

**ASIAN DEVELOPMENT BANK**

**TAR: OTH 36147**

**TECHNICAL ASSISTANCE**

**FOR THE**

**DEVELOPMENT OF A FRAMEWORK FOR SME SUPPORT**

**December 2002**

## ABBREVIATIONS

ADB	–	Asian Development Bank
BDS	–	business development services
DFI	–	development finance institution
DMC	–	developing member country
SME	–	small and medium-sized enterprise
TA	–	technical assistance

## NOTE

In this report, "\$" refers to US dollars.

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## I. INTRODUCTION

1. Given the increasing number of ongoing and planned projects of the Asian Development Bank (ADB) in the area of small and medium-sized enterprises (SMEs), there is need to take stock of the state of SME development in the region and elsewhere and review the effectiveness of the adopted policy and institutional approaches with the aim of developing a conceptual framework and guidelines for future sector operations. The ADB Finance, Industry, Trade Committee identified the related technical assistance (TA) as one of the priorities for interregional TA<sup>1</sup>. The TA framework is in Appendix 1.

## II. ISSUES

2. Most enterprises in developing member countries (DMCs) can be classified as SMEs. Although exact definitions vary from country to country, SMEs account for the majority of total employment in DMCs and produce a significant share of each country's Gross Domestic Product. They also provide much of the growth of employment and income for many economies, while the contributions of larger enterprises tend to remain stable. SMEs tend to be more labor-intensive than their larger counterparts and, therefore, have lower capital costs associated with the creation of new jobs. Because of their size and structure, SMEs can be more flexible and adapt to market needs more quickly than larger enterprises in comparable industries. Particularly in transitional economies, SMEs are expected to act as engines for private-sector-led economic growth and diversification. Increases in SME efficiency can also improve the competitiveness of larger firms that depend on SME suppliers, and therefore improve the competitive position of the economy as a whole.

3. The SME sector comprises very different types of businesses across a wide range of economic sectors. There are essentially two categories of SMEs: those that are growth-oriented, and those small businesses and microenterprises that operate at the subsistence level and provide employment and income mainly for their owners and a relatively small number of external employees. The development of both types of SMEs helps reduce poverty directly because they contribute to economic growth and income generation. Subsistence enterprises represent the vast majority of SMEs in DMCs. Among the growth-oriented SMEs are businesses that can be characterized as "innovators," which usually operate in growing markets, as well as businesses that are efficiency-oriented and/or network-intensive, which tend to grow through acquisitions.

4. It is estimated that only about 10% of SMEs are fast growing. Many growth-oriented SMEs in DMCs do not realize their potential because of poor competitiveness, inferior product quality, and low efficiencies due to backward technologies, outdated equipment, and a lack of management skills and understanding of market demand. Further growth of SMEs in many countries is constrained by (i) market failures, which restrict SMEs' access to finance and product markets; (ii) a policy, regulatory, and institutional environment that discriminates against smaller firms or is associated with significant compliance costs; (iii) an uncertain legal environment, which impedes the enforcement of contractual obligations, including those related to debt recovery; and (iv) lack of adequate access to infrastructure, and business advisory and information services.

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<sup>1</sup> The TA first appeared in *ADB Business Opportunities* (Internet edition) in March 2002.

5. Most DMCs have sought to develop SMEs through special policies and support mechanisms. Policy and institutional approaches to SME development vary greatly among countries and range from the (often subsidized) provision of SME financing and other services through specialized public sector institutions to market-based finance and service mechanisms that use private commercial service providers. Recently there has been increasing emphasis on promoting SME development by creating an enabling policy environment, which fosters SME competitiveness and reduces the transaction costs for smaller companies. The removal of regulatory and administrative barriers is expected to encourage enterprises operating in the informal economy to formalize their status, which is a precondition for expanding their operations.

