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FINANCE AND SMALL AND MEDIUM-SIZED ENTERPRISE DEVELOPMENT

Paul Cook
IDPM
and Frederick Nixson
School of Economic Studies
University of Manchester

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Crawford House, Precinct Centre, Oxford Road, MANCHESTER M13 9GH
Tel: +44-161 275 2804/2800 Fax: +44-161 273 8829
Email: idpm@man.ac.uk Web: http://www.man.ac.uk/idpm/

1. INTRODUCTION

Interest in the role of small and medium-sized enterprises (SMEs) in the development process continues to be in the forefront of policy debates in developing countries. The advantages claimed for SMEs are various, including: the encouragement of entrepreneurship; the greater likelihood that SMEs will utilise labour intensive technologies and thus have an immediate impact on employment generation; they can usually be established rapidly and put into operation to produce quick returns; SME development can encourage the process of both inter- and intra-regional decentralisation; and, they may well become a countervailing force against the economic power of larger enterprises. More generally the development of SMEs is seen as accelerating the achievement of wider economic and socio-economic objectives, including poverty alleviation.

Staley and Morse (1965, p.318) identify a 'developmental approach' to SME promotion which has as its objective the creation of 'economically viable enterprises which can stand on their own feet without perpetual subsidy and can make a positive contribution to the growth of real income and therefore to better living levels'. This approach emphasises the importance of efficiency in new SMEs. Small producers must be encouraged to adopt new methods, move into new lines of production and in the longer-run, wherever feasible, they should be encouraged to become medium- or even large-scale producers.

More recent concerns associated with the growth and efficiency of smaller enterprises have also become prominent (Mazumdar, 1997). Using the case of Northern Italy, Piore and Sabel (1984) have argued that small enterprises are more efficient because they have adopted a flexible specialisation approach. Correspondingly, there has been growing interest in whether this model has or can be replicated in developing countries (Schmitz, 1989; Pederson, 1994; Schmitz and Musyck, 1994; Schmitz, 1995).

The role of finance has been viewed as a critical element for the development of small and medium-sized enterprises. Previous studies have highlighted the limited access to financial resources available to smaller enterprises compared to larger organisations and the consequences for their growth and development (Levy, 1993). Typically, smaller enterprises face higher transactions costs than larger enterprises in obtaining credit (Saito and Villanueva, 1981). Insufficient funding has been made available to finance working capital (Peel and Wilson, 1996). Poor management and accounting practices have hampered the ability of smaller enterprises to raise finance. Information asymmetries associated with lending to small scale borrowers have restricted the flow of finance to smaller enterprises. In spite of these claims however, some studies show a large number of small enterprises fail because of non-financial reasons (Liedholm, MacPherson and Chuta, 1994).

The purpose of this paper is to discuss the focus of previous studies on the relation between finance and small and medium-sized enterprise development and to identify some of the gaps in our knowledge. While a considerable amount is known about the characteristics and behaviour of small and medium-sized enterprises, this knowledge continues to be imperfect and a large number of questions remain unanswered in relation to finance and small enterprise development. This paper discusses some of the issues raised by previous research and points to newer areas that can fruitfully be researched.

Section two provides some general characteristics of previous research on small enterprise development and indicates the main areas of emphasis. The third section reviews some of the

issues that emerge from the literature that has attempted to assess the impact of policy reform, particularly financial sector reforms on small and medium-sized enterprises. Interesting issues are raised by the effects of reforms on both the demand and supply of finance. The fourth section discusses issues related to the theoretical treatment of the relation between finance and small and medium-sized enterprise development. An attempt is made in the concluding section to identify the kinds of testable hypotheses that emerge from the body of theory and to discuss their implications in the context of low income countries. The Appendix discusses the proposals for the directions of the current research programme and provides an outline of proposed fieldwork activities for the next year.

2. STYLISED FEATURES OF CURRENT RESEARCH

SME Research in Industrialised Countries

There are a number of distinctive features concerning the nature of economic research on small and medium-sized enterprises. First, the bulk of research has predominantly been undertaken in the context of US and UK firms and has sometimes entailed comparisons with other European economies (Storey, 1995). As such, the theoretical work has assumed an institutional setting and made assumptions about the policy environment that is relevant to these economies. Second, much of the theoretical work on enterprises has related to larger firms, and in the context of smaller firms, research effort has tended to focus on the larger smaller enterprises. Third, research has been divided between those examining the macro environment within which small and medium-sized firms operate and those directed towards the internal workings of enterprises.

With respect to the macroeconomic environment the work has involved: assessing the importance of aggregate demand and the role of macroeconomic policies for small enterprise development; the role played by the various formal sector and informal sector lending institutions that provide credit for the small scale sector, and the importance of promotional policies in terms of providing managerial, technical and marketing information to small enterprises. With respect to internal factors, attention has concentrated on the choice of investment; employment; firm level performance and productivity; capital structure and the ownership and incentive structures for management.

Fourth, there has been less work directly related to small and medium-sized enterprises in low income countries. It is also the case that the major proportion of this work has been empirical rather than theoretical and it is reasonable to conclude that relatively little is known about the behaviour of entrepreneurs in low income countries relative to those operating in higher income countries.

SME Research in Low Income Countries

The literature on low income countries follows the same divide between studies that are concerned with external and internal factors that affect small and medium-sized enterprise development. In terms of external factors, much of the earlier literature in the 1970s was concerned with the biases established against smaller enterprises through trade and industrial policies pursued in low income countries and with the design of appropriate support institutions that would compensate for these so-called policy-induced biases. Policies of economic liberalisation were introduced later, partly with the aim of reducing the bias in favour of larger enterprises. The 1980s also witnessed a greater concern for the importance of recognising the need for and integrating policies at the macro, meso and micro level towards the development of smaller enterprises in low income countries (Stewart, 1990).

Earlier work on the internal workings of small and medium-sized enterprises was mainly concerned with the size of small firms and providing explanations for their growth. Staley and Morse (1965) examined the stages small firms pass through as an economy grows. They postulated several reasons why small firms in low income countries initially grow rapidly before their share in total industrial activity begins to decline. Rapid growth of small firms could be explained where: demand was rising as rural incomes were growing and where infrastructure costs still favoured small firms locating near fragmented markets; subcontracting and local assembly was common, as for example in varieties of machine-shop activities and where smaller firms produced a range of differentiated and innovative products serving small total markets. But as Anderson (1982) pointed out these propositions had not been quantitatively tested by the early 1980s.

