FIVE

Giving Small Businesses a Chance

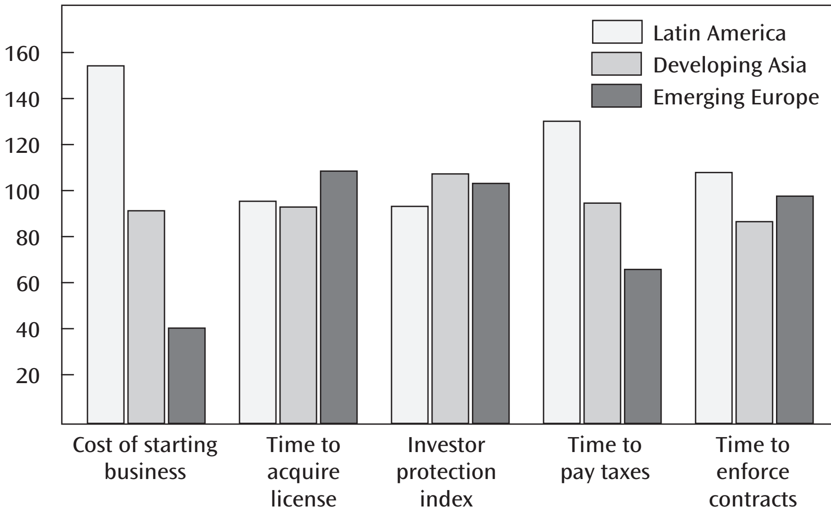
Doing business in Latin America is very difficult for small and medium-size enterprises (SMEs), in every dimension. In business surveys, Latin American SMEs report higher obstacles related to legal matters, financing, and corruption than do larger enterprises in their own countries and SMEs in developed countries.[1] Moreover, analysis of surveys indicates that equivalent obstacles hurt SMEs much more than other enterprises.[2] The silver lining of that finding is, of course, that any improvement in the business environment will bring a disproportionate benefit to SMEs. And there is indeed much room to improve. The available comparative indicators of the quality of business environments paint a grimmer picture for Latin SMEs than their peers in, say, developing Asia and eastern Europe (figure 5-1). Typically, a Latin American SME faces unduly slow and cumbersome bureaucratic procedures (which invite corruption), poorly designed tax regimes, onerous labor legislation, tight financing constraints, and costly transportation and communications infrastructure.[3]

1. As illustrated in the World Bank Enterprise Surveys (www.enterprisesurveys.org), Investment Climate Assessments (World Bank 2005d, 2005e), and World Business Environment Survey 2000 (Batra, Kaufmann, and Stone 2003).

2. Beck, Demirgüç-Kunt, and Maksimovic (2005) finds that the extent to which financial, legal, and corruption problems affect firm growth depends on firm size, with smaller firms being most affected by these factors.

3. In high-income OECD countries, it takes on average six steps over twenty-five days at a cost of around 8 percent of per capita income to open a new business. By contrast, Latin

FIGURE 5-1. Ease of Doing Business Index[a]



Source: IMF (2006b) based on World Bank's Doing Business Database.
a. Average across countries = 100.

American entrepreneurs on average go through eleven procedures over seventy days at a cost of 60 percent of per capita income to start a business, second only to their peers in sub-Saharan Africa. In Latin America, procedures to close a business take twice as long (3.6 compared with 1.6 years), bankruptcy proceedings cost twice as much (15.8 percent compared with 6.8 percent of the estate), and the recovery rate (how many cents on the dollar claimants such as creditors, tax authorities, and employees can recover from an insolvent firm) is about a third of that of high-income OECD countries (26 percent compared with 72 percent of debt, respectively) (World Bank 2006a). Senior management executives in Latin America report spending more than 10 percent of their time in a typical week dealing with government tax, customs, and labor regulations; dealing with government officials; completing official paperwork; and so forth. That figure is the highest of any region and compares with just under 3 percent in OECD countries (World Bank Enterprise Surveys). In Brazil, active SMEs surveyed in 2004 cited high levels of taxes and compulsory government payments as the main obstacle to doing business. The owners of failed SMEs also reported a high tax burden as a key reason for their failures (SEBRAE 2004). In Mexico, high energy prices affect the competitiveness of businesses across sectors and sizes. But the quality of electricity service is especially poor for SMEs, which often experience variations in frequency and voltage and service interruptions. Large firms have fewer quality problems because they generally are served by more reliable, high-tension wires (World Bank 2006d). On the effects of corruption, see chapter 8 of this volume; for more on infrastructure costs, see chapter 11.

