

Case study commissioned by the Department for International Development, UK

A Contribution to WDR 2005 on Investment Climate, Growth and Poverty

**Donor Experiences in Supporting Reforms to the
Investment Climate for Small Enterprise Development**

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Key Messages

1. Small enterprises occupy a unique position in the investment climate that influences their capacity to reduce poverty and contribute to economic growth.
2. Small enterprises require reforms to the business environment that are more specific than those required for private sector development.
3. The international community can contribute to the quality of reforms undertaken by governments in developing countries.
4. There are a number of 'good' practices emerging among donors engaged in supporting reform efforts.

The views and opinions expressed in this study are those of the author and do not necessarily correspond to the views or policies of the Department for International Development (DFID), UK.

Introduction

1. This case study highlights the influence the business environment has on the potential of small enterprises to contribute to economic growth and poverty reduction. It also contributes to a better understanding of the role the international community is playing in supporting domestic efforts to reform the investment climate.

2. The information presented in this paper draws from research commissioned by the Committee of Donor Agencies for Small Enterprise Development.¹ The research sought to improve the understanding of the similarities and differences in donor agencies' efforts to help countries improve their policy environments for small enterprise development.² Five countries or regions were selected for the review. These were: the Balkans, encompassing Albania, Bosnia-Herzegovina and FYR Macedonia (Xhillari 2002), the Caribbean, specifically Dominica, Grenada, Guyana, and Jamaica (Manuel 2002), Peru (Machacuay 2002), Tanzania (Olomi 2002), and Vietnam (Mallon 2002).

3. Two main arguments are presented. Firstly, small enterprises occupy a unique position in the investment climate, which influences their capacity to reduce poverty and contribute to economic growth. Governments, civil society, business organisations and international donors are often divided on what a sound investment climate for small enterprise growth looks like. Some claim that what's good for enterprises of all sizes is good for small enterprises; others are concerned with the disadvantages small enterprises face in an investment climate that is more favourable to large enterprises. While there are divisions on how best to address this issue, it is clear that small enterprises face proportionally greater costs and obstacles than large enterprises.

4. Secondly, the international community — through bilateral and multilateral donor and development agencies — can contribute to the quality of reforms undertaken by governments in developing countries. Improving the investment climate for economic growth and poverty reduction requires interventions by

governments at macro, meso and micro levels. Donor agencies can add-value to these reform efforts through the use of their own experience, diagnostic tools and technical assistance. There are lessons described in this paper on the ways donor agencies can best support domestic reform processes.

5. The preparation of a national Poverty Reduction Strategy Plan (PRSP) can provide a valuable means for donors to support reforms that make the business environment more conducive to economic development and poverty reduction through small enterprise development. However, PRSPs and other frameworks used by donors to package their support, often focus only on reforms that benefit the private sector in general and pay little attention to the business environment in which small enterprises operate. Small enterprises are frequently relegated to welfare-oriented development portfolios. They are not recognised enough as a productive source of economic development and a mechanism for greater economic participation by people from poor or marginalised communities.

Small Enterprises in the Investment Climate

6. The private sector has emerged as a powerful engine for development. There is growing international evidence that governments that are serious about the growth of their economies — as well as the promotion of equity and the reduction of poverty — need to develop a climate in which entrepreneurship and private investment is encouraged. The OECD (1995) has described private sector development as ‘a basic organising principle for economic activity where private ownership is an important factor, where markets and competition drive production, and where private initiative and risk taking set activities in motion’. DFID (2000, p. 2) also recognises that economic growth is a ‘powerful driver of sustained poverty reduction. Vigorous growth and private sector development is strongly associated with poverty reduction, while rising levels of productivity are likely to enhance living standards’.

7. One of the premises on which the benefits of private sector development have been articulated concerns market failure. Failures in the market place and the broader business environment in which markets operate contribute to inequity and the creation and maintenance of poverty. Thus, by improving the environment in which the private sector operates — by reducing or removing these failures and making the environment more *enabling* of private sector development — the economy will operate in a more effective and efficient manner. Reforms of this kind enhance the capacity of the private sector to contribute to economic growth and, subsequently, the reduction of poverty.

