

□ BUILDING AN ENABLING ENVIRONMENT: A LONG-TERM PERSPECTIVE OF MICROENTERPRISE

By Charles Cadwell, Kathleen Druschel, and Thierry van Bastelaer, The Center for Institutional Reform and the Informal Sector (IRIS) at the University of Maryland

Microenterprise works best in countries where the political, economic, and social environments allow small entrepreneurs to succeed beyond the level of basic survival, say Charles Cadwell, Kathleen Druschel, and Thierry van Bastelaer from the IRIS Center at the University of Maryland.

Drawing on the last two decades of experience, the authors suggest that donors should focus more on the fundamentals that "enable" successful microenterprise development. These include solid legal and financial institutions, regulatory reforms, governments that respond to the needs of their citizens, and business groups that can advocate changes to policies and practices that hurt their members' ability to build and expand their businesses. Effectively addressing the problems of today's poor, they say, requires a better understanding of the mechanisms that perpetuate poverty and the processes by which those mechanisms can be improved.

In Kabul, Afghanistan, new microenterprises, having sprung to life in the early hours after the Taliban fled the capital city in 2001, sell previously banned items such as music and radios as well as scarce necessities such as food, clothing, and fuel. Across Bangladesh, millions who lack education, capital, or information about distant markets nonetheless carry on business activities that demonstrate remarkable resilience and contribute to significant portions of that country's exports. In Africa, communities ravaged by HIV/AIDS still have active markets, with ever-increasing income generation activity, as families burdened by adopted children and ailing adults struggle to survive.

While there is wide acceptance of the critical role small businesses and microenterprises play in providing jobs and raising national income, the poorest countries are often found lacking in this outcome. The greatest gains from entrepreneurship are found in places where the political, economic, and social environments allow entrepreneurs to succeed beyond the level of basic

survival. This "enabling environment" for microenterprise depends to a large degree on good governance. In countries where citizens have only a limited control over the policymakers and the public sector, the enabling environment is often weakest.

It is not always clear what can usefully be done to promote opportunities for microenterprises so that they can prosper. While donors have often aimed support at microfinance, or increasingly, delivery of business development services, these efforts have not been adequate to broadly improve standards in poor societies. Even as initiatives such as the Grameen Bank – the Bangladesh bank that introduced and popularized the idea of giving small loans to microenterprises – have expanded, the majority of poor people continue to lack access to a range of market-supporting services, including credit and savings services, from both government and the private sector. These enterprises most often cite as obstacles to their growth: lack of police protection from crime, access to other government services based on favoritism rather than merit, collection of illegal payments by government officials, unpredictable regulatory and enforcement practices, and a lack of government support for private agreements and collective arrangements between and among individuals and firms. In light of these challenges, how should policymakers in poor countries re-think their approach and how can donors influence this process?

Two decades of experience suggest that donors need to put more resources into those programs and policies that "enable" – create the conditions for – successful microenterprise development. An "enabling environment" comprises institutions: laws, policies, and informal rules, as well as the bodies that implement them. These institutions support transactions that rise above the simple exchange observed in street trade. The common example of an economic institution is credit, where repayment requires some means of enforcing a contract. The peer pressure for loan repayment that is central to

group lending practices represents a rudimentary form of contract enforcement. But development depends on a variety of complex forms of agreement, which permit not only the extension of small, local credit but also the mobilization of savings, the accumulation of capital within firms, formal degrees of ownership, and transparent processes by which to access information.

The weakness of the enabling environment in the poorest countries has many causes. Poor effectiveness and low credibility of the state and its officials undermine policies across the board, including those essential to microenterprises. A lack of specific policies and low capacity to implement them also hinder improvement in specific areas of a microenterprise-enabling environment.

These gaps are difficult for external donors to fill easily or quickly. Narrow “technical assistance” services (such as training of entrepreneurs or facilitated access to markets) have not been the solution; even when such programs have been available to host countries at low or no cost, governments generally fail to implement them. This is one of the reasons that donors are increasingly paying attention to the incentives, which motivate action on the part of officials, policymakers, and other economic and political actors. Attention to how economic decisions are taken, by whom and with what end is an essential part of the work needed to improve the environment for microenterprises. Steps to facilitate access to credit by small firms will founder if credit contracts are not routinely enforced by courts, or if property registries are non-existent or corruptly run. So it is important to understand why courts in some places provide better contract enforcement services and why some local governments prey on firms while others encourage enterprise.

