

# SME Development

Government Procurement  
and Inclusive Growth



**ADB**

Asian Development Bank

# Why Promote SMEs?

## Inclusive Growth

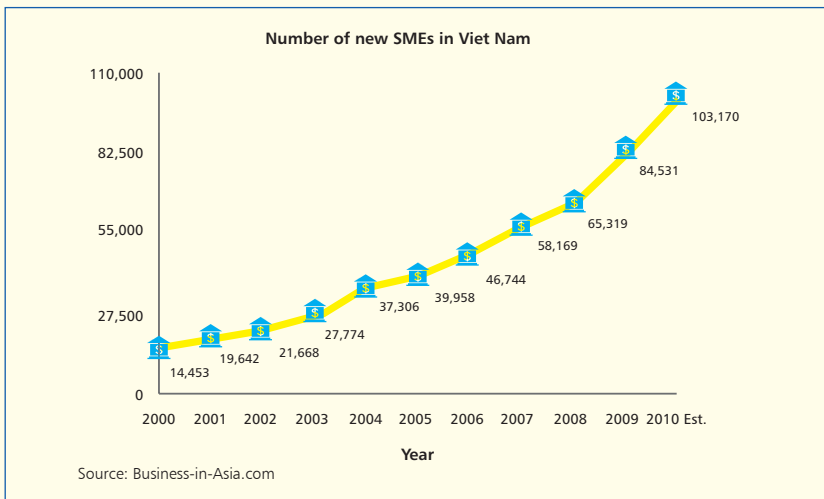
Despite the Asia and Pacific region's unprecedented economic success and poverty reduction, income inequality is widening. Economic data suggests that a significant number of Asian countries have experienced increased income inequality over the past 2 decades.<sup>1</sup> Small and medium size enterprises (SMEs) can play a major role in closing this divide. According to the SME Finance Forum, they are crucial for growth and job creation, accounting for nearly 86% of employment opportunities in developing countries. SMEs are seen to reduce income concentration with a disproportionate impact on minority or poor populations.<sup>2</sup> Earlier World Bank estimates suggest that SMEs in the People's Republic of China (PRC) account for 99.9% of the total number of businesses, employ 84% of the nation's workforce, and account for 71% of total sales.<sup>3</sup>



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- <sup>1</sup> ADB, *Asian Development Outlook 2012: Confronting Rising Inequality in Asia* (Outlook), pp. 45–46.
- <sup>2</sup> While some studies have questioned the extent of SME impact on poverty alleviation or decreased income inequality, it is now well-established that SMEs play an important role in job creation and are positively associated with GDP per capita growth, see, e.g., Beck (et al.), *SMEs, Growth and Poverty: Cross—Country Evidence*. 2004.
- <sup>3</sup> See <http://info.worldbank.org/etools/docs/library/49256/fan.pdf> (2003)

“...SMEs [are] in PRC’s national economic and social development an important force. Promotion of SMEs is to maintain stable and rapid development of the national economy, an important basis for the relationship between people’s livelihood and social stability [and] a major strategic task...[There is] need [for] more active and effective policies and measures to help SMEs overcome difficulties... to achieve sound and rapid development.”

– Premier Wen Jiabao, PRC State Council, August 2009



The public sector in many instances is an important market for small businesses, so improving public procurement practices by removing obstacles and boosting the involvement of SMEs is a key priority. Developing a more SME-friendly approach to public procurement means SMEs can maximize their potential for job creation, growth and innovation. Increasing involvement of SMEs in public procurement schemes can, if properly designed, result in higher competition for public contracts, leading to better value for money and efficiencies for contracting authorities.