6. In the related development debate, there has been a shift from supply-driven strategies to market-driven approaches. In finance, the supply-driven subsidized and directed credit schemes of the past, which were implemented mainly through institutions similar to development finance institutions (DFIs), are generally not encouraged anymore because of their distortionary effects and lack of financial sustainability. Instead, approaches that utilize commercially driven allocation mechanisms have gained prominence. The approaches include measures to facilitate commercial bank lending to SMEs by overcoming inherent collateral and information problems and introducing improved lending policies, systems, and procedures for SME clients; credit scoring models; credit information services; and credit guarantee funds that minimize moral hazard by sharing risks with banks. In addition, leasing continues to be seen as an appropriate mechanism for addressing especially smaller businesses' lack of collateral. Venture capital funds for SMEs are still being promoted although there is growing realism about their viability. This kind of financing is suitable for only a very few SMEs with high returns on capital.

7. In the area of business development services (BDS), models have evolved from the direct provision of (usually subsidized) services by a fully funded public intermediary organization in line with Government-determined priorities, to demand-oriented approaches as exemplified by voucher-based schemes, which seek to be more responsive to SME needs while promoting private domestic BDS providers. SMEs are increasingly expected to share at least some of the costs associated with such services to encourage effective use.

8. Recent SME development concepts, especially for more developed economies, are also taking into account current management theories, particularly theories related to competitiveness clusters and supply-chain management, which are based on the economic benefits of interfirm cooperation. How to induce linkages among SMEs or between SMEs and larger enterprises, that purchase their products and services is an area that is increasingly being looked into, and for which project concepts are being tested.

9. ADB has been supporting SME development for several decades. Until the mid-1980s ADB processed only a few SME-related projects, mainly in the form of credit lines, which were channeled through specialized DFIs to eligible SMEs, in line with national industrial development strategies. From 1987 to 1991, ADB intensified its SME-related operations. During this period, ADB financially supported SME development in a number of countries mainly through commercial financial institutions. Associated TA sought to strengthen the lending function of financial intermediaries and support the development of new financial instruments and credit information services. With the shift in ADB's financial sector operations from the provision of financial intermediation-type loans to policy-based interventions that address underlying structural weaknesses of the sector, the number of new SME projects declined substantially after 1991.

10. With ADB's adoption of poverty reduction as its overarching operational goal in 1999, there has been renewed interest in SME-related projects, which are perceived to have direct benefits for the poor. ADB has increasingly been seeking to address policy constraints affecting SME development. The creation of equal opportunities for SMEs and larger enterprises has been pursued in a number of countries through policy-based loans that aim at enhancing industrial competitiveness. In addition to promoting market-oriented economic and industrial policies in DMCs, ADB has increasingly been focusing on firm-level issues that affect SMEs' competitiveness. TAs that seek to introduce market-based BDS and facilitate SMEs' access to finance are being implemented in a number of DMCs. Planned SME projects are likely to comprise policy-based components/projects that seek to establish a conducive policy, legal, regulatory, and institutional environment for SMEs as well as technical and financial assistance for developing market-based financial services and BDS.

11. Given ADB's increasing operational interest in SME development and the wide range of relatively new approaches in this area, it is necessary to (i) assess the global experience with strategies for developing SMEs, (ii) identify successful operational approaches DMCs and ADB can use, (iii) develop within ADB a vision that is shared with Government counterparts, and (iv) develop practical guidelines for SME operations.

### **III. THE TECHNICAL ASSISTANCE**

#### **A. Purpose and Output**

12. The TA aims at strengthening ADB support for SME development. It will review SME development strategies and support mechanisms in DMCs and other relevant countries and, on the basis of the assessment, develop a framework for designing and monitoring ADB-financed SME development programs.

13. The expected TA results and deliverables will include:

- (i) successful strategies and mechanisms for SME development identified from the assessment of international research and experience,
- (ii) a common vision and conceptual framework for ADB-supported SME programs and projects,
- (iii) best practice guidelines for ADB-supported SME operations,
- (iv) a comparative interregional database on SME development and the related policy and institutional environment,
- (v) a seminar to discuss TA findings with DMC representatives, and
- (vi) the design of an external ADB web site to facilitate access to relevant information on SME development strategies and mechanisms.