Large enterprises in the region are, of course, not fully immune to those obstacles. But they have access to greater and more varied resources that help them to absorb the associated costs, they exert political influence to get special treatment, or they move operations to, and obtain financing from, foreign jurisdictions that offer a better business environment. Small businesses and microenterprises do not have those options. To minimize the costs of regulation and taxes, they often opt to remain informal as a way to stay in business, further reducing their ability to borrow, acquire new technologies, and expand in the long run.[4]

Reflecting the interaction between informality and smallness, the corporate sector in Latin American countries tends to be characterized by the so-called "missing middle." At one extreme, a few large enterprises account for a large share of a country's GDP and, at the other, many small firms and microenterprises account for a small fraction of GDP but a large share of employment and household income.[5] The missing middle reflects the difficulties that small enterprises face in breaking the size barrier to become medium-size firms.

Improving the business environment to level the playing field for SMEs is easier said than done. For example, significant reforms in the 1990s that

4. Informal, small firms operate without being registered, regulated, or taxed (Palmade and Anayiotos 2005). In Peru, nearly three-quarters of all microenterprises and small businesses operate outside of the formal economy; informality is much higher among microenterprises (75 percent) than among small firms (37 percent) (Perú–MTPE 2006). In Chile, there were 1.4 million microenterprises and small businesses in 2004, of which approximately half were informal. Chile's informal microenterprises were shown to have significantly lower sales than their counterparts in the formal economy as well as 25 percent less capital (Chile Emprende 2005). A recent assessment of informality in twelve Latin American countries suggests that burdensome procedures often deter micro- and small entrepreneurs who attempt to formalize their businesses, raising costs and forcing them to remain informal (see, for example, ILD 2006a-2006d). See also the discussion in Perry and others (2007b).

5. Angelelli, Moudry and Llisterri (2006) reports that large firms constitute less than 0.5 percent of total firms in Latin America and employ close to one-fourth of the private sector labor force. At the other extreme, microenterprises and small businesses together account for 97 percent of all businesses and 63 percent of total private sector employment. In five of seven countries with data available, microenterprises and SMEs together contribute to less than 50 percent of GDP. In Brazil, formal microenterprises and small businesses account for 98 percent of all firms, nearly 70 percent of total private sector jobs, and about 20 percent of GDP (SEBRAE 2006). In Peru, microbusinesses and small firms (both formal and informal, excluding self-employed individuals) account for 98 percent of total firms, employ 60 percent of the labor force, and contribute 42 percent to GDP (Perú–MTPE 2006, 2005).

produced more stable financial systems did not boost financing of SMEs to the extent expected.[6] At one extreme, large, reputable corporations can raise financing from local or international banks or securities markets.[7] At the other extreme, microenterprises have seen their access improve in recent years. In the middle are SMEs, for which financing, even for working capital, seems to have stagnated. In order to expand, SMEs must rely on retained earnings or borrow short term at high interest rates through credit cards or current account overdrafts.[8]

The need for renewed policy efforts to give small businesses a better chance is more urgent than ever given the growing competitive challenges of economic globalization.[9] Most of our equity tools (for example, for building infrastructure, smoothing booms and busts, and improving education) would benefit SMEs indirectly. We focus in this chapter on two areas in which policies could have direct effects: broadening access to financing and reducing other costs of doing business.

Broadening Access to Financing

For at least two decades, the singular focus of policy for improving the access of the poor to finance has been on "microcredit"—that is, on the

6. De la Torre, Gozzi, and Schmukler (2007a) and De la Torre and Schmukler (2004) discuss at length the nature of this gap with respect to the state of development of Latin American securities markets.

7. Segmentation of access to financial services can deepen with financial globalization (De la Torre and Schmukler 2004); for example, IDB (2005) provides evidence that foreign bank penetration (relative to GDP) tends to lower financing constraints, but mostly for larger firms, and that consolidation of the banking sector increases financing constraints for small firms. See also Clarke, Cull, and Martínez Pería (2001); Clarke and others (2005); and Beck, Demirgüç-Kunt, and Maksimovic (2003).