Earlier researchers were also preoccupied with investigating the extent to which small firms form the foundation for larger firm growth. As Anderson (1982) reported, the body of that research claimed that,

> 'firms practically always begin as very small entities, with low amounts of capital drawn from the savings of the owner or borrowings from friends and relatives; initial levels of employment are low, typically less than a dozen, though the figure varies with the nature of the business; the social and occupational backgrounds of the owners varies greatly; and the firms that expand into medium or large scale activities do so continually or in steps. Expansion can be very fast for some firms, though the growth rates appear as broadly distributed as their final sizes' (p.923).

Anderson (1982, p.926) concluded that the available empirical evidence suggested that a significant part of the growth of large scale enterprises was rooted in the expansion of once small firms through the size distribution.

In low income countries work directed towards the internal workings of enterprises has been hampered by the lack of basic data on the management and characteristics of smaller firms. Considerable effort has been expended on attempting to gather consistent and measurable information about small firms. Industrial censuses in a large range of low income countries have not been undertaken annually; they have concentrated on larger enterprises; they have only infrequently surveyed small enterprises and have often been published with long delays. As a consequence, useful time series data for smaller enterprises from official sources are largely absent.

This has had implications for research efforts into small enterprises in low income countries in three important ways. First, a considerable amount of time has been spent on gathering baseline information on small firms. This has involved identifying universes and constructing samples; devising methods to deal with delinquent returns and editing the results in a consistent manner. Second, information collected tends to be more qualitative than quantitative because of the poor record keeping and lack of cross referencing sources through formal channels that can be used to confirm the reliability of surveyed data. This tends to limit their use in statistical analysis. Third, surveys are more often conducted on an ad hoc basis at a point in time. Few compare different points in time and fewer still have attempted to use the same database for follow-up work. As a result time series work on the small scale

sector is relatively scarce. The preoccupation with gathering baseline data and the restricted nature of the data that have eventually been collected has resulted in a preponderance of studies that have attempted to describe and report on the characteristics and features of the small scale sector rather than test theoretical propositions about relationships and the expected behaviour of the small firm sector. This is not to suggest that theorising and testing of theories is completely absent in relation to work on small enterprises in low income countries, but in comparison with work in industrialised countries or in relation to research on the behaviour of larger foreign-owned enterprises in low income countries, it is quantitatively much less evident.

In contrast to the earlier work, a distinctive feature of the current spate of empirical work undertaken in low income countries rests with its concentration on attempting to identify the constraints facing the development of the small scale sector (Levy, 1993). Most surveys have sought to capture the range of factors that inhibit the growth and development of small firms. A large proportion of this information has been collected from smaller firms through questionnaires asking owners and managers to give their views on either the kind of constraint they face, whether it be related to such factors as access to finance, poor managerial skills and lack of training opportunities and the high cost of inputs, or on the severity of the constraints, often ranking them on an ordinal scale. Few studies have concentrated on a particular constraint, so that finance has most often been identified as a inhibiting factor as part of a larger investigation into a wider range of variables. The results in terms of the significance of financing acting as a constraint to development are mixed and it is difficult to draw firm conclusions about the subject. Interpretation is complicated because of the qualitative nature of the surveys and to the fact that enquiries have almost exclusively been directed at firms that exist rather than following the histories of those that have eventually failed.

In summary, it cannot be denied that a considerable amount is known about the behaviour of smaller firms in a range of areas relating to growth, efficiency, management, investment and employment. A smaller proportion of this work is theoretical in nature. The vast majority of studies, particularly those relating to low income countries, are empirical, and in general surveys have been used to generate basic information on smaller enterprises where official enumeration is lacking. The dilemma facing researchers is how to maximise the use of existing surveys and forgo the need for newer enquiries which may waste resources and time by duplicating or replicating existing sources of information. What seems clear is that, in the past, there has been a too distinct separation between theoretical work that advances hypotheses about the small scale sector and empirical work that has not clearly sought to test hypotheses but instead has been involved with describing the characteristics of small enterprises. In part, this can best be explained by the preoccupation with gathering original data that in some way has crowded out initiatives to apply the data to test theories. Alternatively, it may simply reflect data inadequacies once they had been collected. Whatever the reasons, it is apparent that work in relation to low income countries, where these data problems most evidently exist, has lacked the formalised hypothesis, data collection and testing approaches widely adopted in other branches of industrial studies.

3. IMPACT OF POLICY REFORM

In the 1990s greater attention has been given to assessing the impact of economic reforms on smaller enterprises introduced as part of World Bank structural adjustment programmes (Cook, 1996). Overall views concerning the likely impact of these reforms on small

enterprise development have varied. Whereas some claim structural adjustment has brought considerable benefits to small scale enterprises, others stress wide ranging constraints have frequently prevented such effects from reaching small scale enterprises. Empirical evidence in support of these claims is briefly examined in this section in relation to the array of economic and financial reforms that have been implemented in low income countries during the past decade and a half.

The evidence reviewed is found in a growing but relatively small number of studies that directly attempt to measure the impact of economic liberalisation and structural adjustment on the small scale industrial sector (Liedholm, 1990; Koppel, 1991; Steel and Webster, 1992; Boeh-Ocansey, 1994; Dawson, 1993, 1994; Steel, 1993, 1994; Vachani, 1994; Zake, 1994; Helmsing and Kolstee, 1993; World Bank, 1995). Further evidence can be extracted from a larger number of studies which concentrate more specifically on constraints to small scale enterprise development. Direct causal links are, however, difficult to find owing to the paucity of time series data that can be used to measure the impact of structural adjustment on small scale enterprise development and to the limitations of evaluation methodologies.

Studies broadly fall into three categories: those attempting to determine the impact of measures designed to work through the market mechanism, such as interest and exchange rate policy; those that attempt to assess the overall impact of policy measures on small scale development, which generally include an array of market and non-market initiatives; and, those that review the policy environment. The former set of studies tends to rely on economic data drawn from official statistics such as supplied by the monetary authorities and census bureau for establishment level data. Studies based on direct surveys, as a rule, tend to focus on whether or not the factors previously identified as constraining the development of small scale enterprises have been eased or removed. Finally, policy studies are generally broader in focus, reviewing the existing policy framework and providing prescriptions, often based upon what has appeared to work elsewhere. This brief review concentrates on the first category of studies that have attempted to evaluate the efforts of specific policy packages.

