

Policy discussion paper

# Small scale enterprise and sustainable development



Key issues and  
policy opportunities  
to improve impact

Duncan Macqueen

# 1. Overview

This paper is for all those who can affect enterprise support policies. It discusses two issues:

- ◆ The legitimacy of enterprise policy support that discriminates on the basis of scale (for example, in favour of smaller rather than larger scales of enterprise, however those are defined) – and if it is legitimate;
- ◆ What policy support might best help smaller scales of enterprise to contribute to well-being in its broadest sense?

These issues are explored through an ideological lens involving three important assumptions about broad sense well-being (which is itself assumed to be the aim of 'development'):

- ◆ Greater equity in the distribution of economic and political power is necessary for well-being in both the short and long term.
- ◆ Sustainability is necessary for well-being – at least in the long term.
- ◆ Greater freedom for enterprise across the size spectrum does not necessarily optimise either sustainability or equity – and appropriate policy intervention and good governance is therefore necessary for well-being.

Clarity about such assumptions and the bias they introduce should arm the reader better to make use of what follows. The paper begins by noting how important policy environments are in shaping both the opportunities and constraints faced by SMEs and also the social, environmental and economic impacts of SMEs. Not all policy environments share the same emphasis on sustainability, equity and policy intervention that I have assumed above.



Enterprise exists along a spectrum of scale ('micro', 'small', 'medium' or 'large') and formality. Informality is particularly prevalent at the smallest 'micro' scales of enterprise. Informality has observable impacts on well-being (Becker, 2004). Although for the purposes of this paper I employ the useful short-hand acronym SME (small and medium enterprise), I define it as one with less than 100 employees without any lower cut-off. The lack of cut-off is partly to include relevant discussion about 'micro' enterprise and informality.

SMEs often account for the majority of firms and a substantial proportion of employment in both developing and developed countries (Liedholm and Mead, 1987; OECD, 2000; Hallberg, 2001). However, their characteristics and impact on well-being – and the appropriateness of any consequent policy interventions – vary enormously between sectors and contexts. Policy interventions and their impacts in say small-scale aeroplane manufacture,

cashew nut processing or sarin production will not necessarily have a lot in common! The nature of SMEs affects what competitive challenges and advantages they possess, which of these relate to scale and what strategy should be taken to optimise their contribution to sustainable development (Arnold and Townson, 1998). For example, the size at which any enterprise can make most efficient use of inputs relates to many different features to do with the availability of resources, structure of the market, access to credit, formal and informal regulations, labour relations and so on. Factors such as these must be considered in fine tuning policy interventions directed towards SMEs. But should we intervene in favour of SMEs at all?

There are three commonly advanced positions for policy intervention in favour of SMEs that often overlap with one another:

- ◆ Pragmatist – SMEs often have a numerical significance and 'reach' into the poorest communities that large-scale enterprises lack, and this warrants appropriate support. This holds irrespective of any other advantages or disadvantages that SMEs might have (Haggblade et al., 2002; Scherr et al., 2004).
- ◆ Sceptic – Irrespective of any other advantages or disadvantages that they might have, market failures disproportionately affect SMEs. Such inequity warrants appropriate support (Biggs, 2002; Beck et al., 2003).
- ◆ Advocate – The economic, social and environmental advantages intrinsic to some types of SME in certain particular contexts warrant appropriate support (Schumacher, 1973; Hines, 2004).



The legitimacy of any of these positions is complicated by the difficulty in drawing a cut-off line for support at a particular scale – it can seem inherently arbitrary. Yet arbitrary or not, if we make the three ideological assumptions about well-being described above, there do seem to be unique issues – both advantages (section 3) and disadvantages (section 4) linked to scale. The quality of data on these advantages and disadvantages involves a spectrum from comprehensive reviews to outright speculation. Leaving the general imperative for further data collection aside, tailored policy support on the basis of small enterprise scale could build logically on those advantages and tackle those disadvantages – enhancing broad sense well-being. That is not to say that support to SMEs should supplant support to enterprise as a whole. The paper argues instead that – to the extent that some of the seemingly unique advantages of smaller scale enterprise are considered desirable, or disadvantages and market failures undesirable – support that discriminates on the basis of scale makes good sense.