8. A 2000 survey in Argentina found that about half of industrial small and medium-size businesses were resorting to overdrafts, paying at that time an average interest rate of 2.7 percent per month (38 percent annually) in real terms (World Bank 2004a; Bebczuk 2004). Overall, credit to the nonfinancial private sector (as a share of GDP) remains low (about 9 percent in 2005)—and long-term credit, which is available at reasonable rates only to top-tier companies, remains scarce (World Bank 2006e; Bebczuk 2007). Small firms fare somewhat better in Chile, where less than a third report facing serious financing constraints and where bank credit finances about 25 percent of their investments. In Mexico, on the other hand, financing obstacles are a major problem for nearly two-thirds of small firms, and banks provide only 5 percent of their financing (World Bank Enterprise Surveys).

9. See note 7 for an example in the case of "financial" globalization.

creation of institutions, often by nongovernment groups, designed to make small loans to poor people, often women, and to very small "microenterprises" (a term that in Latin America is generally understood to refer to enterprises with ten or fewer employees.)[10] Progress in providing access to finance for microenterprises has been impressive in at least some countries, but financing for SMEs is still a major challenge.

Microfinance

Over the last two decades there has been considerable progress in Latin America on expanding access to financing for microenterprises, even in countries where the institutional framework is relatively weak—for example, Bolivia and Nicaragua.[11] The strong growth of the microfinance industry has been propelled by innovative lending techniques (for example, the use of credit scoring and e-banking) and the rising presence of credit bureaus, which have enabled microfinance institutions to reach the needed scale and bring costs down substantially.[12] As a result, microfinance has become a self-sustaining and highly profitable business in many countries.

10. There is no set definition of microenterprises or of small and medium-size enterprises. The definition used by enterprise surveys and statistical offices tends to be based on number of employees. Under that definition, microenterprises typically are considered to have ten or fewer employees, small enterprises to have between ten and fifty employees, and medium-size enterprises to have between fifty and 200 employees. For enterprise definitions in eighteen Latin American countries, see Angelelli, Moudry, and Llisterri (2006). For definitions in more than 100 countries, including in Latin America, see Marta Kozak, "Micro, Small, and Medium Enterprises: A Collection of Published Data," International Finance Corporation, January 26, 2007 (http://rru.worldbank.org/Documents/other/MSMEdatabase/msme_database.htm [March 2007]). Banks, in contrast, make their distinctions based on gross sales. For example, banks in Argentina and Chile would consider enterprises to be bigger than "micro" only if their annual sales total at least US$30,000.

11. Latin America has seen more rapid advances in the development of microfinance than any other region in the world. Today there are hundreds of institutions that specialize in microfinance, plus a growing number of commercial banks that seriously target this sector (Berger 2006). By 2005, microfinance institutions in Latin America served approximately 6 million clients (up from 1.8 million in 2001) and managed more than US$5.4 billion in loans (up from US$1.1 billion in 2001). Coverage of microfinance is significant in Chile, Ecuador, and Peru. Microlenders also have performed well in many of the poorest countries, such as Nicaragua, Bolivia, and Guatemala, where they reach 58 percent, 32 percent, and 22 percent of microenterprises respectively (Navajas and Tejerina 2006).

12. See, for example, Hardy, Holden, and Prokopenko (2003) for a description of how the availability of debtor information systems combined with scoring technologies has allowed Banco del Trabajo in Peru to become a commercially viable microfinance institution.

But microfinance penetration is still minimal in some places.[13] In Colombia, interest rate ceilings are a key obstacle. Elsewhere, monetary and banking authorities need to innovate, establishing a regulatory framework and prudential norms specific to and appropriate for microfinance institutions (including regarding capital, loan-loss provisions, and credit risk analysis and management). Special efforts on the policy and regulatory side are critical to support the interest of microfinance institutions in enabling the poor to save as well as borrow.[14] The authorities also should actively promote the modernization of debtor information systems (credit bureaus), with special emphasis on broadening their coverage to include debtors of both financial and nonfinancial institutions, improving the quality of information, and making the information accessible to bank and nonbank creditors (box 5-1). Examples of good practices in the region should be adopted more widely.

SMEs

As is the case for microenterprises, success for small and medium-size businesses requires that the best, most competitive among them be able to grow—from small to medium size and from medium size to large. Growth, in turn, requires that they have better access to credit at a reasonable cost.

But access to credit for SMEs continues to be a largely unsolved problem in Latin America, even in the countries that have made significant

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Credit scoring is an automated statistical technique used to screen loan applicants. It involves analyzing a large sample of past borrowers to identify the characteristics that predict the likelihood of default. Scoring systems usually generate a single quantitative measure (the credit score) to evaluate the credit application (De la Torre, Gozzi, and Schmukler 2007b). Schreiner (2003) and Salazar and others (2003) present an overview of how scoring works and its application to microfinance.