8. Within the broad thrust of private sector development, small enterprises have a unique and significant position. While private sector development encompasses all kinds of private business endeavours, including large enterprises, multinational corporations, etc., small enterprises are by definition smaller. However, their smaller size places them at a disadvantage to larger enterprises — a disadvantage that can be either exacerbated or alleviated by the business environment.³ While improvements to the environment in which the private sector operates should affect conditions for enterprises of all sizes, this may not always be the case. The capacity of small enterprises to contribute to economic growth and poverty reduction commonly require reforms that specifically address the biases and obstacles faced by small enterprises.

9. Small enterprises contribute to a range of national social and economic goals, including the reduction of poverty. They are responsible for the creation of most new jobs in both developed and developing countries. Together with larger enterprises, small enterprises play an important role in mobilising resources and allocating them amongst productive activities. Because of its connection with poverty reduction strategies, the small enterprise sector is commonly characterised as a welfare or survivalist sector. Often, small enterprises are owned by or employ people from marginalised groups. Women make up a significant proportion of small enterprise employees, as do the family members of small enterprise owners and managers. In an effort to use small enterprises as a mechanism for poverty

reduction, governments, donors, and other development agencies provide extensive inputs to small enterprises. These are usually in the form of financial and business development services provided to overcome the internal deficits of many of these enterprises. However, whether or not they face internal constraints to growth, small enterprises also face external constraints.

10. Many women and men in the small enterprise sector who come from poor and marginalised groups are affected by external constraints to their competitiveness and profitability. These external constraints can be structural (i.e., in the form of laws or institutions that inhibit small enterprise activities) or systemic (i.e., where small enterprises have no voice, or no place to take disputes, or where there are biased attitudes or practices working against small enterprises). By ignoring these environmental impediments, the small enterprise sector will not be allowed to provide its full contribution to the reduction of poverty.

11. Small enterprises are ubiquitous in the informal economy. Such enterprises operate in an extra-legal capacity and while they contribute to household incomes and economic growth, their contributions are rarely recognised (e.g., official statistics usually cannot capture this information). The informal economy is a problem for most governments in developing countries. The jobs created in the informal economy, while important at an individual and household level, are often insecure, poorly paid, and dangerous (ILO 2002). However, rarely is the connection made between a poor business environment and a burgeoning informal economy.

12. The research evidence is clear: small enterprises are more vulnerable to biases and constraints in the business environment than larger enterprises. As Beck, Demirgic-Kunt, and Maksimovic (2002) state: 'small and medium sized firms face greater financial, legal and corruption constraints compared to large firms', and, significantly, 'the impact of constraints on firm growth is inversely related to firm size.' Thus, an environment that enables small enterprise growth will differ from one that treats all enterprises (small or large) as the same.⁴

13. What is good for the private sector in general is not equally good for small enterprises in particular. Reforming the business environment for small enterprise development can be lost among efforts to reform the climate for private sector development. Small enterprises have a specific set of concerns that need to be addressed in the business environment (e.g., anti-small enterprise bias) and it is important to ensure that reform measures respond to the needs and priorities of smaller enterprises.

Defining the Investment Climate

14. The need for a specific focus on small enterprises within a broader set of reforms that promote the private sector is a contestable topic. Indeed, it is indicative of the different ways that governments, civil society, business representative organizations, and international donor agencies conceptualise the term 'business environment' or 'investment climate'. It is difficult to identify a common understanding among donor agencies as to what elements the business environment encompasses and how these elements affect the competitiveness of small enterprises.

15. Some donors apply a purely pragmatic approach to this issue by addressing obstacles to business activity as they discover them, while others have applied a significant amount of resources to understand this issue better.⁵ The use of these terms appears to reflect an underlying preference or interest of agencies. For example, the investment focus applied by the World Bank's "investment climate" reflects an interest in promoting private sector investment, including foreign direct investment, into development activities.