The paper sifts out some of the most promising opportunities for policy breakthroughs. These opportunities span governance reform, incentive to encourage particular types of private sector structure and behaviour, and options for standard setters. The paper proposes that engagement in three areas would have significant impact:

- ◆ Models of incentive, competition and procurement policy that have proven most effective in supporting the wide range of social, environmental and economic benefits of SMEs.
- ◆ Patterns of SME ownership and association that have secured greatest social, environmental and economic benefits.
- ◆ Processes of standard setting and labelling and constructive consumer engagement that have enhanced the benefits of SMEs.

## 2. The impact of the policy environment on SMEs

We have noted above that SMEs do not operate in a vacuum. Their activities and impacts are shaped by the context in which they operate. For example, there is broad global range of policy environments and business strategies that produce a wide spectrum of resultant impacts on SMEs.

Some policy environments couch well-being in terms of income and the efficient return on capital. Business environments in such contexts may be orientated towards maximising economic growth. Sustainability may be perceived as contingent upon increasing wealth – equity may be perceived as less important than absolute income – and policy intervention in the market on any grounds, let alone scale, may be seen as distorting or inefficient. Within such contexts, the possession of capital and large-scale efficiencies have a lot going for them. Evidence shows that the SME sector also flourishes in fast growth economies. Yet this is believed to be a symptom of growth, rather than driving it (Biggs, 2002). Large firms increasingly outsource non-core business into low cost SME environments, in which competition is deliberately encouraged. Such outsourcing may partly explain the correlation between economic growth and a large SME sector. On the other hand, large firms' procurement practices can squeeze out small firms altogether (see Box 1). Grouping together is often a survival instinct of SMEs to try to combat inequitable distributions of capital or market power. It can also be used to develop capital and market power of their own (e.g. forming a cartel around produce not provided by larger companies). Group 'standards', including for sustainability, are often used as a barrier to entry to new entrants and a subtle tool to push out competitors. Some innovative programmes have succeeded in strengthening the position of SMEs within such environments (e.g. the micro-credit of Grameen Bank – Yunus, 1998).

Alternative policy environments couch well-being in social terms – putting greater emphasis on returns from labour. These often foster business environments that are more interventionist. Sustainability and the distribution of wealth may be perceived to take priority over growth and absolute levels of income – requiring strong policy intervention. Large-scale enterprise can be seen as an attractive option in such policy environments partly because it reduces the transaction costs of interventionist policies. But in some contexts, such as India, SMEs have also received strong policy support (see Box 2). Grouping together in such contexts has allowed impressive feats of collective efficiency and adaptation to changing markets.

### Box 1. Dairy processing firms and supermarket chains in Brazil

Supermarket chains' share of food retailing in Brazil has stabilised at around 43%, though consolidation within the sector has been rapid. The top five chains control 70% of the supermarket sector and these chains have taken a dominant role in food distribution. The bargaining power of the largest retailers has changed buyer-seller relationships and tightened suppliers' margins.

The retailing of milk has shifted rapidly into supermarkets, partly in line with the dramatic growth in popularity of UHT milk, which now comprises 75% of the formal milk market. Before the 1990s, most of the main dairy processing firms were central cooperatives. Deregulation of the dairy market between 1989 and 1993 saw almost all of these cooperatives sold to multinationals. Nestlé, Parmalat and Fleischmann Royal control around 60% of the Brazilian dairy market. The top three dairy processing companies in Brazil – Nestlé, Parmalat and Brazilian-owned Vigor – had 53% of the market in 1996. By 2000, eight of the 10 largest food companies in Brazil were multinationals, with Nestlé the biggest.