13. Microfinance has been far slower to develop in larger countries such as Brazil, Mexico, Colombia, Argentina, and Venezuela, where the majority of the region's poor live and where more than half of all microentrepreneurs are based. In Mexico and Colombia, microfinance institutions reach 12 percent and 7 percent of microenterprises respectively. In Brazil and also in Venezuela, microfinance penetration is less than 2 percent; in Argentina, it is less than one-third of 1 percent (Navajas and Tejerina 2006). See also the analysis in Christen and Miller (2006).

14. Roodman and Qureshi (2006) points out why microfinance institutions have tended to expand in lending services more than in providing the financial service of savings and other deposits.

BOX 5-1. Microfinance Expansion

In Latin America—more than in Africa and Asia—microfinance has become self-sustaining and profitable. Several microfinance institutions (MFIs) take deposits as well as make loans, and many are able to borrow from banks or have guarantees from banks that enable them to lend. What has worked for MFIs in Latin America? We highlight the following three key contributors:

First, *scoring technologies* have played a crucial role in reducing costs, even where the contractual environment is deficient. Hardy, Holden, and Prokopenko (2002) describes how the availability of debtor information systems (credit bureaus) combined with scoring technologies has allowed Banco del Trabajo in Peru to become a commercially viable microfinance institution. Schreiner (2003) presents an overview of how scoring methods work and their application to microfinance. Encouraging the adoption of new technologies has allowed microlenders to reach the needed scale and to standardize their products.

Second, the establishment and continuous modernization of *credit bureaus* through legal and regulatory changes as well as through the catalytic role of public policy have also been critical. The credit information systems in Brazil, Chile, Argentina, and Peru fare the best.[1] Credit bureaus that disseminate information on debtors (positive as well as negative) allow new entrants to build a credit record and its associated "reputation collateral" and help drive down the costs of debtor screening and monitoring.[2] In order to facilitate transparency and arm's-length lending, the regulatory framework must encourage symmetry in making information available to lenders. Because credit bureaus benefit from economies of scale, public policy should facilitate cooperation among creditors (in order to avoid excessive fragmentation of the industry) while maximizing creditors' access to debtor information and adequately protecting privacy rights.

Third, successful MFIs have adopted adequate *risk management policies*. MFIs and banks are high-volume, low-margin businesses that manage high credit risk. So, as in the case of Calpiá Bank in El Salvador, they display significantly higher capital-to-asset ratios and have much more aggressive provisioning policies than typical commercial banks.

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1. Most Latin American countries have well-established, good-quality public and private credit registries in which most banks participate. Factors like the absence of laws restricting information sharing within the financial sector, increased foreign investment in credit registries, and the long-time use of this tool in the retail sector help explain advances in the sector since the 1990s. Brazil's SERASA is the largest Latin American credit registry, with annual sales close to US$150 million. (The country's extensive chamber of commerce network operates a credit registry and bad-check list on a state-by-state basis.) Argentina and Chile also have strong private credit registries. As in other developing regions, the consumer side of credit registries appears to be more developed than the small business side.

2. Evidence in Djankov, McLiesh, and Shleifer (2007) suggests that credit registries have a positive impact on firms' access to bank finance, especially in poorer countries. See also IDB (2005) and Love and Mylenko (2003).

progress toward developing more resilient financial systems.[15] Part of the problem is that SME lending relies on local legal, information, and judicial systems, which are inadequate in most Latin American countries. Other forms of credit contracts, such as consumer loans and even microloans, have expanded more quickly, presumably because they rely less on the quality of financial statements and on local institutions for contract enforcement and because scoring techniques and credit bureaus appear to suffice for managing lender risks. As firms grow and become less homogeneous, however, scoring methods become less applicable and the relevance of financial statements, collateral laws, bankruptcy regimes, and judicial processes rises.[16] Because entering the SME lending business implies high fixed costs, banks move only reluctantly into this sector—and then only when other lines of business have been fully exploited. Moreover, in the absence of visible improvements in the contractual environment, even the modernization of credit bureaus, which helps microfinance, may have less impact on SME lending, because banks that invest in finding and building relationships with SMEs will avoid sharing with other banks the information that they gain about individual firms.[17]