In January 2012, PRC’s Ministry of Finance and Ministry of Industry and Information Technology outlined a number of preferential procurement policies for SMEs to boost their development. Measures include, among others, requiring government departments (i) to set aside at least 30% of annual budgets for SME procurement, with not less than 60% of this amount reserved for small and micro enterprises; (ii) to apply SME price preferences of between 6%–10% in particular instances; and (iii) to encourage larger businesses not only to subcontract but also form consortiums with SMEs and, in those latter cases, to provide price preferences of 2%–3%. Three months later, in April 2012, the Cabinet of the Government of India approved the Public Procurement Bill. This legislation recognizes SME preference schemes, among others, that set an annual goal of procuring a minimum of 20% of goods and services from micro entities and SMEs in India. IFC estimates the micro and SME sector in India to account for 45% of industrial output and 40% of exports, comprising 30 million enterprises in various sectors employing approximately 70 million people.<sup>4</sup>

The potential benefits of SME participation in government procurement can include:<sup>5</sup>

- a) Greater employment as SMEs are more labor-intensive compared to larger firms.

<sup>4</sup> IFC, *Micro Small and Medium Enterprise Finance Market in India* (2012).

<sup>5</sup> G. Piga, “Procurement and Preferences,” *ADB Research* (October 2011).

- b) Incremental multiplier effects through decentralized procurement with a disproportionately positive impact on local economies through repeated cycles of localized expenditure.<sup>6</sup>
- c) More varied competition through use of targeted assistance, including “set asides” and/or bid price preferences.<sup>7</sup>
- d) Decreased influence of established networks of larger firms (that may exclude SMEs through collusive or corrupt bidding practices or otherwise).

## Dynamic Export-oriented Asian SMEs<sup>8</sup>

The ability of SMEs to grow is amply demonstrated across Asia: In 1984, Legend Holdings was formed with 25,000 CNY (approximately \$10,000) in a guard house in PRC. It grew to be the largest PC company in the PRC and today is a \$21 billion personal technology company called Lenovo. Approximately 3 years earlier, in 1981, Infosys was started in India by seven people with \$250 and has grown into a global leader in consulting, technology, and outsourcing with revenues of over \$7 billion.

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<sup>6</sup> The “multiplier” approach has been used in the UK through a so-called ‘plugging the leaks’ operational tool called “LM3.” This tool assists local organizations measure the impact their purchasing has on the local economy by tracking where the money received by their local suppliers and contractors is subsequently spent—under the motto “it’s not just where you spend your money that matters but also where the people you give it to spend it.” See: [http://www.pluggingtheleaks.org/public spending/index.htm](http://www.pluggingtheleaks.org/public%20spending/index.htm).

<sup>7</sup> Some sources suggest that SMEs are a ‘unique source of innovation and competition’ (see, e.g., EIM, *SMEs’ Access to Public Procurement Contracts*, March 2004), although the correlation between increased SME participation in public procurement and greater innovation remains unclear.

<sup>8</sup> For an earlier comprehensive review of the role of national public procurement programs in promoting export - oriented SMEs, see UNCTAD/WTO, *SME and Export - Led Growth: Are There Roles for Public Procurement Programmes to Assist SMEs?* (2002).

# Barriers Facing SMEs

## Disproportionate Bidding Costs

A government bidding process means that firms incur threshold administrative or 'fixed' costs not associated with production costs of goods or services. This disproportionately affects SMEs as a proportion of their total financial and staffing resources, compared to larger firms.<sup>9</sup> A 2010 study concluded that, in the United States (US), costs per employee due to regulation appear to be at least 36% higher in small firms than in medium size and large firms, a disproportion in compliance costs that is particularly true in the manufacturing sector.



### Other cost-related barriers may include:

- onerous supplier and contractor registration requirements
- detailed bid information and documentary requirements
- costs of supplying a performance bond or guarantee
- costs of inspection requirements during bidding
- protracted bid qualification, evaluation and award procedures
- lengthy payment intervals after contract award which require significant interim cash flows and financing costs
- complex contract dispute resolution procedures

## Risk Aversion

Added to these costs is the tendency of government procurers to be risk averse when dealing with SMEs. Government procurers may specify more stringent financial or experience requirements that exclude newer and financially weaker SMEs. Through application of such qualification criteria, procurers also reduce work for themselves by not having to evaluate a larger number of bids from SMEs.