16. In general, the investment climate or business environment relates to those features found outside the enterprise itself. This includes influences ranging from economic, social and cultural systems, to policies, laws and other kinds of rules, to institutions and the behaviour of other enterprises. The Swedish International Development Cooperation Agency has grouped the factors that affect the development of the private sector into three levels of economic activity: macro, meso

and micro (Sida 2001). Factors at the macro and meso level help to form the environment in which enterprises operate, while factors at the micro level impact upon firms directly. The macro level factors affecting the behaviour of firms include the social and cultural context; the political systems, including the influence of governance; and the economic systems and policies. Each of these three spheres combines to affect the markets in which the private sector operates. Markets are institutions that set the rules and norms for private sector activity. Thus, the business environment affects markets and the behaviour of firms.⁶

17. Because of its role in setting and enforcing policy, legislation and regulations, government is the main agent involved in the reform of the environment in which small enterprise development and poverty reduction occurs. However, there are other actors that play a role in the business environment, especially in democratic societies that promote pluralism and the role of civil society in policy-making — see Box 1.

18. While the business environment focuses on institutional arrangements in which the rules and

<p>Box 1:</p> <p>Actors found in the business environment</p> <ul style="list-style-type: none">• Parliamentary and policy-making bodies• Political parties• Government line ministries• The judiciary• Regulatory authorities• Local and district government authorities• Private sector organizations• Financial and business development service providers• Universities and academic research organisations• Worker organisations• Local, community-based and civil society organizations• International donor and development organisations

practices of private sector activity are regulated, promoted or supported, the organisational actors identified in Box 1 perform specific functions within this environment. Hence, these actors are important in the process of reform and can be supported by donors to contribute to reform efforts. Among these actors, the role of the private sector generally and the small enterprise sector in particular is important. The domestic private sector is an important advocate for change. However, in many countries formal private sector organisations are dominated by large enterprises.

Indeed, large enterprises can be very influential advocates in their own capacity. Because small enterprises are often poorly organised in formal associations, their capacity to advocate is reduced. As shown below, some donors attempt to address this through interventions that support the organisation and representation of the small enterprise sector.

Donor-Supported Reforms

19. The second argument of this paper concerns the role the international community can play in supporting reform efforts in developing countries. By focussing on the role of the business environment for small enterprise development, donor agencies have sought to deliver their development assistance in a more strategic manner. Because donors want their interventions to be sustainable and reach as many small enterprises and people living in poverty as possible, they are required to work at a higher level than many have previously (e.g. at a senior political level). Some donor agencies have been used to working with host governments at a high level for some time (e.g. World Bank, Asian Development Bank), usually in support of macroeconomic reforms. Private sector development and improvements to the investment climate are frequently found among the work of these donors, although the concern of small enterprises in the business environment is less common. Other donor agencies have focussed on small enterprise development specifically through the design and support of financial and business development services. However, in recent years these agencies have broadened their efforts to include support for reforms of the business environment in which small enterprises operate. The Balkans, Peru and Tanzania, provided significant evidence of how donor's agencies previously engaged in small enterprise development services have broadened their involvement to include support for the design of small enterprise promotion policies and strategies, as well as for reforms to the legislative and taxation frameworks in which small enterprises operate (Machacuay 2002; Olomi 2002; Xhillari 2002).

Donor interventions in reform processes were found to fall into five broad categories:

20. Supporting a stable macroeconomic environment: Support to create a market-oriented economy in which the private sector can operate in an efficient manner with the aim of achieving national development goals, such as poverty reduction, employment and wealth creation, trade liberalisation, etc.

21. Direct policy and legal reforms for the private sector in general: Support to ensure that policies, laws and regulations do not unduly encumber the private sector. Reforms occurring in this field are not specifically targeted toward the small enterprise sector.

22. Direct policy and legal reforms for small enterprises specifically: Support to remove anti-small enterprise biases found in policies, laws and regulations and to ensure that the reform of these instruments are responsive to the conditions and capacities of the small enterprise sector. Reforms in this field generally seek to facilitate the promotion of the small enterprise sector.

23. Strengthening organisations for policy design, implementation and enforcement: Support to ensure that existing and newly created or reformed policies, laws and regulations are properly implemented and enforced in a transparent, equitable and market-oriented manner.

24. Strengthening organisations for representation and advocacy: Support to ensure that the small enterprise sector is properly represented in policy and legislative processes, and that representative organisations can advocate for change to government in a consistent and knowledgeable manner, driven by mandates that come from small enterprises themselves.