#### **B. Methodology and Key Activities**

14. The proposed TA will assess the relevance, cost-efficiency, and effectiveness of policy and institutional approaches adopted for SME development in selected DMCs and other countries. It will also review the feasibility and applicability of new mechanisms for providing market-based business advisory services and finance to SMEs, as well as the use of cluster and supply-chain concepts for SME development. On the basis of this assessment and other available research, key driving factors as well as effective strategies for successful SME development will be identified.

15. To the extent possible, the assessment will draw on available research and the work of aid agencies and organizations that are active in the field and in tangential areas such as microfinance and private sector development. In particular, recommendations by relevant aid committees such as the Committee of Donor Agencies for Small Enterprise Development will be used. In some areas, however, additional information and analysis will be needed to ensure operational relevance.

16. From the assessment, operational approaches for supporting the creation of a conducive SME policy, regulatory, and institutional environment as well as SME financing and BDS will be identified. Specific approaches for promoting growth-oriented SMEs and subsistence SMEs will be developed, as necessary. The proposed strategies will consider the differences in business conditions between transitional economies and economies with an established private enterprise sector.

17. The TA will seek to facilitate the development of common positions on potentially controversial issues such as SME credit lines and credit guarantee schemes. For each policy and institutional issue, a range of feasible options that respond to the different conditions, needs, and development strategies of DMCs will be presented.

18. Best-practice guidelines will be prepared to facilitate the formulation and implementation of SME programs and projects. The guidelines will contain detailed diagnostic, design, and monitoring tools. The preparation of sector roadmaps will be covered as well.

19. Meaningful indicators for assessing the state of SME development and the effectiveness of SME policies will be identified. To ensure consistency, standardized indicators will be used to the extent possible, given the differing definitions of SME in different countries and the inherent problems with measuring activities of the informal sector. A comparative database for these indicators will be established to facilitate monitoring of SME development and the associated policy environment in the selected DMCs and other countries. The database will initially cover DMCs with ADB SME operations and other Asian countries with successful SME sectors for benchmarking purposes. It will contain relevant information on (i) SMEs' contribution to economic growth, trade, and employment; and (ii) conditions and strategies for developing the SME subsectors including the underlying policy, legal, and institutional environment. The aim is to identify a few, but useful, indicators that can be collected regularly and easily. The database will be compiled from existing studies and research, in particular World Bank SME assessments, statistics of OECD, business environment surveys financed by USAID, and ADB private sector assessments and investment climate surveys, which will be complemented by in-country assessments as required. Upon completion, the database will be maintained by ADB with inputs from other sources.

20. The TA will also develop a framework for assessing and addressing social and environmental concerns in the context of SME operations, taking into consideration international experience in this area. The situation of female entrepreneurs, their contributions to economic development, and the impact of SME development on female employment and income generation will also be considered.

21. To ensure the relevance of the TA findings, the recommendations will be discussed with relevant public and private sector representatives from DMCs and from organizations engaged in SME development.

22. The detailed terms of reference for the TA are in Appendix 2.

### **C. Cost and Financing**

23. The TA is estimated to cost \$400,000 and will be financed on a grant basis by ADB's TA funding program. The cost estimates and financing plan are in Appendix 3.

### **D. Implementation Arrangements**

24. ADB will be the Executing Agency for the TA. The TA will be implemented over 9 months starting in March 2003. The expected completion date is December 2003. The TA will involve about 9 person-months of international and about 10 person-months of domestic consulting services. A team of international and domestic consultants will be recruited on an individual basis in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB on the engagement of domestic consultants. The international consultants will include experts on SME policies, finance, and business development.

25. The consultants will submit an inception report to ADB within 1 month from the start of their services. Draft final reports on each consultant's findings and recommendations will be submitted to ADB and the participants, at least 4 weeks before the planned workshop. The final reports will incorporate workshop discussions and results and will be disseminated through the external ADB web site.

26. A regional workshop will be held at ADB toward the end of the TA to facilitate the exchange of views on the TA findings among SME policy decision makers, practitioners, and SME representatives from DMCs and countries that have successfully developed SMEs.

## **IV. THE PRESIDENT'S DECISION**

27. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$400,000 on a grant basis for the Development of a Framework for SME Support, and hereby reports this action to the Board.