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<sup>9</sup> ADB. *Strategic Importance of Public Procurement*, p. 10.

# Contract Aggregation

Government procurers may also favor fewer, higher value contracts to avoid costs associated with procuring more, but lesser value contracts. Large contract values appear to affect smaller- and micro-sized firms far more than larger firms. Centralized procurement—which might be strongly justifiable on the grounds of increased price economy because of aggregated purchasing—tends to result in diminished SME participation in the absence of effective SME preference schemes. Conversely, in more localized or decentralized procurement, the probability is higher that SMEs will win public contracts primarily because of smaller and more manageable contract values. Empirical evidence suggests that both minority and non-minority small businesses consider unbundling of large contracts as a critical factor in increasing their access to successful bidding opportunities (See footnote 5).

## CASE STUDY

### **FIRE FIGHTING EQUIPMENT: Promoting SMEs Through Framework Contracts<sup>10</sup>**

The relevant United Kingdom (UK) market for supply and maintenance of fire fighting equipment was dominated by one large firm prior to 1999, Chubb. The UK government procurer, NHS PASA, decided to stimulate competition in that market through use of a framework agreement which saw the entry into the market of Cotswold Fire Fighters Ltd, and Walker Fire UK, both of which were small firms, and later with UK Fire International Ltd. The framework contract did not guarantee any business to any selected firm. Prices for generic services were set within the framework, with any other services separately negotiated. Market share (by value, within the framework contract, which was previously more than 95% with Chubb) became Chubb 48%, Cotswold 33%, Walker 13% and UK Fire 6%, with a total annual contract value of around £1 million.

Broadening the market increased competition. Costs to the NHS are believed to have been reduced by about 10% for core services such as maintenance of fire extinguishers. NHS Trusts who contracted out to UK Fire prior to 2003 also made substantial cost savings, as that firm's introduction into the framework arrangement saw it significantly reduce its prices.

Substantial entry of smaller companies into the market raised teething problems, as the scale and diversity of needs of NHS presented a steep learning curve for new suppliers. Further, smaller companies did not offer the full range of services offered by Chubb. Consequently, it was sometimes more cost effective for NHS to contract with more than one firm to obtain the full range of required services, in which case higher transaction costs partly offset savings in contract values.

In sum, the single large firm, Chubb, ultimately commanded a smaller market share and may have lost some economies of scale. However, NHS believed that the overall efficiency of the market, and incentives for continuing efficiency gains, were usefully increased.

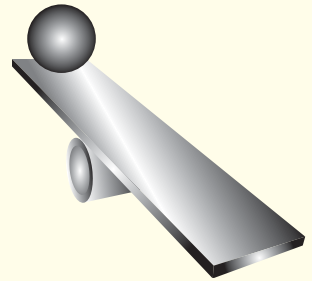
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<sup>10</sup> DTI. *A Study of the Benefits of Public Sector Procurement from Small Businesses*. 2005. p. 72.

# Leveling the Playing Field

## Minimizing “Size” Discrimination

In order to minimize or, ideally, eliminate the effect of such size discrimination against SMEs, many public procurement regimes increasingly use enhanced information distribution networks and electronic procurement, including electronic catalogues. Some approaches also include targeted training and outreach as well as affirmative efforts to unbundle larger contracts consistent with reasonably cost-effective award outcomes. More structured schemes use price preferences and/or set asides (or quotas) in favor of SMEs. Less frequently applied measures permit the use of SME aggregation of qualification and related criteria—through SME cooperatives and associations—for increased competitive bid positioning.



## Potential Risks

Preferential procurement schemes can be manipulated to facilitate ‘market capture’ or ‘rent seeking’ by vested interests, resulting in higher prices for goods and services as well as market behavior that undermines transparency and competition. For example, bogus SMEs can be established by larger firms or there can be collusion among SMEs. Further, government-sponsored SME procurement schemes, if designed or implemented in less than optimal ways, can lead to longer-term inefficiencies and higher costs through increased SME dependency on government bid preferences or set asides.