For decades Latin American governments have tried to redress the poor access of SMEs to credit by creating public banks that made loans to this sector at below-market interest rates. But those banks have often been plagued with problems of governance and political interference. The resulting poor loan origination and collection practices, exacerbated by political pressure to grant debt forgiveness, in many cases led to recurrent claims on government budgets.[18] The banks' subsidized interest

15. Even in successful corporate bond markets like Chile's, access to financing is highly segmented. Between 2000 and 2003, 100 percent of all the corporate bond issues in the local stock market went to larger firms. In Argentina and Mexico in 2004, the top ten companies accounted for more than 70 percent of trading in domestic stock markets; in Brazil, Chile, and Peru, the ten largest firms accounted for roughly 50 percent of total stock market value traded that year (De la Torre, Gozzi, and Schmuckler 2007b). See Beck and De la Torre (2007) and De la Torre, Gozzi, and Schmukler (2007b) for a discussion of conceptual issues in access to finance.

16. See Beck and Levine (2005) for evidence on the impact of contractual and legal environments on financial depth.

17. IDB (2005) suggests that in Latin America (especially in medium-size markets) banks may be unwilling to disclose information on small business clients, at least not immediately, even if that would reduce their risk.

18. For example, in 2001 the Brazilian government absorbed the nonperforming loan portfolios of two public banks (Banco do Brasil and Caixa Econômica Federal) at a net cost

rates, furthermore, all too often favored rich and politically connected borrowers. By distorting price signals and incentives, subsidized credit programs probably slowed the creation of new small businesses and accentuated their disadvantages vis-à-vis large firms.[19]

In addition to ongoing improvements in debtor information systems and the diffusion of scoring techniques for evaluating smaller firms (see box 5-2 for the indirect effects of continued strengthening of the overall financial system),[20] key policies to encourage development of the SME finance sector include

- improving the institutional infrastructure that backs credit contracts: securing the legal rights of creditors, in terms of both executing guarantees and implementing timely corporate bankruptcy proceedings; securing the judicial and nonjudicial processes for contract enforcement; and strengthening titling and property registries.[21]

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of about 6 percent of GDP. And in Mexico the government had to recapitalize Banrural (now Financiera Rural), a development bank providing financing to the rural sector, with more than US$1 billion in 1999, even after having significantly downsized its operations in previous years. See De la Torre, Gozzi, and Schmukler (2006). For further discussion of the role and record of public banks in Latin America, see IDB (2005) and Levy-Yeyati, Micco, and Panizza (2007, forthcoming).

19. Many state-owned banks have since become private, and often taxpayers are stuck with financing their losses, as governments assumed their debts. And little has arisen—either in banking or in debt or equity markets—to take their place.

20. Developing small business credit-scoring technologies would help in evaluating risk more efficiently and act as an effective account management tool. Evidence that doing so might be feasible in Latin America is provided in Miller and Rojas (2005). In the United States, FICO (Fair Isaac Corporation, the best-known credit score model in the United States) provides some 350 lenders with a highly developed set of credit-scoring models based on information on both small businesses and their owners. FICO contributes to approximately 900,000 lending decisions a year, considerably reducing loan processing time and costs. See also Berger and Frame (2007) on small business credit-scoring models in the United States.

21. Loan contracts are not enforced effectively in Latin America. Laws and judges tend to have an unduly pro-debtor bias in disputes, making it excessively costly for creditors to recover collateral in cases of default. In most of the region, titling and property registries are weak and poorly managed, which makes it difficult for creditors to establish the priority and seniority of their claims (IDB 2005; IFC 2006; World Bank 2006c). Countries that have implemented titling reforms perform better than those that have not; but there is still a long way to go if the region is to achieve international standards (see ILD 2006a-2006e). Djankov, McLiesh, and Shleifer (2007) finds that both better creditor rights and the presence of credit registries are associated with a higher ratio of private credit to GDP, controlling for total GDP, per capita income growth, and contemporaneous inflation. The study shows that private credit rises following either improvements in creditor rights (especially in the case of

BOX 5-2. As Securities Markets Grow

Broadening SME access to financing requires more than a single-minded focus on a particular type of credit product or financial entity. Policies to promote access must take into account the overall functioning of the financial system. For example, while it is unrealistic to expect institutional investors (for example, pension funds) and securities markets to become the main source of *direct* financing to SMEs, the development of securities markets—especially debt markets—and the institutional investor base is nonetheless crucial to generate the *indirect* effects needed to improve the overall availability of financing for SMEs. In effect, as securities markets grow, they will attract the larger and blue-chip corporate clients away from banks, thereby forcing banks to move down market and seek new business by lending more to SMEs.[1] To be sure, expectations have to be tamed to the extent that the development of centralized securities markets depends significantly on liquidity, economies of scale, and network externalities, which can be very difficult to achieve in small emerging markets.