## TECHNICAL ASSISTANCE FRAMEWORK

<b>Design Summary</b>	<b>Performance Indicators/Targets</b>	<b>Monitoring Mechanisms</b>	<b>Assumptions and Risks</b>
<p><b>Goal</b></p> <p>Reduce poverty in developing member countries (DMCs) by facilitating sustainable economic growth and employment generation through small and medium-sized enterprise (SME) development</p>	<p>Improvements in poverty indices</p> <p>Gross Domestic Product (GDP) Growth</p> <p>Increases in employment rates</p>	<p>Poverty surveys</p> <p>Macroeconomic data</p> <p>Labor statistics</p>	<p>Effective redistribution mechanism through appropriate taxation and budget process</p> <p>Adequate social security system</p> <p>Macroeconomic stability</p> <p>Growth of labor-intensive sectors</p>
<p><b>Purpose</b></p> <p>Strengthen Asian Development Bank (ADB) support for SME development</p>	<p>ADB projects for SME development to:</p> <p>increase SME sector contribution to overall output and GDP growth</p> <p>increase SME competitiveness and productivity</p> <p>increase SME-related employment</p>	<p>Macroeconomic and SME-related data</p> <p>SME surveys</p> <p>Project progress reports</p> <p>Project Completion Reports</p> <p>Impact assessments</p>	<p>Governments' commitment to SME sector development and required policy reforms</p> <p>Use of best-practice guidelines for identifying, designing, and implementing of ADB SME projects</p> <p>Stable macroeconomic conditions</p>
<p><b>Outputs</b></p> <p>Identification of successful strategies and mechanisms for SME development</p> <p>Development of common vision and conceptual framework for ADB supported SME projects and programs</p> <p>Establishment of a comparative interregional database on SME development and the related policy and institutional environment</p>	<p>Comprehensive review and adequate analysis of international experience and research on SME development</p> <p>Best practice guidelines for the identifying, designing, implementing, and monitoring SME projects and programs</p> <p>Comparable and meaningful performance indicators for SME development</p>	<p>Project reports</p> <p>Feedback from ADB operational departments and DMCs governments</p>	<p>Consultant findings and recommendations appropriate and effective</p> <p>Acceptance and adoption of consultant's recommendation</p> <p>Availability of sufficient and adequate data</p>



## TERMS OF REFERENCE

### A. International Consultants <sup>1</sup>

#### 1. Team Leader (estimated input, 3.5 person-months) <sup>2</sup>

1. The team leader/SME development expert will perform these tasks:

- (i) Assess international experience with development of small and medium-sized enterprises (SMEs) and identify key success factors for increasing the productivity and competitiveness of the SME sector and its contributions to economic growth.
- (ii) Examine how SME development can effectively contribute to poverty reduction.
- (iii) Assess the validity of cluster-based approaches for SME development; considering international experience and emerging research, identify conditions for success.
- (iv) Review international experience with fostering supply-and-value chains between SMEs and larger enterprises domestically and abroad; identify the necessary conditions and terms for such a relationship.
- (v) Identify effective, cost-efficient Government as well as private-sector-led programs for promoting SME development based on a comprehensive review of international experience and available research.
- (vi) Identify successful aid agency models for supporting SME development.
- (vii) Review ADB's experience with SME projects and assess the effectiveness of support mechanisms used.
- (viii) Draft best-practice guidelines for SME operations. This will involve the following tasks:
  - a) developing a comprehensive checklist for assessing the adequacy of the policy, legal, regulatory, and institutional environment for SME; development;
  - b) preparing sector roadmaps including, among other things, identifying of suitable indicators for SME development, assessing SME development needs in line with overall strategies for achieving sustainable economic growth, and proper phasing of reform and support programs;
  - c) developing operational approaches for supporting the creation of a conducive SME policy, regulatory and institutional environment as well as suitable SME financing and business development services (BDS) distinguishing between strategies for transitional economies and economies with an established private enterprise sector, as well as approaches for promoting growth-oriented SMEs and subsistence SMEs, start-up and established SMEs, and export-oriented SMEs and those producing for the domestic market;

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<sup>1</sup> One consultant can cover more than one area of expertise.