**“ Small and medium-sized enterprises collectively not only employ a majority of workers in the United States and the EU, but are also a critical source of innovative processes, products, and services that are key engines of economic growth, job creation, and competitiveness. ”**

**– Ambassador Miriam Sapiro at the EU-US SME TEC Workshop, Rome, Italy  
July 12, 2012.**

# SME Growth through Government Procurement

## Definitions

Each country has its own classification system for SMEs but most are classified by paid in capital, average annual turnover and number of employees. Relevant thresholds are typically sector or industry specific, for example, manufacturing, wholesale, retail, services, mining, general and heavy construction, and agriculture. Categories can include micro-enterprises, very small enterprises, small enterprises and medium enterprises, with different thresholds for number of employees, annual turnover, and/or sales receipts or revenues.

SME procurement schemes are most often applied by governments in two ways: bid price preferences that load the lowest non-SME bid or provide a discount to the lowest SME bid and set asides which provide quotas for SMEs.<sup>11</sup>

## Bid Price Preferences

Bid price preference schemes for SMEs generally take one of two forms with essentially equivalent results. Under the first formulation, bids from eligible SMEs are discounted by a given margin (e.g., 5%) and, if the lowest evaluated bidder is an SME, it is awarded the contract. The second method handicaps or loads the lowest bid of a competing non-SME bidder by a given margin of preference (e.g., 10%). If the competing SME bidder is the lowest evaluated bidder, it is awarded the contract.

Under another less common approach, within a given margin of preference (e.g., 10%), the least costly SME bidder has a first option of matching the lower offer of a non-SME bidder. If the SME cannot match the lower cost of the large firm, then the next lowest SME bidder is given the same opportunity. If no SME within the given preference margin matches the lowest non-SME bid, then the contract is awarded to the large firm.



<sup>11</sup> Piga, see Footnote 5.



Other bid preference schemes are not based exclusively on the application of a price margin for a specified class of bidders. For example, some bid preference schemes frame evaluation criteria that provide additional points or weightings as part of a 'bid score card' depending on the extent to which the preference targeted group is integrated into the bid submission. In such cases, the preferred bidder need not qualify as a SME to be eligible for preferential procurement treatment. Instead, such bidders obtain competitive advantage, i.e. additional points, in bid evaluation through use of SMEs as subcontractors or suppliers, for example, or by proposing SME targeted employment or specialized training.

## Set Asides

Under a set aside—essentially a quota—a certain percentage of designated government procurement contracts or total spending is reserved or 'set aside' for a targeted category of bidders that meet the preferential qualification criteria, such as SME status. The critical difference between this approach and use of bid price preferences is that, under set asides, there is a segregation of competition as targeted firms, i.e. SMEs, can only compete against each other. Procurement set asides are most often applied to historically disadvantaged individuals such as minority groups. This approach has been used to promote SMEs in public procurement, particularly in South Africa and the United States.



## US Approach<sup>12</sup>

The US approach covers small business, small disadvantaged business (i.e. owned by historically disadvantaged individuals), veteran- and women-owned small business and other categories. The program essentially targets US-based individuals and enterprises that contribute to the US economy through payment of taxes and use of US materials, labor and services.

At the federal level, annual targets are established in terms of percentage value of total contracts awarded to small businesses. Implementation is undertaken through federal procuring agencies and local and state authorities who collaborate with the US Small Business Administration (SBA). However, the SBA has overall regulatory authority. The scheme includes an exit strategy for SMEs after a specified period of time, assuming they do not grow sufficiently to encounter automatic exclusion.

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<sup>12</sup> For more details on US (and Korean) approaches, see Footnote 5, pp. 43–49.

There is flexibility within the US program to use either bid price preferences or set asides, depending on which approach is considered most suitable and depending on the particular sub-class of small business target group covered.