1. De la Torre and Schmukler (2004) outlines challenges in the development of securities markets for small emerging economies.

- facilitating the use of movable collateral (for example, accounts receivable, future wage earnings, livestock, machinery, and inventories); changing the legislation and civil codes on pledges and guarantees; modernizing the registries for movable assets; and streamlining the mechanisms for repossession of collateral.[22]

developed countries) or the introduction of credit registries (in the case of developing countries). Evidence in Haber (2006) suggests that in Mexico, weak contract rights and property rights are key explanatory variables for the low levels o f credit offered by Mexican banks.

22. In most countries, the requisites demanded by financial institutions for granting credit and accepting collateral remain very complex and costly. The process of establishing collateral and obtaining credit can take sixteen months and cost about US$3,500 in Guatemala; in Colombia it takes more than three years and costs around US$1,800 (ILD 2006b, 2006e). Peru has recently implemented a centralized collateral registry, which began operating in May 2006, as part of an effort to broaden access to credit. In Mexico, reforms in 2000 provided for the creation of a federal public registry of commerce on movable property, but collateral registries continue to be run by the states, with each state deciding how to operate the registries and how much to charge in taxes and duties, with no links among them. The process of converting registries to electronic access has been very slow; in some states security agreements still are manually transcribed on paper. Mexico has a law providing for out-of-court enforcement, but creditors cannot enforce a nonjudicial order if the debtor opposes it. Moreover, the debtor is likely to successfully challenge as unconstitutional any out-of-court enforcement action,

- enhancing minority shareholder rights as well as improving accounting and disclosure practices. Both are of special relevance if firms are to break the size threshold by issuing equity and debt securities in local and international markets.[23]
- instituting a set of policies designed to encourage diversification of financial intermediaries and products: removing legal, regulatory, tax, and other obstacles to the development of factoring and leasing, which are key sources of working capital and investment financing for small and medium-size businesses;[24] promoting competition in credit markets by, for instance, allowing the entrance of non–deposit-taking credit institutions—such as the Sociedades Financieras de Objeto Limitado (Sofoles) in Mexico; and facilitating, through suitable regulations, the establishment of bridges between credit institutions and institutional investors (mutual funds, pension funds, and insurance companies).[25] Governments might also consider encouraging reciprocal credit guarantee agreements to increase the availability of credit to small businesses. In such agreements, lenders share loan decisions and monitoring with agents who are in a better position to

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regardless of the terms of the original contract. In the end, both parties often end up in court anyway (World Bank 2006c; IMF 2007d). Brazil faces some of the same challenges as Mexico in facilitating the use of collateral (see IFC 2006).

23. Market participants in most of the medium-size and larger Latin American countries typically consider bond or equity issues of less than US$50 million unlikely to whet the appetite of large institutional investors, in part because smaller issues would not generate sufficient secondary market liquidity to enable orderly exit. This sort of size threshold for new issues is also needed to spread out the transaction costs of issuing, as discussed in Zervos (2004). However, $50 million is a hefty sum in relative terms for many Latin American countries. It is, for instance, a multiple of the capital of most of the corporations within Latin American countries and, hence, is a threshold that leaves only a handful of firms eligible to participate through securities issuance in the local, centralized stock exchanges.

24. For a discussion of factoring markets and the possible role of government policy, see De la Torre, Gozzi, and Schmuckler (2006) and Klapper (2006). Argentina is promoting markets for invoice factoring through changes in the country's legal and regulatory framework. Some of the legal steps necessary include allowing and protecting the transfer of invoices from small businesses to financial agents, establishing clear procedures to enforce the buyer's payment of invoices, and strengthening the creditor rights of factoring agents vis-à-vis the borrowing firm (IDB 2005; Bakker and others 2004).