If any interaction with the government – from entry into school, to access to health care, to access to business licenses – requires a bribe, then the obstacles facing microenterprise are merely examples of more fundamental governance problems, as has been suggested above. Communications and transportation infrastructures are much more likely to be underdeveloped and poorly distributed in places with weak governance institutions. Services central to microenterprise, such as the issuance of land titles and enforcement of contracts, will also be lacking. Private providers of some of these necessary services, who might try to step in to fill a gap left by government, are themselves often stymied by the same entry barriers that result from weak or corrupt

governance mechanisms. So another aspect of such a “market augmenting government” – a government that works to increase the reach of the markets rather than replace them – is the scope it provides for markets to evolve their own institutions, or for government decisions to be informed by markets. Where these mechanisms are suppressed, citizens will seek economic and political opportunities in other ways – by emigration, withdrawal into the sector of the economy that is not officially recorded or recognized, and political and social dissent.

These observations suggest that, in an era of diminishing donor resources, a focus on improving the enabling environment for micro, small, and medium enterprises is likely to affect significantly larger numbers of enterprises – and at a lower per capita cost – than reliance on targeted programs of enterprise support. As an example, in the fiscal year that started October 1, 2001, the U.S. Agency for International Development (USAID) spent just under \$170 million in microenterprise efforts. Ninety two percent of that amount provided direct support to microfinance initiatives or business development services. The remaining 8 percent was devoted to improving the enabling environment for microenterprises, much of which funded the development of policies related to provision of microfinance rather than the broader environment for microenterprise. This is not to suggest that USAID misunderstands the nature of the challenges facing microenterprises – indeed its staff includes leading thinkers and practitioners in the field – but rather to recognize that the agency faces significant pressures from Congress and interest groups to pursue programs that more closely reflect a concern for short-term humanitarian assistance than for long-term development.

There is no doubt that many or most of the recipients of aid are better off for it. But it also is quite obvious that the main causes of economic and social distress often remain unaddressed in the very same places where diligent microfinance or business development efforts have been under way for a long time. A program of support for microenterprise has to be refocused.

A growing number of donor initiatives are starting to reflect this reality and translate new thinking into practice on the ground. The joint World Bank-International Financial Corporation Small and Medium Enterprise Capacity Building Facility has supported efforts in building business organizations that advocate changes to policies and practices harmful to their members’ ability to build and expand business. In Malawi, the National

Association of Business Women advocated for changes to the land law policy, which would allow women to obtain property titles and thus secure commercial loans. In Belarus, 18 local business associations work together to garner media attention about stifling enabling environment policies. USAID is working at this, too, by conducting research on how policies interact with poverty, implementing programs that target the microenterprise environment, and increasingly emphasizing governance concerns, especially in the fragile and failing states, which are often home to the poorest of the world's citizens.

Tackling these larger problems will take more time – the issues are complex, and change of governance is not yet a well-understood process. Only a few countries have improved their enabling environment quickly (and some would suggest that countries such as Poland or Slovenia are special cases). In most places, bettering this environment remains a difficult matter. Bad policies have beneficiaries who cling tightly to their benefits, even if those beneficiaries might be better off in the long run with change. Organizing microenterprises to overcome this inertia is a difficult task everywhere, but especially in places with little interaction between the state and citizens.

If our concern is development (or if we believe U.S. national security concerns make poverty reduction an even more urgent task than it currently is), then policies and programs need to be effective in their overall impact on broader economic and social goals, not just successful in meeting the needs of direct recipients. This calls for significant re-thinking in our microenterprise approach.

It requires long-term commitment to the policy environment and to governance mechanisms that support that environment.

If donors accept this broader perspective of poverty reduction, they will need support from those who advocate for the poor and for microenterprise. They will need support from those who purport to advocate for private sector development. Donors will need to develop better understanding of the processes by which actual improvements are made in the enabling environment. Which policies can be initiated by local governments, even in countries with repressive regimes? What options are there for organizing advocacy groups? Are there ways to support private provision of “public” goods such as dispute resolution or commercial standard-setting?

These are issues that we have worked on at the University of Maryland's IRIS Center since our founding by development economist Mancur Olson in 1990.

Because the poor and microenterprises bear the fullest brunt of poorly conceived policies and inadequate governance, attention to the governance and institutional environment offers a powerful response to the poor's real needs. To effectively address the problems of today's poor, we need to understand much more about the mechanisms that perpetuate their poverty and the processes by which those mechanisms can be improved. □

Note: The opinions expressed in this article do not necessarily reflect the views or policies of the U.S. Department of State.