Agricultural Price Liberalisation

Agricultural price liberalisation is expected to contribute to raising farm incomes in situations where government-controlled prices previously led to low farmer remuneration. It is argued that policies that kept agricultural prices at the farm gate at a low level provided little incentive for farmers to expand their output. In combination with unfavourable exchange rates, this had the effect of stifling agricultural-based export production. Price liberalisation and the lessening of controls over price setting and procurement are expected to improve rural incomes and lead to an increase in demand for non-agricultural products. It is likely that a significant proportion of these goods and services will be provided by smaller enterprises (Elkan, 1993).

In assessing the effects of agricultural price liberalisation on the small scale sector, the impact of devaluation in increasing the cost of agricultural inputs is often left out of the equation. Studies show that such increases in the cost of imported machinery and fertilisers frequently offset any advantage achieved through price liberalisation. Increased costs have prohibited the use of fertiliser by some Gambian and Nigerian farmers resulting in decreased production levels and reduced farm incomes. Fertiliser costs in Nigeria rose 700 per cent between 1983 and 1990, increasing the cost of food production, increasing prices and reducing rural incomes (Dawson, 1994). As Liedholm (1990) shows, studies in Africa, including those from Sierra Leone and Nigeria, have shown a strong link between local income and both

demand for small scale enterprise products and enterprise size. Dawson's study is no exception. The reduction in incomes has meant that many could no longer purchase new goods, but instead relied on repairs to existing commodities. The fall in demand for small scale enterprise products which followed was associated with a move within the small scale enterprise sector from production towards activities in the service sector, particularly in response to the increased demand for repairs. Concerns with both access to inputs, tools and machinery and with markets and demand are also shown to be significant in Botswana, Lesotho, Malawi and Zimbabwe (Mead, 1994).

In an attempt to reduce parastatal deficits, structural adjustment policies in Zimbabwe have also lead to falling real producer prices since the end of the 1980s. Closure of rural-depots and food security stock sell-outs have contributed to the problem (Pederson, 1994). Low agricultural prices, combined with increasing consumer prices attributed to devaluation and drought, have led to contracting low income and rural consumer markets.

More positive results from agricultural liberalisation come from Ghana and Tanzania. In these countries the numbers of agricultural retail and processing firms have increased considerably following price liberalisation and the removal of parastatal monopolies. In Tanzania, where controls had previously been somewhat stricter, the benefits were particularly evident. The presence of small-traders throughout the country has lead to increased efficiency in marketing produce and in turn to reduced crop wastage, previously caused by inefficient state co-operative staff's inability to collect and purchase crops when necessary. Where the National Milling Corporation in Tanzania previously dominated grain milling, deregulation has lead to a rapid increase in the number of small scale milling enterprises (Dawson, 1994).

Import Liberalisation and Devaluation

Removal of trade barriers, reduction in import tariffs and the removal of quotas and other import restrictions such as licensing are expected to improve the competitiveness of local enterprises. It is anticipated that import liberalisation will increase access to imported raw materials and intermediate goods embodying new technology that will benefit smaller enterprises. A more open policy towards direct foreign investment will encourage greater use of sub-contracting arrangements involving smaller firms and provide learning opportunities for locally employed workers to become local entrepreneurs (World Investment Report, 1994). It is also anticipated that liberalisation will enable small enterprises to acquire new skills that will assist in the process of improving indigenous technological capacity. Import liberalisation is also expected to contribute to the competitiveness of local enterprises through the consequences of the direct effect of import competition and through stimulating new enterprise entry into the market as imported inputs previously unavailable lead to lower costs. The adjustment of overvalued exchange rates is likely to improve prospects for developing the export potential of local labour intensive activities. It is expected that the price-increasing effects of devaluation will not have a major impact for small enterprises since imported inputs are not important elements in their cost structures.

Trade liberalisation and currency devaluation measures have had mixed results. As Dawson (1994) highlights, increases in import costs of raw materials and inputs in Nigeria have averaged 515 per cent between the late 1980s and early 1990s. This has resulted in a shift in demand from imported products to good-quality locally produced goods in the middle and upper range of the market. Small-scale enterprises able to produce high quality products have been able to expand in response to increased demand. Of Dawson's sample, 16 per cent

of those in Lagos and 26 per cent in Zaria benefited from increased profitability, following trade liberalisation measures.

Likewise, the Ghanaian exchange rate which depreciated from 2.75 *cedis* to the US dollar in 1983 to 1075 *cedis* in 1994, resulted in prohibitive import costs that led, as they have in Nigeria, to the opening up of specialist niches (Steel and Webster, 1992; Boeh-Ocansey, 1995). Those producing non-traditional items, in direct competition with imported products such as freezers, water coolers and drums, were found to be particularly successful. An increase has also been noted in the number of enterprises producing low-cost import substitutes for items such as pottery, paint and simple agricultural machinery. Those concentrating on innovative processing of raw materials and recycled products also appear to have benefited.

Similar evidence is revealed in Dawson's questionnaire survey of 672 small firms in Suame, Ghana and from a 1991 study of small-scale entrepreneurs in Tanzania (Dawson, 1993). Devaluations of the Ghanaian *cedi* between 1983 and 1988, and of the Tanzanian shilling between March 1984 and June 1992, allowed small-scale enterprises to compete with, and in some cases displace, imported goods. Ghana's small-scale industries have been particularly successful in competing with products such as machine and tool parts, specialised nuts and bolts and bulky food-processing equipment. Increased access to imports and new components has also allowed small-scale industries to diversify product lines, increase output and improve quality. This has been particularly beneficial for those producing for donors and large firms who pay high prices for quality products, for example saw-milling equipment producers, animal feed-mills and food-processing enterprises producing for large firms and donors in Ghana. Evidence of similar benefits being derived from increased access to better quality imports has also been recorded by Kessous and Lessard (1993) in Mali.