As a result of higher price competition, dairy companies have consolidated their supply bases. The number of farmers delivering milk to the top 12 companies, for example, decreased by 35% between 1997 and 2000, and the average size of those farm suppliers has increased by 55%. Nestlé alone shed 26,000 farmers from its supply list in the same period – a drop of 75%.

Source: Vorley (2004)



There are strong links between the debates on SMEs vs. large scale firms and the debates on localisation vs. globalisation of trade. SMEs might be favoured by and within drives towards localisation. Large firms might be favoured by and within drives towards international trade. Of course, within the latter scenario, potentially beneficial technological spill-overs from export markets to local markets can occur (e.g. improved food quality and safety).

Whether through choice or through imposed conditionality (e.g. conditions applied to financial loans), many countries pursue policies based on returns to capital within the context of globalisation. SMEs therefore face a particular set of challenges. Although numerical increases can occur, many of these SMEs may be marginalized. At the wrong end of scale efficiencies, SMEs can often only offer less satisfactory wages and conditions (see Box 3). While some well-documented exceptions occur in some high tech industries or industrial clusters (Nadvi and Barrientos, 2004), SMEs often have to cut social and environmental corners to remain competitive. They may be penalised for their lack of formal policies and practices on Corporate Social Responsibility (CSR) – at which ironically they might excel in more supportive contexts (Fox, 2004) because they are often locally embedded (see below).

Different policy environments (and we have by no means exhausted the possibilities) also affect the distribution of economic power. Skewed distributions of economic power can be self-reinforcing, for example,

### Box 2. Changing policy protection for SMEs in India

The policy environment for small scale enterprises in India is generally very favourable. Whilst economic reforms initiated in 1991 have led to the removal of numerous protection measures regarding Indian industry in general, a number of measures have been retained specifically to protect the small scale sector. Many items are reserved for exclusive production by SMEs (almost 800 individual products in 2001), and SMEs are entitled to special excise concessions, simplified tax procedures, priority sector lending and concessional credit, preferential purchase by central and state government organisations, assistance for technology development and modernisation, incentives for ISO 9000 certification and various export incentives.

However, economic liberalisation and changes in trade policy (India joined WTO in 1994) have meant that small scale enterprises are facing increased competition from foreign companies, which they used to be protected against, and it remains to be seen to what extent government protection and support can enable Indian SMEs to flourish in an increasingly competitive globalised market.

Liberalisation of the economy is not uniformly bad for SMEs – some restrictions to their functioning have also been lifted. For example, industrial licensing is no longer required for a range of forestry enterprise, and the stringent restrictions governing the siting of small scale industry have been relaxed in comparison with large scale industry.

Source: Saigal and Bose. (2003)

generating demand for luxury imports rather than spreading wealth to local SMEs. Large firms often use power to 'capture' decision makers and further skew policies in their favour (for example some elements of the

petrochemical industry in the USA). At the lower end of the size scale, SMEs often remain informal to avoid administrative costs. Informality undoubtedly poses a problem for government revenue capture – and for any

support that governments might wish to direct towards SMEs (see Box 4). While informality may not pose a problem for broader social welfare, there can be hidden negative issues relating, for example, to gender (Kantor, 1999) or child exploitation (UNICEF, 2003). Conversely, there may be positive issues to do with reduced need for monitoring labour and higher investment in the long term interests of family firms (Toulmin and Guèye, 2003). Informality does not necessarily equate to powerlessness. Some federations of SMEs become very powerful themselves (e.g. micro-retailers in India) and these may have strong vested interests of their own.