The US scheme requires that, if the relevant procurer fails to adopt a small business set-aside, the decision must be exhaustively justified. An example of when set asides may be considered inappropriate is where the procurer finds there is a lack of adequate competition with the use of a total or partial set aside: for example, when only a small and a large firm are likely to participate in a given tender in two lots, if one lot is subject to a set aside for small firms, the likely award will only be to the single small firm. In such a case, under the US scheme, it is permissible to disallow the use of such set aside.

Notably, the US approach includes use of SBA Procurement Center Representatives to facilitate implementation. Procurement Center Representatives are SBA representatives working in SBA areas offices (and other federal purchasing centers) who are also assigned to particular, usually larger, state procurement agencies. Among other activities, Procurement Center Representatives:

- a) review procurement solicitations to maximize opportunities for small businesses, including recommending of appropriate bid price preferences and set asides, and suggesting alternative procurement packaging or contract slicing to optimize opportunities for small business;
- b) identify and recommend small business concerns for inclusion in any list of prospective bidders to be solicited for a particular procurement;
- c) conduct periodic reviews of state contracting authorities to ensure proper implementation of SBA policies; and
- d) sponsor and participate in conferences and training designed to increase small business participation in public procurement.

**“Small businesses are the heart of the American economy. They’re responsible for half of all private sector jobs—and they created roughly 70 percent of all new jobs in the past decade. So small businesses are not only job generators, they’re also at the heart of the American Dream.”**

**– President Barack Obama. 2009**

## Korean Approach

The Republic of Korea provides an Asian example of an integrated approach to promoting SME growth using a procurement platform. Unlike countries such as the US and South Africa, the Republic of Korea uses neither bid price preferences nor set asides to encourage SME participation in its public procurement market.

The Korean Public Procurement Service Authority (PPS) has several initiatives to increase SME participation in government procurement used mostly within Korea's electronic procurement platform, Korea On-line E-Procurement System (KONEPS).

Among other initiatives, PPS provides the following:

- Advance payments to SMEs that qualify for an advance payment program for delivery of goods contracts, as much as 70% of the purchase price.
- An SME network loan program involving selected financial institutions with terms allowing SMEs that qualify for the PPS Surrogate Payment Program to obtain bank loans for up to 80% of the relevant contract price to cover the costs of contract execution.<sup>13</sup>
- An “SME Excellent Government Supply Products” award program to increase SME product visibility among all government suppliers, contractors and consultants. Each year, under this program, high quality performance and innovative technology products provided by SMEs are included in the KONEPS product catalogue accessed by government suppliers of goods, works and consulting services.<sup>14</sup>
- A Multiple Award Schedule (MAS) for SMEs, which is a simplified process for procurement of recurring, high volume purchases at more competitive pricing associated with volume buying through use of indefinite delivery contracts.<sup>15</sup> SMEs are given an opportunity to provide continuing orders, assuming satisfaction of MAS bidding requirements overall, and for each specific order, within the duration of the relevant indefinite delivery contract.

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<sup>13</sup> Under SPP, procurement-related services fees collected by PPS (from procuring authorities) through a revolving fund are applied to ensure early or timely payments to SMEs during contract execution. Moreover, as part of this integrated PPS scheme to decrease SME barriers – to –entry, fees for various bidding procedures are waived for SMEs.

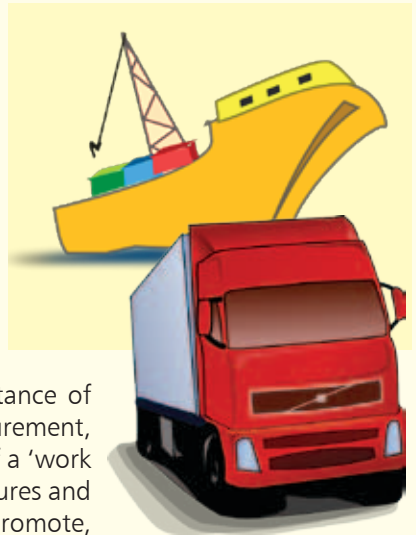
<sup>14</sup> For 2008, for example, over 2000 SME products were reportedly so listed.