There appears to be direct evidence that small enterprises are better able than larger enterprises to adapt to changes in the post trade liberalisation period. In the case of Senegal, the impact of trade-liberalisation on large-scale over-protected industries was severe. In contrast, small-scale industries adapted product lines to meet new market niches (Steel, 1993). Successful new product lines, including oil presses and expellers, water pumps and storage tanks and drill presses, have also been adopted in Tanzania (Bagachwa, 1993). Similarly, through skill and institutional development, small-scale textile producers in Sri Lanka increased quality and became more export-orientated in response to the trade liberalisation programme which commenced in 1977 (Steel, 1993). Zimbabwe has also opted to phase their trade liberalisation process, with initial focus concentrating on capital goods and intermediate inputs to allow for adjustment in consumer industries, although in this case the implications for small-scale producers are less clear.

Despite the success stories however, a significant number of studies indicate that the majority of small scale enterprises lack the capacity to meet standards required within these niche markets (Dawson, 1994). Instead for them benefits gained through the removal of barriers which previously restricted access to imports have been offset by the rising and prohibitive cost of imports, created by currency devaluations. While several firms in Dawson's (1993) Tanzanian study contracted as a result of increasing import costs, others were forced to cease operation. More than 50 per cent of Dawson's (1994) Nigerian sample reported a reduced use of imports following liberalisation. Since the price of tools and equipment in Zaria increased by 1075 per cent, few have purchased imported power driven machinery since 1986. Costs of replacement parts also became prohibitive. As a result, 25 per cent of the

Zaria sample experienced a decrease in the use of operating equipment and a down-grading of technological capacity amongst small-scale enterprises.

The move away from more technological-intensive production towards a labour-intensive operation may also result, in part, from vastly reduced real wages and increasing interest rates. Steel and Webster (1992) identified similar results in their Ghanaian study, where increased labour absorption was revealed when 62 per cent of the enterprises surveyed in their study recorded increases in employment and only 39 per cent reported increases in production. The World Bank (1995) further confirmed this in their studies of Ghana, Mali and Senegal.

Increasing costs of imported raw materials have also led to increased competition for, and costs of, local raw materials and recycled products in Nigeria (Dawson, 1994). Whereas previously small-scale enterprises had little competition for recycled materials such as rubber, metals and plastics, as import costs rose large-scale enterprises recognised the benefits to be gained from recycling existing materials. As a consequence, prices for these items went up as demand increased. The prices for scrap aluminium have increased by 500 per cent, steel by 1000 per cent and plastic by 700 per cent between 1986 and 1993. Likewise, as new export commodities such as timber, leather and scrap metal are encouraged, the supply for the local market is adversely affected. Evidence exists of lower quality goods and increased prices for goods catering to the local market. The devaluation of the *naira*, while the surrounding countries' currencies remained overvalued, has led to further supply problems as materials are smuggled out of the country.

Steel and Webster (1992) also reported that following price liberalisation the high cost of local raw materials, including agricultural goods, was proving to be prohibitive for smaller enterprises employing between 10-29 employees in Ghana. Larger enterprises were able to substitute local supplies for imported inputs.

Small-scale enterprises were also expected to benefit from the elimination of import controls and the foreign exchange auction for all imports, implemented as part of the trade policy reform programme in Zambia in 1985. However, administrative requirements, such as the owning of a commercial bank account, frequently prevented small-scale enterprises from taking advantage of the increased access to foreign exchange and imports.

In some cases, trade liberalisation appears to have led to increased competition from imports which local producers have been unable to match. This has been the situation regarding the importation of mass-produced, low-cost, high-quality products against which locally produced, labour-intensive products have had difficulty in competing. Steel and Webster's (1992) study found import competition was significant for 12 per cent of the enterprises. Moreover, in specific sectors, import competition was seen to be more significant, with 21 per cent of metal producers (predominantly in agricultural machinery) and 29 per cent of soap and cosmetics producers viewing imports as a major source of competition. Other studies of the experience of structural adjustment in Ghana have cited the significance of increased import competition (Boeh-Ocansey, 1995). After trade liberalisation, Singaporean vegetable oil and Dutch soyabean oil were found to be or superior quality and cheaper than locally-produced brands; likewise imported alcoholic drinks were cheaper than a traditional unrefined local beverage. The increasing cost and decreasing quality of local traditional industrial and micro-enterprise products, the dumping of cheap manufactured goods and the importation of second-hand goods further exacerbated the problem.

Trends in Tanzania were similar, with imported second-hand clothing, plastic sandals and soap having a particularly adverse impact on local producers (Dawson, 1993). In Tanzania local standard nuts and bolts have almost entirely been displaced by imports (Dawson, 1993). Further supporting evidence comes from the Ghana study by Osei *et al* (1993) where, of the 1365 small-enterprises studied, 34 per cent of those who have contracted since 1983 cited increased imports as the cause.

Export promotion policies have also had a limited impact on small-scale enterprises as few have the capacity to produce sufficient quantity or quality for export and lack the necessary contacts and ability to develop this capacity. Only two per cent of enterprises in the Osei *et al* (1993) study in Ghana were engaged in export production. Likewise, Pedersen's (1994) study in Zimbabwe found that, while a significant small-scale clothing sector existed, twenty five large-scale firms accounted for most exports. In turn, the lack of export earnings constrains the purchase of imported inputs. Overall, the impact of trade liberalisation in Zimbabwe appears to have had a predominantly negative effect on small-scale enterprises, with a smaller market resulting from increasing food prices and devaluation (Pederson, 1994).

Industrial Policy Reforms

Industrial policy reforms which facilitate the access of small-scale enterprises to production and markets previously monopolised by large-scale enterprises, are intended to promote competition and improve efficiency. Similarly, the privatisation and 'break-up' options of large-scale public enterprises are also seen to offer increased scope for small-scale enterprise production. The removal of subsidies, protection and long-term support to parastatals is seen to assist this process. It is also anticipated that links between large- scale and small-scale enterprises will be encouraged, particularly where large-scale direct foreign investment increases the use of subcontracting arrangements with small-scale enterprises. In turn, these are expected to increase skills training, and encourage technological improvement and increased production.

Evidence supporting some of these predictions is given in the World Bank (1994) study of small and medium-scale enterprises in East Asia. It shows that enterprises in middle income developing economies, such as Singapore, Republic of Korea and Taiwan, have benefited from industrial sector reforms. In this case, it is apparent that a relatively developed market, skilled workforces, technology-intensive production and public and private support mechanisms have assisted small enterprises in capturing niche markets and undertaking sub-contracting arrangements. In contrast, countries such as Malaysia, Thailand and, in particular, Indonesia, which have been relatively constrained by less developed markets, less-skilled workers and inadequate government support, have had less success in developing their small and medium-enterprise sectors. The lack of absorptive capacity amongst small-scale enterprises is seen as the largest constraint to their development. Factors such as a lack of management, technological skills, basic technology and insufficient finance are seen to be significant, particularly where multinational firms are able to offer considerable benefits to small-scale sub-contractors who are able to offer technology-intensive quality products.