### Box 3. Labour conditions in timber-based SMEs in Brazil

Recent work in Brazil assessed labour statistics for more than 50,000 forest harvesting, wood processing and furniture manufacture enterprises. Results showed the huge importance of small and medium enterprise to the Brazilian forest sector and a positive correlation between the size of enterprise and the average remuneration per employee. Smaller enterprises paid less well. Differences were most pronounced for more advanced processing sectors such as furniture manufacture. In addition, there was a positive relationship between the size of enterprise and the likelihood that employment would involve formal registration (with added security benefits from Brazil's historically socialist legislature). It should be noted, however, that these figures do not reflect work conditions (i.e. closeness to home, flexible working hours, paid meals etc).

Source: May et al. (2003). See [http://www.iied.org/docs/flu/SME\\_pubs/](http://www.iied.org/docs/flu/SME_pubs/) for further work on forestry small and medium forest enterprise

### Box 4. Vietnam's craft and industry villages (CIVs): SMEs falling through the cracks

In Vietnam's Red River Delta, up to 80 percent of non-farm employment is provided by handicraft micro-enterprises on a home-based, piecework basis. Incomes from these activities are critical for the Delta's rural households, given the region's acute land scarcity and growing population. However, current national and provincial programmes to support rural industries fail to include the handicraft micro-enterprise sector for a number of reasons. The services provided (serviced plots in rural industrial zones or handicraft zones with access to water, sanitation, electricity and roads) only offer a minimum size that is far too large, and require advance payments that are unaffordable for micro-enterprises. Incentives are offered to industries that hire local workers - but this only applies to formal types of employment and does not take into account home workers. This is a missed opportunity, as micro-enterprises not only provide incomes to a vast majority of the Delta's population, but also often involve polluting activities (air pollution through fumigation of rattan and bamboo; water pollution through dyeing of fabric...) that affect primarily the workers' households and neighbourhoods. As the volume of production activities grows, environmental concerns become more pressing, and relocating micro-enterprises away from residential areas into serviced locations becomes increasingly desirable.

Source: Thanh et al. (2004)

In summary, policy environments have a significant influence on the number, type and health of SMEs. Neither policy intervention, nor the lack of it, is neutral in how they affect SMEs. So what are the main advantages and disadvantages of SMEs that policy interventions might seek to address?

### 3. Advantages of SMEs – the legitimacy of policy support that discriminates on scale

The advantages of small scale are often not static. Rather they are best seen in terms of the endless transitions that confront the poor. For example, SMEs are particularly important in rural to urban transitions where they can provide flexible diversification of income. SMEs are important in transitions from state controlled to market driven economies where flexibility to learn and change are critical characteristics. They are also important in the transition from family labour to sharecropping to waged labour in rural settings.

With the obvious exception of exporters, SMEs tend to be embedded in local culture. As a result they enjoy closeness to customers, seasonal, diurnal or other flexibility and often the cost benefits of informality. Some of these advantages particularly favour women with childcare and domestic responsibilities – where working hours and closeness to home are important. SMEs are certainly critical to people on the fringe of survival and some at least go on to become enduring or expanding entrepreneurial successes. In a recent multi-sectoral workshop on the advantages of SMEs it was observed that they can play a unique part in reducing certain elements of poverty such as: insecurity and powerlessness, social inequity, mass production drudgery, ecological or landscape uniformity and loss of cultural identity.

<b>Dimensions of well-being</b>	<b>Economic</b>	<b>Social</b>	<b>Environmental</b>
<i>Basic survival</i>	Provide local outlets for inputs and outputs without externally imposed standards	Strengthen connectedness to and responsibility for sustainability of production	Negative environmental problems are local – more quickly spotted and dealt with
<i>Livelihood security</i>	Reduce outside dependency with greater local resilience in uncertain times	Provide flexibility – flexible working hours are especially important for child carers	Multi-functionality especially at a micro level builds environmental resilience
<i>Affiliation and relationships</i>	Profits accrue locally, are often reinvested locally with local economic multipliers	Greater social equity that humanises relationships in buying and selling – building community	Shorter transport distances reduce pollution and human risk
<i>Creative endeavour</i>	Distribute economic opportunities and returns fairly across multiple owners	Use local knowledge and skills – with ownership over business outcomes	Increased options to use, and consequent vested interest in conserving, the local resources
<i>Aesthetic awareness</i>	Exploit local niches and maintain diversity in available products	Understanding of local tastes fosters craftsmanship	Diverse enterprises at landscape level creates space for biodiversity
<i>Cultural identity</i>	Locally accountable with less power to capture and corrupt power and policies	Provision of culturally sensitive options – options to empower marginalized groups	Local product or service design strengthens cultural landscapes