<sup>15</sup> Volumes contracted by KONEPS through use of MAS are reported to have approximated almost US \$9 billion, over 250,000 contracts, during 2008

# SME Procurement Preferences and Trade Liberalization

Procurement preferences for SMEs may violate the current World Trade Organization (WTO) regime dealing with government procurement in the context of international trade, as framed in the General Procurement Agreement (GPA). National treatment and non-discrimination provisions of the GPA may be seen to prohibit discrimination in favor of national SMEs. However, SME procurement preference schemes that apply equally to domestic and foreign SME suppliers and contractors (an unlikely situation in practice) would arguably be consistent with such GPA provisions.<sup>16</sup>

The GPA permits 'special and differential treatment' for developing countries. Such countries, in order to meet their specific development needs may, at the time of accession, negotiate for use of offsets, as well as price preference programs, provided the use of such measures are 'transitional' and will be phased out after a given period. Recognizing the importance of facilitating SME participation in government procurement, the GPA has expressly provided for development of a 'work program' for SMEs. This includes a review of measures and policies used by signatory countries to assist, promote, encourage or facilitate SME participation in government procurement, as well as the undertaking of a special SME survey in signatory countries<sup>17</sup>



Apart from such transitory 'special and differential treatment' for developing countries, SME procurement preference schemes are likely to violate GPA mandated tendering procedures for 'covered' procurement which require the conditions of bid participation to be limited to technical and financial criteria essential to ensure a firm's capability to fulfill the relevant contract. The extent to which procurement packaging is framed in a non-discriminatory manner and requires technical and financial capacity requirements

<sup>16</sup> For more details, see J. Linarelli, "The Limited Case for Permitting SME Procurement Preferences in the Agreement on Government Procurement," WTO Regime on Government Procurement: Challenge and Reform (Sue Arrowsmith and Robert Anderson, [Eds.]) pp. 444-480."

<sup>17</sup> See GPA, Article XXII, Section 8(a) and Annex 5 (GPA protocol negotiated in December 2011)

that, in effect, promote *de jure* and *de facto* qualification of eligible local and foreign SMEs for a particular tender, it is arguable that such an approach is consistent with GPA tender procedure requirements.

The history of GPA negotiations between specific signatories reveals that, in certain cases, SME procurement preference schemes have been permitted. This is true, for example, in the case of GPA accession by Japan and the US whereby each country maintains small business set asides and/or bid preference schemes. Allowance for local SME procurement promotion schemes in particular circumstances is also characteristic of some regional and bilateral preferential or free trade agreements. Under the North American Free Trade Agreement, for example, joint programs to promote SME participation in government procurement opportunities have been expressly permitted.<sup>18</sup>

Recognition of SME preference schemes, among particular GPA signatories, seems co-related to the relative size of the procurement market of the contracting party maintaining such preference. Put differently, only GPA negotiating countries with substantial import markets in public procurement have sufficient policy autonomy to retain domestic (including SME) procurement preference schemes. This is perhaps a major reason why GPA accession by smaller developing countries has been limited.

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<sup>18</sup> NAFTA, Article 1021.

# Options for Policy Makers

The use of SME procurement preference schemes need to be objective, targeted and with an exit strategy to ensure that they do not become a mechanism to subsidize inefficient and/or corrupt SMEs.

A range of options may be considered, including non-procurement related policy tools that affect SMEs in more direct and transparent ways, to promote sustained growth and competitiveness. These include, for example, increased access to credit markets, input subsidies (e.g., for raw materials) and/or technical and marketing support for finished products. Equally important, to promote increased evidence-based policy formulation, it is critical to use robust management information and data collection systems to monitor the relative performance and success of SME procurement preference schemes over time.

