations using their own capital, with shortfalls being met from relatives, friends, or other non-institutional sources. This fact has been documented in a number of studies on the financing of SSE in several countries. (See for example, Chee Peng Lim 1977 and W. König 1990).

This problem is important because lack of credit is the major constraint faced by SSE in most countries. Access to credit from financial institutions for SSE is relatively difficult in most countries because loan sizes are small while the costs of processing are high in relation to the loan amounts. In addition, the track record and reputation of a putative SSE borrower is likely to be limited (as is the system of financial accounting), which adds to the costs of loan processing. Also, the probability of failure is high even for well-conceived new ventures. Only after an SSE has some record of success is it generally able to tap into the resources of the formal financial system.

SSE' s access to credit in the formal financial sector has been made worse in some countries where governments introduce credit regulations, such as maximum interest rates. Such a policy intensifies discrimination against SSE. When interest rates are fixed by government regulations at below market clearing levels, the demand for funds will exceed the supply. Under such circumstances, banks tend to deny credit to SSE first because of the higher costs of lending to such enterprises, as noted above. Thus, paradoxically, the problem of SSE financing is often exacerbated by well intentioned but ill-conceived government monetary policies.

Administrative devices used to implement industrial policies, such as those used in the Rep. of Korea and Taiwan also discriminate against SSE. For example, credit and foreign exchange to buy raw materials and capital goods were rationed by the authorities in Taiwan before 1964. LSE were given the lion's share of imports since they were regarded as priority sectors [Chee Peng Lim 1993].

The financial position of SSE is most severely affected whenever there is a "credit crunch". For example, as a result of the current economic slowdown in the Rep. of Korea, the Bank of Korea reported that 9,682 SSE went bankrupt in the first 11 months of 1992. The bankruptcies came as the large conglomerates absorbed most of the available bank loans, leaving SSE with little credit. In fact, whenever there is a shortage, be it credit or energy, SSE are most vulnerable. For example, SSE have been the most severely affected during the Philippines' current power crisis ("Stripped of power," Far Eastern Economic Review, 24 June 1993: 60).

Ironically, not only do SSE have problems getting institutional credit, they are often expected to finance LSE. In India for example, many SSE have become bankrupt because they are expected to supply goods to the distributor on credit. Apart from credit, SSE also suffer from various other predatory business practices imposed by LSE. A frequent example may be seen in subcontracting which is often based on an unequal relationship between SSE and LSE. Thus most of the time the latter are able to dictate the terms and conditions of sale that SSE are obliged to comply with, including the management and internal operations of the small subcontractors. Consequently, SSE subcontractors are the first to be squeezed by the parent companies whenever there is a recession.

At the macroeconomic level, a noncompetitive environment places SSE in a disadvantaged position. For example, a major obstacle to SSE development in the Philippines is the prevalence of "oligopolistic and rent-seeking" behaviour in the country. Selected oligopolistic LSE favoured by the government use their political influence and acquire profit-generating advantages, such as exclusive franchises (as in the case of the Philippines Long Distance Telephone Corporation), favourable tax rates and high tariff walls to ward off outside competition. Even public enterprises, especially in those countries where there is excessive state involvement in the economy, may also pose a grave threat to the ability of SSE to compete. In these countries, for example, Sri Lanka, a lot of economic activities is in the hands off public or parastatal enterprises which often use their monopoly to shape the structure of industry in favour of LSE. For example, the government-owned State Gem Corporation of Sri Lanka controls both gemstone exports and imports of uncut stones for calibration and re-export. It regulates in such a way that imposes a disproportionately severe administrative burden for SSE involved in the export of calibrated gem stones. One SSE exporter, whose experience apparently is not atypical, according to B. Levy (1993:79), reported that he personally spends two days processing the shipment of an export order and three days processing the clearance requirements prior to receipt of a parcel of gemstones sent by a foreign buyer on a no-foreign exchange basis for calibration and re-export. In a typical month, he reported, he has no alternative but to devote fully 50 per cent of his time to overcoming bureaucratic hurdles set up by the State Gem Corporation and by Customs (which operates a parallel apparatus to regulate international trade in gemstones).

3. Suggestions

It should be pointed out that SSE would have enough problems of their own without having to worry about the impact of government policies and the predatory business practices of LSE. (Admittedly, SSE have partly themselves to blame for some of their internal and external problems. For example, some SSE have not been able to organise themselves effectively and have done little to help themselves, apart from depending on government assistance.) Nevertheless, if governments are serious about enhancing the role of SSE in economic development, they should implement effective measures to ensure a more level playing field for small and large scale enterprises.