## 4. Disadvantages of SMEs - grounds for caution

While there are many potential advantages of small scale, there are also some significant disadvantages in certain contexts. SMEs tend to suffer from high input, transaction and investment costs. This is in part due to poor bargaining power and lack of collateral. Evidence suggests that SMEs are neither necessarily more nor less innovative, job creating, supportive of worker welfare or environmentally friendly than larger enterprises (Biggs 2002). Business is business, and whether it is international financiers or family members who are 'shareholders' in enterprise, there is still a risk that financial profit will be put above sustainability and equity without strong regulation to the contrary. But transaction costs inevitably make engaging with SMEs costly. It is difficult to interact with or influence multiple owners spread over wide geographical areas. As noted already, the problem is compounded by informality (Schneider, 2002). Support for informal SMEs risks strengthening production in forms from which government revenues cannot be collected. Also, the sheer diversity of SMEs makes generalised policy prescriptions difficult – what works for one may not work for another.

Targeting effective support programmes on the basis of scale is complicated. SMEs associate with larger enterprise in many different ways. Support intended for SMEs may simply end up in the hands of large firms that control supply chains. Alternatively it is easy to end up favouring medium scale enterprise over and against the micro and small firms that are most in need.

In some instances support on the basis of scale may not be advisable. Some SMEs constitute terrible examples of gender discrimination, labour conditions and environmental damage. Where the local sense of community has been eroded through rapid social change, some of the benefits of smaller scale may evaporate. In other cases long-standing relationships of local corruption may make further support to SMEs questionable.

In view of these difficulties, support for SMEs must be holistic, highly attuned to local reality. Support activities such as credit, preferential procurement, labelling and so on require an enabling environment in which SMEs are genuinely supported at all levels (see Box 5). It is likely that programmes will have to be highly nuanced, evolving incrementally over time, rather than involving one-size-fits, all prescriptions.

### Box 5. Cashew processing SMEs in Mozambique

A medium scale cashew processing factory, Miranda-Caju, opened in April 2002. An entrepreneur with a one-year low-interest bank loan that was guaranteed by the government cashew Institute, Incaju, set it up. The guarantee was made possible because the government levies an 18% tax on the export of unprocessed nuts, to encourage in-country processing. The government also provided land and a building that required extensive rehabilitation. The factory was designed with the help of Technoserve, a USAID-financed NGO that aims to support entrepreneurial women and men in poor rural areas. All the equipment was manufactured locally in the province. The Dutch NGO, SNV, facilitated contact with a large Dutch buyer who exports cashew nuts to various parts of the world.

The factory provides employment for about 100 local people. Workers have contracts. They receive one free meal at work and they have access to health assistance and severance pay in case of work-related illness or accidents. Although the wages are low, particularly for women, the wages and working conditions are better than they are in other factories in the south of the country. This is largely due to the relationships developed between government, NGOs, entrepreneur and buyer. According to local informants, there have been positive spin-offs in the local economy. Since then, this entrepreneur has set up another factory in the province and two others have been set up along similar lines, by other entrepreneurs. Despite the successful features of this partnership, however, it must be noted that some of the employees would still state a preference for the conditions once found in the historical model of larger state regulated and subsidised factories.