25. Within these five fields of intervention, donor agencies use different tools or instruments. These range from technical and financial assistance, to the facilitation of high-level dialogue and consultation processes, to training, study tours, research,

and demonstration projects. Attachment 1 contains a list of the tools and instruments used by various donors in the countries under study.

26. In some cases, donors were found to support reform efforts on a regional basis, rather than simply focussing only on a single country. For example, among the countries and regions studied, USAID was found to support a regional reform programme in the Caribbean, while the World Bank supported efforts by the Organisation of Eastern Caribbean States. The Caribbean Community and the Caribbean Centre for Development Administration were also bodies supported by donors for this purpose (Manuel 2002). Similar donor support efforts were found in the Balkans and east Africa (Olomi 2002; Xhillari 2002).

27. The particular field of reform and the use of reform tools or instruments depend on how donors identify priorities for reform — whether or not this is done in association with the host government. Thus, entry points for reform vary from one country or region to the next. In the case of Vietnam, for example, the move to a more market-oriented economy, which fosters the growth of small privately owned enterprises, required a shift in both the macroeconomic framework, as well as changes to the policies, laws and regulations governing small enterprises (Mallon 2002). In contrast, the challenges in Tanzania centred on the need to address the ‘missing middle’ in the enterprise profile of the country, where there were a number of large enterprises and masses of micro enterprises, leaving a gap with only a few small and medium-sized enterprises. Thus, the draft SME Development Policy was a focus for a number of donors (Olomi 2002).

28. In Peru, many donors were initially interested in broad private sector reforms such as the simplification of administrative arrangements and deregulation. However, it became clear to some donors that many of the problems faced by small enterprises remained and that small enterprises required reform measures that specifically targeted this sector. Many small enterprises did not necessarily use the regulatory framework (i.e. enterprises operating in the informal economy) and reforms were required to address their particular circumstance (Machacuay 2002).

29. There are a number of factors that contribute to the identification of reform agendas by donors and host governments do not always agree with donors on the priorities for reform. Some donors use conditional reform processes, where development assistance is offered — usually in the form of substantial financial assistance — on condition that reforms to the business environment are made. Most often these are reforms at the macroeconomic level. A historical example of conditionally framed reform measures is the structural adjustment programmes of the 1980s and 90s. However, the current formulation of Poverty Reduction Strategy Plans (PRSPs) provide a setting in which macroeconomic reforms can be bundled alongside specific poverty reduction interventions.⁷ Thus, donors use the carrot of financial assistance as an incentive for reforms that host governments may otherwise be less enthusiastic about.

30. In most cases government-led reform processes provide more sustainable and conducive conditions for reform. Donors can inform, prod, raise awareness, and encourage governments to consider specific reform efforts, but in the end, it is domestic national governments that set the mandate for reform. Governments have to see the problem with the current arrangements and recognise the benefits that reform can bring. This is often more easily achieved in the field of private sector development than small enterprise development. Many governments, while tacitly appreciating the employment creation and economic development potential of the small enterprise sector, are less enthusiastic about making reforms that benefit this sector.

31. Donor reform interventions are most effective when they add-value to domestic reform processes by offering sound analysis of the business environment — before and after reforms — and by bringing international experiences and up-to-date knowledge (e.g. regulatory best practices). Sida claims that ‘determining priorities for interventions must take account of local conditions, the status of factors, the way they are perceived by the private business sector and the performance and particular characteristics of the private business sector. The aim should be to focus

quickly on factors that represent binding constraints and important strengths for the development of the private business sector' (Sida 2001, p. 50). The World Bank (1998, p. 57), says 'ideas matter more than money'.

32. Reforming the business environment in which small enterprises operate is a time-consuming process that can take donors well beyond their normal project cycles. Thus, donors need to find ways where they can pursue a reform agenda over time, such as by extending project timeframes and engaging counterparts over a longer period of time.⁸ Donors are often required to collaborate with each other and with other domestic actors in their support of reform efforts. In Peru and Tanzania, there were some very useful structures identified that promote donor collaboration and coordination (Machacuay 2002; Olomi 2002).

33. Donor agencies should recognise that reforming the business environment requires efforts that cut across different policy portfolios and levels of government. Not only should business environment reforms be contextualised into country development plans to ensure they are fully integrated and aligned with the broader efforts of donors, they should also be systematically and comprehensively applied.⁹ Reforming the business environment requires a careful balance between the reform of policies, laws and regulations, and the strengthening of the institutions and organisations that enforce or implement them.