Studies from Africa highlight similar mixed results. The study by Osei *et al* (1993), focused predominantly on enterprises at the smaller end of the small-scale sector in Ghana, shows evidence of only limited use of linkages between small and large-scale enterprises. Only 15 per cent of small enterprises surveyed produced for large-scale enterprises. Similarly,

linkages between small-scale enterprises were found in only 18 per cent of cases. In contrast, Dawson's (1993) comparative study of Ghana and Tanzania showed that small-scale enterprises in Ghana showed a greater capacity for technological and quality improvements and for developing beneficial links with large-scale enterprises in the growth sectors than those in the less sophisticated sector in Tanzania. Access to equipment from government auctions following the break-up of large-scale state enterprises in Ghana, together with the movement of retrenched skilled government staff to the small-scale sector, assisted this process. The clustering of firms in urban areas in Ghana allowed these more sophisticated firms to enhance the collective efficiency of the sector as a whole through the development of further linkages between these and other small-scale firms.

The development of external linkages has proven more difficult for both countries. In Ghana, Boeh-Ocansey (1995) shows that ten years of structural adjustment have done little to entice foreign investment. Between 1990-1992 FDI inflows amounted to US$19 million per annum. compared with US$68 million in l970 alone. Furthermore, finance for the privatisation of state-owned enterprises has accounted for much of the foreign investment inflows in the earlier part of the 1990s. Moreover, nearly half of the approved investment portfolios at the Ghana Investment Centre targeted low-technology, natural-resource based products, indicating, as Boeh-Ocansey highlights, a lack of confidence in high-quality production.

It is apparent that small-scale enterprises cannot always take advantage of the newly-created open markets and subcontracting arrangements. Poorly developed market infrastructures put small-scale enterprises at a competitive disadvantage compared to larger enterprises (Vachani, 1994). Vertical integration within large-scale enterprises provides opportunities to lower transaction costs. Large workforces, together with access to credit and savings for technological and skill development, permit skill specialisation in both technological production and support services. A greater capacity also exists for developing the necessary contacts with overseas suppliers and marketing agents and gives larger enterprises more clout in contract negotiations. In contrast, small-scale enterprises are frequently reliant on the market for support in areas such as accountancy, legal, marketing and transport services and, when institutional development is weak, suffer from high transaction costs. Moreover, most small enterprises lack human resource skills for product innovation and for sourcing and negotiating overseas contracts.

High transaction costs for registration and licensing are also found to constrain small-scale enterprise operations. High transaction costs related to government procedures are seen to be particularly problematic in Bangladesh, Nepal and to a lesser extent in the Philippines (Meier and Pilgrim, 1994). Complicated time-consuming bureaucratic procedures, a lack of information regarding processes and the extra processing payments frequently required, all adversely affect small-scale enterprises relative to larger enterprises which, due to economies of scale and specialist staff, are able to absorb these costs more easily.

There is also evidence that 'administrative discretion' in the allocation of public procurement contracts disadvantages small-scale enterprises. In many cases public procurement is no longer limited to public suppliers, but is open to competitive tenders from the open market. In theory, small-scale enterprises should be able to benefit from government contracts; however public procurement in Bangladesh continues to be dominated by nepotism and in Nepal extra payments are required to secure contracts. This puts small-scale enterprises at a further disadvantage (Meier and Pilgrim, 1994).

Finally, the political and social environment has also been seen to be important in determining the success of small-scale enterprises (Steel, 1994). Indeed, a positive image of profit-seeking in private business in Taiwan Province of China may have contributed significantly to small-scale enterprise success (World Bank, 1994). Conversely, small-scale enterprises in Malawi and Zimbabwe have been adversely affected by shortages and the high cost of raw materials which result from government policies that channel commodities to large-scale enterprises (Mead, 1994).

Pubic Sector Reform

Under structural adjustment, governments have introduced public sector reforms which have focused on the need to increase tradable production, while reducing government expenditure in the non-tradable sectors. Policies have therefore concentrated on support for infrastructure, industry and export production while funding to social services has often been severely cut. While such cuts are not seen to have a direct impact on production, their indirect effect on small-scale enterprise production is very evident. For example, public sector reforms, conducted as part of structural adjustment packages, have led to significant levels of retrenchment, for example in Ghana, where more than four thousand teachers left the education system as a result of adjustment (Cornia *et al,* 1987). Moreover, Dawson (1993) shows that around 100,000 workers, a fifth of registered salary workers, were made redundant between 1983 and 1989. Levels of retrenchment of this order can adversely affect small-scale industries in a number of ways. First, many of those leaving public sector employment in Ghana have set up small-scale enterprises owing to a lack of alternative employment options available. Osei *et al* (1993) found that twenty per cent of new enterprises established after structural adjustment were set up by retrenched workers. While this may be recorded in small-scale enterprise statistics as sector growth, it is more likely to reflect the need for small-scale enterprises to act as a labour sponge when aggregate demand is decreasing. With increasing numbers of enterprises competing in a contracting market in Ghana, a high mortality rate of SMEs has been observed, particularly in branches where barriers to entry are low. Some sectors, such as engineering, appear to be protected against excessive competition because high skill levels raise entry barriers. Similar effects of competition on small enterprises are beginning to be seen in Tanzania (Dawson, 1993).

Second, cuts in education and training and the introduction or increase in education fees, conducted as part of public sector reforms, impede skills development to the detriment of those enterprises wishing to progress beyond the most basic level of production. For example, low levels of trained human resources have been observed to result in low productivity levels and an inability to adapt to changing market demands in Ghana (Boeh-Ocansey, 1995).

Third, the retrenchment of government staff has also had a marked effect on demand for small-scale enterprise goods. Dawson (1994) notes that the retrenchment of a third of salaried workers in Nigeria led to a significant reduction in urban purchasing power and, in turn, in decreased demand for new products. Similar evidence is provided from Tanzania and Ghana (Dawson, 1993). Likewise, Pedersen (1994) emphasises the impact of retrenchment on markets in rural areas and small towns in Zimbabwe where a large proportion of income comes from public sector employment.