<sup>2</sup> This function can be assumed by any of the other experts on the team or by an additional SME development expert.

- d) developing basic design principles and options for SME reform programs and support mechanisms;
  - e) incorporating social, gender, and environmental concerns, as well as labor rights issues, to the design of SME projects, taking into consideration international experience with effective approaches; and
  - f) identifying sample performance benchmarks and monitoring tools for (ADB) SME operations.
- (ix) Design and establish an interregional database on SME development containing relevant information on (a) SMEs' contribution to economic growth, trade and employment; and (b) conditions and strategies for the development of the SME subsectors including the underlying policy, legal, and institutional environment. Identify a few, but useful, indicators that can facilitate monitoring of SME development, keeping in mind the replicability of the information, the cost of obtaining it, and possible entities that could generate this information on a regular basis after TA closure.
  - (x) Develop an external ADB web site with linkages to other sources of relevant information on SME development.
  - (xi) Prepare and organize an international workshop on strategies for SME development for Government officials dealing with SME development, SME representatives, and representatives from financial and other relevant institutions.

## **2. SME Policy Expert(s) (estimated input, 1.5 person-months)**

2. The SME policy experts will undertake these tasks:

- (i) Assess the relative importance of the following factors for successful SME development:
  - (a) stable macroeconomic conditions;
  - (b) availability of adequate infrastructure facilities;
  - (c) business-friendly legal/regulatory framework (for private sector development in general - adequacy of contract enforcement, the importance of defined and respected property rights, private sector legal recourse, and political protection of private enterprises - and for SME development in particular - simple, transparent business registration, licensing, taxation requirements, nondiscriminatory industrial/economic policies, availability of and access to business information, etc.); and
  - (d) availability of financing for SMEs.
- (ii) Identify successful examples of establishing an SME-friendly policy environment, which reduced the costs of doing business and encouraged the formalization of informal sector SMEs, and describe the conditions and process for achieving such changes.
- (iii) Advise on appropriate taxation policies and regimes for SMEs, including the use of tax incentives, and SMEs' need for simple, predictable, and transparent rules and provisions.

- (iv) Advise on business registration and licensing systems that meet the needs of SMEs.
- (v) Identify effective policy and institutional mechanisms for reducing administrative corruption, particularly its impact on small businesses.
- (vi) Assess the need for special SME promotion policies and strategies, and for separate SME-related legislation and administrative structures.
- (vii) Identify strategies for promoting SMEs at the local level and operational mechanisms for related ADB support. In the recommendations, also address this issue in conjunction with overall efforts to decentralize public services, which are under way in several ADB member countries.
- (viii) Advise the team leader on suitable policy and indicators and benchmark for a business environment.
- (ix) Give the team leader the necessary inputs for the guidelines and the web site.
- (x) Recommend how to solicit and incorporate the views of entrepreneurs in policy development and project interventions.
- (xi) Present policy-related findings and recommendations at a workshop.

### **3. Business Development Services (BDS) Experts (estimated input, 2 person-months)**

#### 3. The BDS experts will perform these tasks

- (i) From a review of international experience, present examples of effective information, as well as business and technical advisory and training services for SMEs and identify key factors for their success. Also, assess the need for public SME support services and advise to what extent cost-sharing arrangements with SME users are feasible.
- (ii) Develop an operational strategy for ADB support for developing sustainable SME business support mechanisms and schemes. Consider cost-recovery mechanisms, market orientation, and the governance of such schemes. Include an assessment of how governments and ADB can promote and support private sector provision of BDS, for example through voucher and matching grant schemes.
- (iii) Prepare guidelines for assessing SMEs' demand for support services and the capacity of service providers.
- (iv) Advise how synergies between the provision of BDS and SME financing can be maximized while preventing conflict of interest.