25. In this connection, the Latin American Shadow Financial Regulatory Committee (2004) recommends that countries fix their regulatory framework to allow for the emergence of mutual fund–style institutions (for example, by defining responsibilities vis-à-vis shareholders, capital requirements, and so forth) whose assets are a diversified portfolio of loans to SMEs and whose liabilities are shares owned by institutional investors that can be traded in the secondary market.

observe borrowers' effort or who have privileged information on or leverage over borrowers.[26]

- focusing on new reform strategies for development banks. Most important are reforms aimed at separating subsidies from financing. Subsidies in the form of below-market interest rates fuel misallocation of resources and mismanagement of risks and stifle the development of private markets. Promoting market-based and sustainable broadening of access for underserved sectors requires new and innovative instruments, such as technical assistance, matching grants, and special programs to modernize financial market infrastructure. In Mexico, the promotion by Nacional Financiera (NAFIN) of an Internet-based market for SME receivables discounting is a good example of a development bank playing a market-friendly role.[27]

The policies suggested above concentrate largely on improvements to the contractual and informational environment that can unblock credit to SMEs. These policies, while important, are of course not sufficient. In particular, they cannot by themselves give rise to high-quality entrepreneurship, profitable projects, and investment optimism in the SME sector. These latter ingredients are even more important, in the sense that they alone could unleash adequate financing to SMEs even where weaknesses remain in the contractual environment.

Reducing Other Costs of Doing Business

Latin American SMEs, compared with their peers in advanced economies, have limited access to information and technology. Incomplete information

26. See Llisterri (2006); Llisterri and others (2006); and Malhotra and others (2006) for further discussion.

27. In Mexico, NAFIN, a development bank, created an Internet-based system to provide factoring services to SMEs, ameliorating information problems, reducing transaction costs, and fostering competition among financial institutions. The system works by creating chains between buyers (large creditworthy firms) and their suppliers. Large buyers post the receivables into the system, preventing fraud. All financial institutions can bid to factor a specific transaction; the electronic platform allows wider participation, especially of smaller regional banks. Since the start of the program in 2001, NAFIN-supported market infrastructure has brokered more than 1.2 million factoring transactions (98 percent by SMEs). For more details on this case, see De la Torre, Gozzi, and Schmukler (2006). The study by De la Torre, Gozzi, and Schmukler (2007b) discusses the potential for market-friendly government interventions and examines a number of case studies, including that of NAFIN.

and uncertainty, together with practical difficulties caused by weak property rights in appropriating the gains from innovative effort, make these enterprises reluctant to invest in learning and innovation. Most countries have a long history of government programs that offer management and technical support for small and medium-size enterprises. But frequently such public programs have been of poor quality, being excessively supply-driven and failing to focus on the new and changing needs of small businesses.[28] A number of countries have expanded private sector participation in the design, implementation, and evaluation of SME support programs, with some positive results (see box 5-3). In Brazil and Chile, for example, small businesses are increasingly required to share the costs of the services that they receive. These are steps in the right direction.

Here are two additional specific steps:

- First, a major "spring cleaning" of government red tape—regulatory, tax, and bureaucratic intrusions—that affects small enterprises. Much of the bureaucratic nuisance that hinders SME development stems from regulations that have lost relevance but continue to be embodied—often unconsciously—in the inertia of administrative habits.[29] A high-level independent taskforce, with members from outside the government, can lend credibility and prestige to such a spring cleaning.

28. World Bank (2004a) highlights the excessive number of uncoordinated and overlapping support programs for small businesses in Argentina. With a few exceptions, programs showed low coverage and poor outcomes. Whether federal, provincial, or municipal, most suffer from insufficient strategic vision and coherence. There is also a lack of adequate monitoring and assessment mechanisms, making evaluation of cost effectiveness and impact very difficult. In Mexico, the number of firms participating in the largest public SME support program (which provides training services on a cost-sharing basis) fell sharply from about 94,000 firms in 2001 to 7,000 in 2005 because of the program's budget cuts and low efficiency (overhead figures were close to 60 percent). Among participating firms, the impact of the program on firm productivity was minimal (World Bank 2006d). See also Lopez-Acevedo and Tan (2005) for further discussion and evaluation of Mexico's SME programs.

29. Colombia has made significant progress in reducing red tape by means of interinstitutional coordination, simplification of existing procedures, and technological strengthening of government agencies. By mid-2006, hundreds of bureaucratic procedures had been simplified and dozens eliminated. Almost all formalities for starting a business in Colombia can now be completed in one day at one of the Centros de Atención Empresarial, which are established and managed by the Confederation of Chambers of Commerce and local governments. The process previously took from fifty-five to sixty days and involved seventeen separate procedures. Costs of starting a company have fallen by up to 75 percent for microenterprises and small businesses (Castro Forero 2007). See also Sislen and others (2007) for progress in reducing red tape in Lima, Peru.