Financial Sector Liberalisation

Financial liberalisation is expected to result in the reallocation of domestic credit towards smaller enterprises, and the substitution of more expensive forms of credit for cheaper ones.

Moreover, while nominal and real interest rises are anticipated, real returns are expected to outweigh this burden. It is also argued that the process of transferring from an administrative process of credit allocation to a market based mechanism will not only improve the access to credit for smaller local enterprises, but will also lower the transactions costs associated with borrowing. Further, in cases where highly subsidised export credit schemes exist for larger enterprises, financial liberalisation can be expected to remove this bias.

Questions have been raised in the developing country context over these predictions. Taylor (1988) argues that financial liberalisation will not result in more funds for borrowing being available. As interest rates rise funds available will be diverted out of the informal sector to the formal sector. An increased share of borrowing will take place in the formal financial sector but the total available funds between the two sectors will remain unchanged. The net result in a macro sense means there will be no new borrowing and this contradicts the McKinnon-Shaw hypothesis that argues that financial liberalisation, by increasing interest rates, leads to higher savings, investment and growth. Unfortunately, the desired effects have not always materialised in the way that policy prescriptions envisaged. As Steel (1994) highlights, high transactions costs and risks associated with small loans, a lack of collateral and an historical orientation towards larger enterprises, continue to restrict small scale enterprise access to formal credit.

The case of Ghana shows that despite financial sector reform, the strengthening of banking capabilities and the introduction of numerous financial instruments, such as the stock exchange, a venture capital company and business assistance funds, access to institutional credit for working capital and equipment continued to be a major constraint to small enterprise development (Steel and Webster, 1992). Even where demand for small scale enterprise products appeared strong, a lack of credit meant that many small enterprises did not have the capacity to respond and expand production. Interest rates of 30 per cent or more, high transactions costs and an administration and culture unfriendly to small scale enterprises contributed to the problem (Boeh-Ocansey, 1995). The Ghana study by Osei *et al* (1993) cites similar evidence; 95 per cent of the respondents depended solely on personal resources and loans from relatives and friends. Dawson's (1993) work in Ghana and Tanzania also confirms these findings; of the 672 small scale enterprises in the Ghana study only two had received a bank loan and in Tanzania the formal banking system was seen to be out of reach for almost all small enterprises. The World Bank reported that around 90 per cent of small enterprises surveyed indicated that access to credit was a major constraint to new investment (World Bank, 1994).

Kariuki's (1995) study of bank credit access in Kenya illustrates this point further. A survey of 89 small and medium-scale firms in manufacturing and service industries, combined with secondary information from commercial banks, found that from 1985 to 1990 the average real volume of credit for the sample firms fell, except for the year 1986 which showed a marginal increase of 1.5 per cent. Several deterrents to utilising formal credit were identified. Small scale borrowers were found to be faced with higher nominal interest rates at higher inflation rates in the latter half of the 1980s. Moreover, the explicit transactions costs of borrowing were found to be high in relation to interest costs.

The cases of Bangladesh, Nepal and the Philippines appear to support these claims (Meier and Pilgrim, 1994). Despite specific programmes aimed at small scale enterprises, only between 12 per cent and 33 per cent of those surveyed were found to have access to formal credit and, of those, the majority were from the larger end of the sector. Again, factors such

as the relatively high cost of processing small loans, the need for high collateral and bureaucratic procedures were seen to restrict lending to small scale enterprises. The taxation policies which were also examined were found to have little impact on small scale enterprises, particularly as many of those surveyed were found not to be paying taxes.

Similar evidence regarding the lack of importance given by small scale enterprises to tax policies is also found in Southern Africa, including Niger, Botswana, Swaziland, Lesotho, Malawi, and Zimbabwe (Mead, 1994). Studies for these locations found little concern for government regulations, except from those enterprises concentrated in targeted locations and specific sectors such as food processing. Instead the greatest concern for the majority of those surveyed was the lack of access to working capital, credit and finance.

4. THEORETICAL PERSPECTIVES

Most of the theoretical work on small firm finance and the behaviour of institutions that lend to small scale enterprises has been undertaken on the industrial countries, particularly the US and the UK (Chittenden, Hall and Huchinson, 1996). A large proportion of this work has tended to concentrate on firms that, in terms of size, lie towards the upper end of the spectrum, where the range of ownership and financing options becomes wider.

In general, two areas of research have become prominent. First, there are studies that have attempted to examine the implications of different financial structures found in different sized firms. In part, these are based on survey work which has attempted to catalogue the range of finance sources available to smaller firms and to examine their implications for growth and investment. In firms where forms of equity have been employed, this work has been extended to incorporate an investigation into a number of distributional issues concerning income flows to owners and managers and inside and outside shareholders (Myers, 1998). Much of this analysis has been set within the framework of a principal-agent approach. The conditions under which each respective interest operates are examined with reference to the internal incentive systems that emerge in firms and to the external factors, such as the macroeconomic policy environment and the development of legal systems that offer potential protection to outside investors in firms (La Porter, Lopez-de-Silanes, Shleifer and Vishny, 1998).

Second, there has been a concentration of theoretically based studies examining the behaviour of various lending institutions, as suppliers of finance to small and medium-sized enterprises. Typically, for small enterprises, these have involved models of lending behaviour based in an agency framework. Central to the hypotheses that have emerged from this body of research is the notion that information asymmetries lead to sub-optimal flows of finance available to smaller firms compared to larger firms. Imperfect information can lead to restricted flows of finance whether the problem lies within the firm, through poor record management or in banks, through the relatively high costs associated with gathering information on smaller firms (Binks, Ennew and Reed, 1992). There is considerable debate over whether or not banks in low income countries have a comparative advantage in lending to smaller firms precisely because they may possess an accumulated knowledge concerning the riskiness of investing that places them in a position to make optimal rather than sub-optimal decisions over lending to smaller enterprises. Building relationships with banks increases the information flow between lender and borrower (Berger and Udell, 1995).

The emphasis on the relative lack of theoretical work ought not to imply that the stock of knowledge gained about finance and smaller enterprises through empirical work is not valuable. Considerable insights have been gleaned from a wide range of empirical investigations (Hall, 1992; Kaplan and Zingales, 1995; Cosh and Hughes, 1996). In terms of work in the UK some general conclusions have emerged and are summarised in Table 1 below. On the right hand side of the Table, the likely situation in low income countries is presented in order to enable a comparison to be made.