Firstly, there is a need to analyse existing and monitor new government policies and business practices for their possible adverse efffects on SSE. Policies should be reviewed to ensure that they generate a supportive environment, correct imperfections in the market and generally foster a development climate for SSE. Decision-makers engaged in SSE promotion should first of all analyse the impact of all existing policies and programmes and identify all discriminations and constraints on the SSE sector, whether they exist in fiscal, monetary, financial policies or in tax rates, tariffs or subsidies; the exchange rate policy and government procurement practices and regulations are also relevant. Macroeconomic policy reforms should be instituted to remove all biases against SSE. Ideally, policies should be neutral for all sizes of enterprises or at least promotional in nature. In reforming fiscal policies, the objective should be a well-functioning tax regime characterised by a minimum of bureaucratic requirements and by transparent, moderate obligations imposed across a broad spectrum of enterprisesf For example, indirect or neutral financial assistance programmes like a small business tax deduction should be automatically available to any qualifying SSE.

At a broader level, the simplification of income tax payment procedures, such as those introduced in India would be a boon to SSE. Under the new rules, selected SSE in India can now pay income tax of only Rs 1400 a year by filing a simple form at the nearest bank. The SSE is not required to file an income tax return or visit an income tax office or even maintain detailed accounts. After paying the stipulated amount of Rs 1400, the SSE is free from any inquiry from the income tax authority.

Financial policy reforms should facilitate access to credit for SSE and stimulate a healthy growth in venture capital, franchising and those areas in which SSE have the greatest potential for active participation. Equally important, legislation should be promulgated to provide for payment of interest on delayed payment to SSE. This could follow the lines of the recently introduced Prompt Payment Ordinance in India which applies to any buyer who purchases goods or services from SSE. (SSE have complained that delayed payment of their bills amount to extending additional cash credit accommodation to the buyer and that in the absence of timely payments, they either remain short of working capital funds or borrow additional credit at very high rates from non-institutional sources, which make their operations non-viable). The Ordinance provides for deterrent provisions, making delay in payments an uneconomic proposition to the buyer.

Secondly, a Council on Competitiveness should be established at the highest level to serve as a kind of appellate court for SSE which feel discriminated by government policies and business practices or regulations. At the same time, the Council should encourage the development of a conducive climate for SSE development. Generally, SSE flourish in countries in which the private sector has a considerable degree of freedom. Thus the Council should review Government policies with a view to lessen monopolistic market structures, facilitate the creation of new enterprises and generally allow market to operate freely. A conducive SSE development climate will include among other elements, a predictable economic policy with limited state enterprise activity and transparent government regulations. Since dominant state enterprises in several countries have directly or indirectly promoted the emergence of LSE, vertically integrated operations and thereby shaped industrial organisations in a way which discriminate against SSE, the Council should encourage privatisation in a manner which will reddress this bias. In the long run, the Council might wish to consider the promulgation of a Magna Carta for SSE such as the Magna Carta Act in the Philippines which set in place as guiding principles for the development of SSE:

a) minimal set of rules and simplification of procedures and requirements in order to ensure stability of rules and to encourage an entrepreneurial spirit among the people;
b) encourage more private sector participation in economic activities;
c) coordination of government assistance in SSE promotion to achieve coherence in objectives; and
d) acceleration of decentralisation in SSE assistance to enhance and attain maximum efficiency in the implementation of the Magna Carta Act.

Thirdly, the government should deregulate and reduce its paperwork requirements to the minimum or at least exempt SSE from those regulations and paperwork which apply mainly to LSE. Regulations should be promotional in nature. Licensing should encourage growth rather than regulate. Specific reforms aimed at reducing bureaucracy, subsidies and controls will likewise help by further enabling SSE to compete for inputs and materials on a more equal footing.

Fourthly, at the enterprise level, lack of standardised and simplified procedures, poor flow of information on the economy, technology and legislation may impede the process of change and adjustment for SSE. Access to information which is biased towards LSE could disadvantage SSE development. Thus the existing information system must be consistently improved and expanded to serve the needs of all enterprises, regardless of size. Information on legislation (company laws, labour regulations, welfare and tax laws), government directives and implementation regulations, economic promotion measures, public invitations to tender, economic data (business and economic forecasts), and technical conditions (new products and processes and quality standards) should be centralised in terms of collection and dissemination to enterprises. A major step is the organisation and management of this centralised information system and networking for the creation, promotion and integration of competitive SSE activities. Such a measure should form the core of any innovative programme for SSE promotion.

Finally, SSE should be integrated into the economic policy and planning framework of the government so that the needs and problems of the sector are always in the minds of policy-makers and government administrators who frame and implement government policies. Support agencies should assist SSE to jointly undertake functions at an optimum scale, which are impossible for the individual SSE because of its size. Such services can include bookkeeping, financial and legal advice, the purchase of inputs as well as marketing. The weakness of SSE in creating their own sales network might be countered by creating cooperative organisations or trading companies which carry out such functions on their own behalf.

In conclusion, the development of SSE cannot be viewed in isolation. Local, national, regional and global policies on political, social, and economic issues all have a bearing on the welfare of SSE. While LSE can depend on their associations at all levels to safeguard their interests, SSE often have to depend on their own resources. This is the message which all policy -makers should bear in mind when framing any policy.

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