Several policy approaches to the promotion of SME participation in public procurement are possible. In some cases, SME structured procurement preference schemes may be necessary. Such schemes need to be justified for targeted sectors in terms of whether competition that SMEs face is constructive or destructive to longer-term industrial growth and comparative advantage.<sup>19</sup> To the extent unchecked market competition is viewed as destructive to SME growth in a priority or targeted economic sector, such schemes would appear justified.

A range of illustrative procurement-related policy options, in terms of potential level of market distortion, is provided in the following Table. The least intrusive policy options involve pre-bidding approaches to promote streamlining and elimination of unduly restrictive or administratively burdensome requirements, as well as use of electronic procurement and unbundling (or 'breakouts') of procurement packages. Such policy options also include provision of targeted technical assistance and training for SMEs bidding for government contracts. More intrusive policy options involve mandating (or giving additional weightings in evaluation for use of) SME subcontracting programs and/or provision of special financial assistance and subsidies for SME to reduce their government bidding and other procurement-related compliance costs. Clearly, the most potentially market distorting approaches are use of price preferences and set asides for SMEs.

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<sup>19</sup> This is typically part of broader policy justification for protection and promotion of nationally identified "infant industries."

**Table: Range of Policy Options<sup>a</sup>**

Less  
Intrusive



Policy	Objectives	Potential Impact
Streamlining	<ul style="list-style-type: none"> <li>• Deregulate</li> <li>• Improve transparency</li> <li>• Improve competition</li> <li>• Standardize documentation</li> <li>• Improve publicity</li> <li>• User-friendly documentation</li> </ul>	<b>Potential Benefits</b> <ul style="list-style-type: none"> <li>• Improve access by SMEs to public markets</li> <li>• Reduce entry barriers</li> <li>• Potential efficiency gains</li> <li>• Avoid inefficiency in implicit political markets</li> </ul>
Eliminating unduly restrictive requirements	<ul style="list-style-type: none"> <li>• Eliminate unnecessary pre-qualification and post-qualification requirements</li> <li>• Innovative qualification programs to ensure SME participation</li> <li>• Thoughtfully apply international standards</li> <li>• More efficient testing requirements</li> <li>• More efficient specification drafting</li> </ul>	<b>Potential Benefits</b> <ul style="list-style-type: none"> <li>• Maximizes end-user choice</li> <li>• Decreased costs to firms</li> <li>• Potential taxpayer savings</li> </ul> <b>Potential costs</b> <ul style="list-style-type: none"> <li>• Increased default risks</li> <li>• Information costs</li> <li>• Could be harmful to SME interests</li> </ul>
Electronic commerce	<ul style="list-style-type: none"> <li>• Obvious benefits</li> <li>• But SMEs in developing and transition countries may still have problems</li> </ul>	
Packaging: “breakouts versus bundling”	<ul style="list-style-type: none"> <li>• Breakouts better for SMEs</li> <li>• But may be more costly than bundling</li> </ul>	

**Low**

Policy	Objectives	Potential Impact
Technical assistance <ul style="list-style-type: none"> <li>• Goal setting and advocacy</li> <li>• Advice and marketing assistance</li> <li>• Cooperatives</li> <li>• Community participation—donor-financed procurement</li> </ul>	<ul style="list-style-type: none"> <li>• Increasing awareness</li> <li>• Promoting SMEs</li> <li>• Supporting SMEs</li> </ul>	<b>Advantages:</b> <ul style="list-style-type: none"> <li>• Less interventionist</li> <li>• Rewards SME efficiency</li> <li>• Optional features</li> </ul> <b>Disadvantages:</b> <ul style="list-style-type: none"> <li>• Ineffective?</li> <li>• Interest group capture</li> <li>• Information problems</li> <li>• Conflicting public policies</li> <li>• Costly to government</li> <li>• Problematic goals</li> </ul>
Training	<ul style="list-style-type: none"> <li>• Human capital development</li> <li>• SME managers</li> <li>• Government administrators</li> </ul>	<b>Advantages:</b> <ul style="list-style-type: none"> <li>• Relatively cheap</li> <li>• Develops skills</li> </ul> <b>Disadvantages:</b> <ul style="list-style-type: none"> <li>• One size fits all</li> <li>• Administrative costs</li> <li>• May not be enough</li> <li>• Need for local focus</li> <li>• Potential for abuse</li> </ul>