34. Finally, donors should take an integrated approach to supporting reform efforts by following four practices. Firstly, they should be strategically focussed on achieving an impact on the business environment for small enterprises and poverty reduction, and not only on narrow programme outcomes. Secondly, donors should engage a range of counterparts (i.e. actors within the business environment) including public sector agencies and private sector representatives. Thirdly, donors should combine interventions at a national level with local or district level interventions. Fourthly, donors should adopt a flexible approach through regular planning, reviews and, where necessary, readjustment of donor interventions.

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Attachment 1: Range of Donor Support

Area of donor focus: Macroeconomic policy framework

<p>Technical assistance Found in all countries and regions studied</p>	<p>Donors found providing this assistance: Asian Development Bank, European Bank for Reconstruction and Development, USAID, World Bank Group</p>
<p>High level dialogue Found in all countries and regions studied</p>	<p>Donors found providing this assistance: Asian Development Bank, European Bank for Reconstruction and Development, USAID, World Bank Group</p>
<p>Policy studies and workshops Found in Caribbean and Viet Nam</p>	<p>Donors found providing this assistance: Asian Development Bank, European Bank for Reconstruction and Development, GTZ, Inter-American Development Bank, Japan Bank for International Cooperation, Japan International Cooperation Agency, USAID</p>

Area of donor focus: Public administration reform and accountability

<p>Technical assistance Found in all countries and regions studied</p>	<p>Donors found providing this assistance: Asian Development Bank, European Bank for Reconstruction and Development, GTZ, Japan Bank for International Cooperation, Japan International Cooperation Agency, USAID, World Bank Group</p>
<p>Financial assistance Found in Balkans and Tanzania</p>	<p>Donors found providing this assistance: Asian Development Bank, European Bank for Reconstruction and Development, GTZ, Japan Bank for International Cooperation, Japan International Cooperation Agency, USAID, World Bank Group</p>
<p>Specialist training Found in the Balkans</p>	<p>Donors found providing this assistance: Asian Development Bank, European Bank for Reconstruction and Development, GTZ, Japan Bank for International Cooperation, Japan International Cooperation Agency, USAID, World Bank Group</p>

Area of donor focus: Market liberalisation/strengthening

<p>Technical assistance Found in all countries and regions studied</p>	<p>Donors found providing this assistance: Asian Development Bank, CIDA, European Bank for Reconstruction and Development, Inter-American Development Bank, Japan Bank for International Cooperation, Japan International Cooperation Agency, USAID, World Bank Group</p>
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Area of donor focus: Privatisation programmes

<p>Technical assistance Found in Albania and Caribbean</p>	<p>Donors found providing this assistance: Asian Development Bank, DFID, European Bank for Reconstruction and Development, EU, Inter-American Development Bank, Japan Bank for International Cooperation, Japan International Cooperation Agency</p>
<p>Financial assistance Found in Albania and Peru</p>	<p>Donors found providing this assistance: CAF (<i>Andean Foment Corporation</i>), European Bank for Reconstruction and Development, GTZ, Japan Bank for International Cooperation, Japan International Cooperation Agency, Inter-American Development Bank</p>

Area of donor focus: Small enterprise promotion policies and strategies

<p>Technical assistance: policy drafting Found in Albania, Guyana, Macedonia, Tanzania, and Viet Nam</p>	<p>Donors found providing this assistance: DANIDA, DFID, ILO, Italy, UNDP, UNIDO, USAID</p>
<p>Facilitation of consultation processes Found in Peru</p>	<p>Donor found providing this assistance: ILO</p>

Area of donor focus: Legislative and taxation reforms

<p>Technical assistance Found in all countries and regions studied</p>	<p>Donors found providing this assistance: Asian Development Bank, AusAID, CIDA, DFID, European Bank for Reconstruction and Development, EU, GTZ, ILO, UNIDO, USAID, World Bank Group</p>
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Capacity building for institutions involved in policy design, implementation and enforcement