Small Firms in the UK	**Small Firms in Low Income Countries**
– small firms have a high reliance on short term financing through the banking sector	– small firms rely on formal and informal sectors for short term finance
– a low proportion of their assets are financed by shareholders so debt to equity ratios are relatively high compared to larger firms	– family and friends contribute a high proportion towards financing small firms' assets
– fixed assets are relatively unimportant in the balance sheets of smaller firms	– unestablished
– trade credit and trade debt are relatively important	– unestablished
– in recent years, leasing and hire purchase and venture capital have become more important	– relatively less important
– small firms have higher transactions costs than larger firms	– confirmed
– smaller firms have greater information imperfections than larger firms	– confirmed
– smaller firms have poor business planning lack of interfirm cooperation between	– more significant in developing countries particularly with respect to financial accounting and management
– small firms weakens relations with financial institutions	– networks shown to be important but little research on relations with financial institutions

The general conclusions shown in the left hand column in Table 1 are drawn primarily from work in the UK, and have either been derived from hypotheses that have been subjected to empirical testing or they have resulted from direct observation and measurement, and theories have been developed to explain them. Most of this kind of analysis continues to be undertaken in the context of the industrialised countries which raises a number of issues concerning its relevance and applicability to the low income country case. Nevertheless, it is useful to review some of the theoretical perspectives that have been developed, principally in an industrialised context, to explain aspects of financial behaviour among small firms and to examine their implications for low income countries.

In Table 2 an attempt is made to select a number of approaches relating to small enterprise finance and examine these elements that may contribute to the development of research in

low income countries. Column 1 provides a summary of each theoretical perspective while columns 2-5 respectively outline the implications for the financing and capital structure of small firms, the implications for their growth, the hypotheses that can be tested and finally the factors that need to be considered when applying the approaches to low income countries. The approaches summarised in Table 2 incorporate results from empirically based studies (Bates, 1971); life cycle models (Weston and Brigham, 1981); pecking order approaches (Myers, 1984); principal agent models (Jensen and Meckling, 1976); transaction cost hypotheses and models of financial sector reform.

Table 2

Approaches	Financial Structure	Implications for Growth of Firms	Testable Hypotheses	Low Income Country Implications
Empirical based studies on financial structure between large and small firms	– small firms more self-financing – rely on shorter term bank credit – less likely issue shares	– firms maximise short run variables – financing gap (no long term finance) inhibits growth	– firms maximise finance from short term sources – how growth changes with different forms of finance	– importance of working capital in LIC – capital market underdeveloped – entry to capital market/ stock costly – insider dealing – avoid entry to avoid tax disclosure
Life cycle approach to explain financial structure	– small firms initially use owners resources – firm survival over time widens financial sources – rapid growth reduces liquidity as rely on short term finance – failure to gain entry to equity markets results in financial gap – linear type progression in financial sources	– growth dependent on obtaining wider sources of finance (which is costly) – failure to gain access leads to growth slow down as rely on internal sources of finance	– firms relying on internal sources of finance fail to grow over time – higher success rate with firms diversifying sources of finance	– limited range of financing options (venture capital, factoring, trade credit etc) – high failure rate among small firms in LICs due to non-financial factors

Approaches	**Financial Structure**	**Implications for Growth of Firms**	**Testable Hypotheses**	**Low Income Country Implications**
Pecking order suggests firms financing needs are hierarchical	– use internal sources – then debt – then equity (outside) – reflects relative cost of sources of finance	– owner reluctance to widen finance because lose control of firm – stock market access costly	– if use internal funds initially, then expect firms with lower profits to go for external funds – high profits gives more internal retained earnings so borrow less in the short term – older firms are more liquid so use less external funds	– small firms only have access to short term borrowing – low liquidity among small firms results in under-investment – growth firms will increase need for external funds if present use short term credit reduces liquidity. Access to long term funds raised liquidity
(1) Agency theory Firms (A) and Banks (P)	– high transaction costs in getting external funds – information problems cannot access risk – banks need signals from small firm owners to assess risk – banks want to reduce risk of lending to smaller firms	– information problems lead to moral hazard and adverse selection – start-up firms are learning, are less likely to hide information and therefore are attractive to banks, get short term finance for growth – increase incentives to agents to act in principal's interest to increase lending	– firms use collatoral to solve agency problems – small firms rely on short term credit because of agency problems – moral hazard implies firms move to high risk, high return investments if rates interest rise – assumes owners of small firms have more information than banks	– small firms have low fixed assets so difficult to induce longer term lending by offering collatoral – small firms have poor record keeping – banks in LICs better knowledge on firm survival, business planning so able assess risk/ overcome agency problems

	– banks need to monitor agent, pass on costs of monitoring through lending – banks follow cautious lending policy will ration credit or charge higher interest rates	– conditional contracts to ensure repayment facilitates lending	– banks reduce risk by raising interest rates – competition in banking lowers interest rate, collatoral, restrictive conditional clauses in lending – banks with imperfect information less likely use price mechanism to allocate their loan funds leads to adverse selection, highest return projects missed	– banks in LICs better vehicle for overcoming information problems than equity markets – small firms willing to pay more for credit not given option if rationing system operates – monitoring costs higher in LICs – competition/ regulation banks suspect
(2) Agency theory insider (A)/outsider (P)	– inside management have better information than outside shareholders – insiders derive private benefits from investment so use internal funds, not want outsiders gaining control	– higher growth firms where legal protection is high have more investment. Outsiders accept lower dividends in knowledge that insiders not misbehave – low growth firms where legal protection is high have low investment since outsiders take higher share in dividends	– do other forms of ownership lead to different investment/ dividend policies ie cooperatives/ partnerships – common law systems offer better protection to investors than those based on civil law	– some LICs legally stipulate payment of dividends – market for selling shares limited in LICs – distinction between insiders and outsiders less clear