Potential  
for  
Market  
Distortion



*continued on next page*

**Medium**

<b>Policy</b>	<b>Objectives</b>	<b>Potential Impact</b>
Financial assistance and subsidies <ul style="list-style-type: none"> <li>• Financing</li> <li>• Bond/ guarantee</li> <li>• Reform/ assistance</li> <li>• Prompt payment reform</li> </ul>	<ul style="list-style-type: none"> <li>• Alleviates significant SME constraints</li> </ul>	<b>Advantages:</b> <ul style="list-style-type: none"> <li>• Direct SME assistance</li> <li>• Some policies efficient</li> </ul> <b>Disadvantages:</b> <ul style="list-style-type: none"> <li>• Inefficient subsidies</li> <li>• Check for GATT compliance</li> <li>• Implicit political market</li> </ul>
Subcontracting programs <ul style="list-style-type: none"> <li>• Voluntary or mandatory</li> <li>• Distinguish goals</li> </ul>	<ul style="list-style-type: none"> <li>• Increase level of SME participation in public and private markets</li> </ul>	<b>Advantages:</b> <ul style="list-style-type: none"> <li>• Sustains demand on SMEs</li> <li>• Similar to set-asides</li> <li>• De-links some political interplay</li> <li>• Second-best trade policy</li> </ul> <b>Disadvantages:</b> <ul style="list-style-type: none"> <li>• Costs and inefficiency</li> <li>• Implicit political market</li> <li>• Hard to dismantle</li> </ul>

**Maximum**

<b>Policy</b>	<b>Objectives</b>	<b>Potential Impact</b>
Price preferences	<ul style="list-style-type: none"> <li>• Targeted assistance in procurements</li> </ul>	<b>Advantages:</b> <ul style="list-style-type: none"> <li>• Direct SME assistance</li> <li>• Awards to SMEs</li> </ul> <b>Disadvantages:</b> <ul style="list-style-type: none"> <li>• Very likely inefficient</li> <li>• May reward inefficient SMEs</li> <li>• Implicit political market</li> <li>• Poor incentives</li> <li>• Hard to dismantle</li> </ul>
Set-asides	<ul style="list-style-type: none"> <li>• Reserve procurement</li> <li>• Limit competition to SMEs</li> <li>• Or award single source</li> </ul>	<b>Advantages:</b> <ul style="list-style-type: none"> <li>• Quickest potential SME gains</li> <li>• Visible gains to SMEs</li> </ul> <b>Disadvantages:</b> <ul style="list-style-type: none"> <li>• Unclear if effective</li> <li>• See above on subcontracting</li> </ul>

More Intrusive

<sup>a</sup> Slightly adapted from Tables 10 and 15, see Footnote 8, pp. 65, 103



Recent research indicates that rising inequality in the Asian context is associated with a declining share of labor income given more efficient, productive and expanded use of capital and technological progress. Thus Asian and non-Asian policy makers need to make growth more employment friendly for wider sections of the population and SMEs can play an important role in this effort.<sup>20</sup> One potentially useful policy tool to spur SME growth and thereby reduce income inequality and promote inclusive growth is the proactive use of government procurement.

Any national level SME procurement policy needs to take into account the impact of SME preference schemes on trade liberalization. In an era of increasing globalization, domestic SME procurement preference schemes that do not promote longer-term comparative advantage at an international level ultimately become mechanisms for local market capture and rent-seeking. This aggravates, rather than reduces, economic inefficiency and income inequality. In the context of trade liberalization, constructive and flexible dialogue on ways to promote SME growth, including the use of carefully targeted and nuanced procurement preferences schemes, is essential.

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<sup>20</sup> *Outlook*. pp. 83–85.

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## About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.7 billion people who live on less than \$2 a day, with 828 million struggling on less than \$1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

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