<p>Technical assistance: on-the-job training Found in Albania, Bosnia and Herzegovina, Guyana, and Jamaica</p> <p>Specialist training Found in Albania and Viet Nam</p> <p>Study tours Found in the Balkans and Viet Nam</p> <p>Financial assistance Found in Albania</p>	<p>Donors found providing this assistance: CIDA, DANIDA, GTZ, Italy, ZDH (German Confederation of Craft Associations)</p> <p>Donors found providing this assistance: ILO, Italy, ZDH (German Confederation of Craft Associations)</p> <p>Donor found providing this assistance: ZDH (German Confederation of Craft Associations)</p> <p>Donor found providing this assistance: Italy</p>
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Area of donor focus: Creating new institutions for SME representation and advocacy

<p>Financial assistance Found in the Balkans, Tanzania, and Viet Nam</p> <p>Capacity building support Found in the Balkans, Tanzania, and Viet Nam</p>	<p>Donors found providing this assistance: SDC, Sida, UNDP, ZDH (German Confederation of Craft Associations)</p> <p>Donors found providing this assistance: SEED, Sida, ZDH (German Confederation of Craft Associations)</p>
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Area of donor focus: Capacity building for new and existing institutions engaged in SME representation and advocacy

<p>Technical assistance: on-the-job training Found in Albania, Guyana, Tanzania, and Viet Nam</p>	<p>Donors found providing this assistance: EU, Caribbean Development Bank, CIDA, Netherlands, Sida, UNDP, USAID, ZDH (German Confederation of Craft Associations)</p>
<p>Research Found in all countries and regions studied</p>	<p>Donors found providing this assistance: GTZ, ILO, UNDP</p>
<p>Specialist training Found in the Balkans and Viet Nam</p>	<p>Donors found providing this assistance: GTZ, ILO, Southeast Europe Enterprise Development (SEED)</p>
<p>Advocacy training Found in Viet Nam</p>	<p>Donors found providing this assistance: DANIDA, ZDH (German Confederation of Craft Associations)</p>
<p>Study tours Found in the Balkans and Viet Nam</p>	<p>Donors found providing this assistance: GTZ, UNDP</p>
<p>Financial assistance Found in Balkans, Caribbean, and Tanzania</p>	<p>Donors found providing this assistance: EU/ACP Business Assistance Scheme, Netherlands, Southeast Europe Enterprise Development (SEED), Sida</p>

Notes

¹ The Committee of Donor Agencies for Small Enterprise Development was established in 1979. Drawing from a diverse range of multilateral and bilateral agencies, the Committee has sought to improve the practice of donors in small enterprise development by commissioning research and sharing information. In 2001 the Committee established a Working Group on Enabling Environment. The Working Group endeavours to learn from experiences in donor-supported efforts to reform the business environment for small enterprise development.

² White and Chacaltana (2002) *Enabling small enterprise development through a better business environment. Donor experiences in supporting reforms in the business environment*, Committee of Donor Agencies for Small Enterprise Development, Working Group on Enabling Environment, Washington. A copy of the full report can be obtained from: <http://www.sedonors.org/>.

³ See, for example: Reinecke (2002), Beck, Demirgic-Kunt, and Maksimovic (2002).

⁴ Despite this, and despite the many benefits small enterprises bring to the achievement of national development goals, governments are more likely to offer incentives and inducements to large enterprises, which are unavailable to small enterprises. Large enterprises are often better organised and have better access to government ministers, which aid their lobbying efforts. Small enterprises—particularly those found in poor communities—are often inadequately organised, “voice-less”, as well as more vulnerable to corrupt and rent-seeking government officials.

⁵ For example: Sida (2001), DFID (2000), the ILO (Reinecke & White 2003), and the World Bank (2001).

⁶ See North (1989).

⁷ Other frameworks used to package donor interventions include Country Assistance Plans and Comprehensive Development Frameworks and UNDAFs (UN Development Assistance Frameworks).

⁸ This may involve building long-term professional relationships and stabilizing staff and information resources so that donor-counterpart relations can be constant over time. It is interesting to note that in Tanzania the three-year staffing cycle of donor agencies was cited as an obstacle to effective donor-government relations. As staff from donor agencies came and left, institutional memory was lost and new staff often brought new agendas (Olomi 2002).

⁹ See World Bank (2001, p. 14)