	– larger small firms where macro environment/legal protection good, outsiders have better information and power	– if dividends a substitute for legal protection then insiders go to external capital market for funds to invest	– if legal/regulatory system weak, outsider shareholders not able to demand high dividends, yield to insiders power and are only short term equity investors – entry to external funds market requires credibility on part of insiders ie pay dividends	
Transactions costs inter-firm transactions costs are high for small firms. Buyers and manufacturers offset high transactions costs by dealing in high volumes		– limits opportunities for small firms – investment in infrastructure will help lower transactions costs		– weak infrastructure leads to higher transactions costs – argued high transactions costs need to be subsidised in LICs ie to introduce new financing form eg venture capital
Financial market imperfections (K, L)	– lowers cost of capital and favours labour – lower wages favour smaller firms – higher efficiency of larger firms means high wages	– capital market and labour market distortions impede growth	– small scale sector likely to be smaller than it would be if no factor market distortions	– factor market distortions greater in LICs – existing studies on effects of liberalisation give mixed results

		– capital market distortions result in small firms with a smaller proportion of net value added	– capital intensity would be higher in small firms if no distortions in capital market – when factor market distortions then lower productivity of smaller firms will result in higher proportion of employment in total even though proportion value added is lower compared to larger firms	– argued high transactions costs

The principal-agent model relating to lending behaviour can be taken to illustrate the kind of issues faced when applying models of this type to low income countries. As developed, the application of principal-agent theory argues that banks have less perfect information on smaller firms than larger firms (costs of gathering this information are higher) and, as a consequence, lending to smaller firms is riskier. The observed outcome from this analysis is less lending to small firms relative to larger ones. In turn, lending institutions are likely to demand higher risk premiums.

In the developing country context, however, it may be argued that banks have better information to assess the riskiness of an investment than the small firm itself. This is because they are continually lending to small firms over extended periods of time and have acquired sufficient insights to be able to make sensible and sound judgements over lending decisions. Banks may have more experience about a small venture's survival prospects than it has information on larger firms, since the latter may be in a better position to conceal and manipulate information to their own advantages. Measuring the extent of information asymmetries is intrinsically difficult. Nevertheless, the low income case may challenge the applicability of principal-agent analysis in terms of the conventional forms established in an industrialised country context, and lead to new insights in which lending institutions, rather than being seen as villains, are acting in the interests of small firm development.

Similarly, the macro and legal environments are assumed to provide important conditioning factors on the behaviour of borrowers, lenders and investors in some of the theories outlined in Table 3. In a low income context this may be even more relevant in the sense that a stable macroeconomic environment and a strong legal system provides significantly higher levels of protection for potential lenders and investors. Alternatively, this may be of little consequence for smaller firms whose source of funding comes predominantly from family and friends.

Simply examining the way in which the demand or supply of finance changes in response to policy changes may not be enough to indicate what kinds of enterprises will survive and contribute to economic growth. A useful perspective may be adopted by attempting to implant financial elements into an approach adopted by Dawson (1993) in an earlier study of Ghana and Tanzania. In this study an attempt was made to identify a set of characteristics embodied in small enterprises which were either favoured or disfavoured by the adjustment process. Table 3 reproduced below indicates the importance of technical and technological factors in determining the way in which small enterprises are likely to respond to structural adjustment. The relatively more technologically sophisticated enterprises appear to have been more able to upgrade their products and services to a level where they have been able to develop linkages with the faster growing sectors of the economy and overcome scale constraints by finding new so-called niche markets more suited to their economies of flexibility and serving an import-substitution function.

Table 3 Enterprise Characteristics Favoured and Penalised by Structural Adjustment Programmes

Characteristics Favoured	Characteristics Penalised
- Low import dependence - Development of linkages with growth sectors of the economy - Significant technological enhancement - High barriers to entry - Innovation - Serving an import-substitution function	- High import dependence - Few linkages - demand mostly from low-income groups - Little technological enhancement - Low barriers to entry - Cut-throat competition

Source: Dawson (1993)

In contrast, enterprises that were technologically weaker tended to remain dependent on low income groups for their main markets, whose purchasing power may have been declining under adjustment.

What this type of analysis and the comparison between Ghana and Tanzania clearly pointed out, however, was not the importance of the cross-country differences in the response to adjustment processes but variations between different types of enterprises within the countries. As pointed out above, some enterprises were better able to respond to the changes created in the policy environment than others. In this respect the creation of an environment favouring small scale enterprise development may not be sufficient to explain why some enterprises improve their performance and other fail. The response of small scale enterprises to structural adjustment reforms is more likely to be related to a wide range of factors, including internal enterprise characteristics, the level of development of the economies' infrastructure and the institutional and political framework that reinforces the sector's development.

5. CONCLUSIONS

At this stage at least four strands of research can be indicated that combine theoretical and empirical perspectives.

(1) Research is needed on the forms of finance used by small and medium-sized enterprises and made available by lending institutions and investors. In particular, a clear picture is required of the financing differences between firms of different sizes and the differences in financing in relation to types of ownership structures. Cross country and regional differences may also exist in these respects.

(2) Research is required into the relation between different financial forms and firm level performance. Existing research on small size and performance has not isolated the importance of different forms of finance. Methods should be devised to examine the relationship between different financial structures of firms and a range of performance measures (including output, productivity, employment, and survival rates).

(3) Research is required relating to the behaviour of small and medium-sized firms with different forms of finance. We need to predict how different forms of finance will affect the allocation of profits between income (dividend flows), investment and consumption and their effect on other forms of expenditure relating to innovation, marketing and human resource development through training. In particular, the links need to be made between different forms of finance and the impact of small firm development on poverty alleviation.

(4) Research is required on the supply side of finance, involving formal and informal sector lending institutions and savers, and the macroeconomic environment, including economic policies, promotional policies and the role played by private, international and non-governmental organisations.

A final point needs to be made. Smallness of factory or plant size is not in and of itself a virtue. The development of SMEs must be a coherent part of a development programme aimed at the achievement of explicit socio-economic objectives which vary both overtime and between countries. Appropriate and effective policy packages for SME development will similarly vary and it cannot be assumed that there will exist a standard policy package. The conditions under which SMEs can realise their employment and growth potential have to be identified and the links with poverty alleviation and other development objectives clearly established.

As Bryce (1965, p.77) warned:

> Properly defined and realistically approached, the small-industry field is important and can contribute much to the whole process of industrialisation. If confused by sentimentalism and approached emotionally with little regard for the costs and benefits involved, small industry development can easily become a missionary movement which accomplishes little but which diverts scarce resources of development funds and people away from other activities which, in most situations, could produce more industrial growth.
>
> (Bryce, 1965, p.77)

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