- (v) Review the suitability of the business incubator approach for developing economies.
- (vi) Recommend strategies for the use of cluster-based approaches for SME development, including related ADB support.
- (vii) Recommend suitable mechanisms for ADB support for promoting supply, and-value chains between SMEs and larger enterprises.
- (viii) Identify conditions and strategies for enhancing SMEs' access to international markets including, among other things, the importance of promoting ISO standards for SMEs; and formulate related ADB support mechanisms.
- (ix) Advise the team leader on suitable BDS-related indicators and benchmarks.
- (x) Give the team leader with necessary inputs for the guidelines and the web site.
- (xi) Present BDS-related findings and recommendations at a workshop.

**4. SME Finance Expert(s) (estimated input, 2 person-months)**

4. The SME finance experts will undertake these tasks:

- (i) Identify policy, legal, regulatory, institutional framework conditions that facilitate the availability of market-based financing for SMEs.
- (ii) Assess the international experience with public SME financial support/financing schemes, identify conditions under which they can be justified, and advise how such schemes can achieve cost-efficiency, market orientation, and adequate governance structures; also identify how public support schemes can best leverage private funding for SME development and present successful examples from developed and developing economies.
- (iii) Assess the effectiveness and performance of venture capital funds in developing economies, identify key factors and conditions for their success, and assess what role ADB can play in promoting domestic venture capital funds.
- (iv) Assess the need for specialized SME stock exchanges after a review of their performance.
- (v) Identify mechanisms for facilitating commercial bank lending to SMEs including conducive policy and regulatory framework conditions, the development of credit information/rating services, and capacity building for efficient risk assessment and management relation to SME lending, and develop suitable approaches for related ADB support.
- (vi) Review international experience with the use of credit scoring models in developing banking systems and identify conditions for their effectiveness.
- (vii) Review international experience with the establishment of specialized "SME banks" with emphasis on their commercial viability.

- (viii) Assess the effectiveness as well as the cost and benefits associated with credit guarantee schemes after reviewing international experience with such schemes and related research, and identify adequate mechanisms for addressing moral hazard problems.
- (ix) Identify suitable measures to develop leasing instruments and industries for the benefit of the SME market and assess how ADB can facilitate the process.
- (x) Review the effectiveness of externally funded credit and equity lines for SMEs and describe under what conditions, if any, they can be justified and describe the principal design features of successful ones.
- (xi) Prepare guidelines for assessing the effective demand of SMEs for finance and the capacity of financial institutions for SME financing.
- (xii) Develop detailed ADB strategies and operational approaches for supporting the establishment of market-based SME financing mechanisms and schemes.
- (xiii) Recommend mechanisms for increasing the availability of trade finance for SMEs and identify relevant ADB strategies and projects.
- (xiv) Advise the team leader on suitable finance-related indicators and benchmarks.
- (xv) Give the team leader necessary inputs for the guidelines and the web site.
- (xvi) Present finance-related findings and recommendations at a workshop.

5. Given the comprehensive range of issues and available experience and research to be analyzed, each international consultant will (i) identify existing relevant analysis and documents, (ii) identify the need for additional analysis in discussions with ADB, (iii) agree with ADB on a suitable approach for such work, and (iv) implement it.

## **B. Domestic Consultants**

6. Up to 15 domestic SME experts will be recruited, as required. Each will provide up to 1 person-month of services to undertake these tasks:

- (i) Collect and compile country-level data and information for an interregional database on SME development, which will contain relevant information on (a) SMEs' contribution to economic growth, trade, and employment; and (b) conditions and strategies for developing the SME subsectors including the underlying policy, legal, and institutional environment.
- (ii) Identify successful mechanisms and projects for SME development in their respective countries.

**COST ESTIMATES AND FINANCING PLAN**  
(\$'000)

<b>Item</b>	<b>Total Cost <sup>a</sup></b>
1. International Consultants	
a. Remuneration and Per Diem	200.0
b. International and Local Travel	25.0
c. Reports and Communications	15.0
2. Domestic Consultants	30.0
3. Workshop	90.0
4. Contingencies	40.0
<b>Total</b>	<b>400.0</b>

<sup>a</sup> Financed by ADB's TA funding program.  
Source: ADB estimates.