BOX 5-3. Competitiveness and Innovation for Small and Medium-Size Enterprises

Argentina's Rafaela-Esperanza Enterprise Development Center (Centro de Desarrollo Empresarial) is part of a new generation of government-sponsored business development services—with the government program as intermediary. Rather than provide services directly to businesses, the public agency arranges for businesses to use consultants selected through competitive bidding. Small businesses pay some of the cost—not necessarily the full cost, but enough to ensure that they are committed to using the advice that they buy. The program combines reliance on private consultants with the recognition that small businesses need some subsidy if they are to get the best technical advice.

To improve the export performance of small and medium-size enterprises, Argentina's Business Restructuring Program for Exports (Programa de Reconversión Empresarial para las Exportaciones) departed radically from the traditional (failed) export promotion programs. Using a US$27 million grant from the government, it required individual firms to pay half the cost of consultants and other services of approved projects. The projects were chosen and the program managed by a private operator, selected by international tender. Between 1996 and 1999, the program attracted close to 1,000 clients; the number of approved projects exceeded expectations, despite economic uncertainties in Argentina's main export market, Brazil.[1]

1. In total, the program attracted 967 clients (the goal was 900) and approved 1,089 projects. Close to 30 percent of the participating firms increased their export markets, and 32 percent increased the number of exported products. It has since ended, due to a combination of neglect and interference from the public agency that provided partial financing.

Paraguay's Voucher Training Program for Microbusinesses (Sistema de Bonos de Capacitación) was initiated to remedy past failures in financing microenterprise training. Program beneficiaries (who ran microenterprises of just a few employees) received publicly funded vouchers. They used them to help purchase training and other services from prequalified private suppliers, who then redeemed the vouchers for cash when a trainee completed the course. Vouchers were valued at approximately U.S. $20 each, which covered up to 60 percent, on average, of the total cost of each course. Courses offered by private providers were evaluated by the participants and the results were made publicly available, allowing interested microentrepreneurs to make an informed choice of providers. The program helped create a market for private training: by increasing microentrepreneur's buying power, it encouraged training institutions to compete to attract clients. Between 1995 and 1997, more than 14,000 vouchers were distributed through the program, and many microentrepreneurs continued to pay for the courses in full after termination of the voucher program. The number and diversity of service providers rose markedly. Managed by an independent contractor, the program avoided problems common to this type of initiative when managed by governments, such as failure to reach the beneficiaries most in need, inappropriate services, and abuses of the support offered. Ecuador and Bolivia have implemented initiatives that build on Paraguay's voucher experience.

Sources: Ventura (2003, 2001); Goldmark (2006); Angelelli and Solís (2002); Oldsman (2000); and Addis Botelho and Goldmark (2000).

- Second, government promotion of clusters and productive chains, especially where comparative advantages are obvious and perhaps also where government smart signaling (for example, through strategic investment in infrastructure and human capital) can "crowd in" private investment and enthusiasm. That would help small businesses identify and gain access to new opportunities.[30] Policy tools to promote clusters and chains could include a judicious use of matching grants, which can improve small enterprise access to the markets for technical and professional services and, at the same time, foster the development of such markets.[31] While this requires a degree of pro-market activism on the part of the government, it is a far cry from the old-style industrial policy of "picking winners."[32]

30. Empirical evidence shows that in both developed and developing countries, when small firms are located in clusters they often are able to overcome some of the major constraints that they face, including lack of specialized skills and difficulty in accessing technology, inputs, market information, credit, and external services. Linking into clusters and value chains also offers an opportunity to access larger and foreign markets (Pietrobelli and Rabellotti 2006; Pietrobelli, Rabellotti, and Giuliani 2006). On the successful cluster of salmon farming and processing businesses in southern Chile, see Maggi Campos (2006). Gomes (2006) examines the case of small fruit exporters in three parts of Brazil who have managed to meet the rising demand of global markets through different strategies and levels of association with the public sector.

31. In general subsidies should go to the firm demanding the service, with participating private firms sharing substantially in the costs of contracting for consulting, technical, and professional services. Service contracting should be demand-driven to ensure the supplier firm's commitment to quality. Even the overall administration of the program can be subcontracted to a specialized private firm. Subsidies also can be used to encourage SMEs to cofinance training of workers.

32. See Recart (2005) on the success of Fundación Chile in fostering innovative business development in key Chilean clusters.