See [www.iied.org/sarl/research/projects/t3proj01.html](http://www.iied.org/sarl/research/projects/t3proj01.html) for further information on cashew research in Mozambique and India



## 5. What promising policy opportunities exist?

We have argued that it is legitimate to support SMEs through an appropriate policy environment. If so, what are the most promising opportunities for supporting them? This section advances three potential policy opportunities – linked to three stakeholder groups: governments, the private sector itself and those who define procurement policies and standards.

Different governments adopt varied policies and institutions to deal with SMEs. Some seek to give SMEs preferential support. Others make deliberate attempts to shut them down or replace them with ‘more modern’ enterprise structures (such as in the Chinese and Thai food retail sectors). Where support is offered, recent analyses have made great progress in identifying what types of practical support (finance, training, infrastructure) to what types of SME make sense (Haggblade et al., 2002). There is also considerable opportunity to shape a supportive policy environment. But less has been done to assess effective models of incentive, competition and procurement policy and how these might interact with bilateral and multilateral commitments. There is a policy opportunity to investigate and install better models – for example for upgrading (e.g. food safety / hygiene) to compete with supermarkets and global brands.

From a private sector perspective, high transaction costs are a major impediment for SMEs. Much has been written about the collective efficiencies that SMEs can gain through different types of association or industrial clustering (Schmitz, 1999; Macqueen, 2004). The architecture within and between SMEs is an important factor in determining the outcome of such associations. There is a policy opportunity to investigate and use a more profound understanding of what models of SME ownership and association have secured greatest livelihood and environmental benefits.

Consumer actions can on occasion provide some support to SMEs – fair-trade is one example. Yet it is rare for consumer concern to translate into anything more substantial than niche markets. Mainstream business is affected much more by procurement policies and standards that are hidden from the consumer (see Box 6). Some forms of standard setting and labelling have discriminated against SMEs that cannot afford to comply or prove that they have complied. A further policy opportunity exists to research and install processes that improve the outcomes for SMEs of standard setting and labelling.

### Box 6. Supply chain standards and market access for small producers

Standards have emerged as a key tool within the supply chains of multiple food retailers and branded manufacturers and processors. Standards manage quality, food safety and various intangible attributes relating to production practices. A prime example is the EUREPGAP protocols, designed by a group of European food retailers. The focus is primarily food safety but with some reference to social and environmental issues. Many individual companies have also developed their own sets of standards. Although often labelled as ‘voluntary’ standards, in the sense that regulatory authorities do not impose them, such requirements often act as ‘entry tickets’ into the market. Producers must comply with the standards, and be able to demonstrate that they have done so, or their products won’t reach the shelves.

Standards may inadvertently exclude smaller producers from supply chains. By applying a ‘one-size-fits-all’ model, the standards may include inappropriate expectations for small companies. But often it is the process of demonstrating adherence, paying for inspections or certification that is prohibitive for SMEs. There are now various efforts under way to explore what can be done to ensure that standards like EUREPGAP do not discriminate against small producers in developing countries.

For further information see: [www.eurep.org](http://www.eurep.org)

## 6. Main conclusions

Despite decades of work on SMEs there is still a heated debate on the merits of supporting enterprises at the smaller end of the size range. The paper has noted that there are several valid positions in favour of support towards SMEs. It has presented some advantages and disadvantages of scale that could be addressed by a programme that discriminates on the basis of scale. I therefore draw the following conclusions:



- ◆ There are good reasons for preferential support to SMEs – whether from a sceptical or pragmatic or advocate’s outlook.
- ◆ Potential economic, social and environmental advantages and disadvantages of SMEs exist – and they could be addressed by tailored support within a strong enforced enabling environment.
- ◆ Creating such a supportive environment requires a flexible and incremental approach across all governance measures – not limited to one-off incentives.
- ◆ Policy opportunities exist to improve the benefits of SMEs but they require further multi-disciplinary action – learning-by-doing.



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Small and medium enterprises (SMEs) often account for the majority of firms and a substantial proportion of employment in both developing and developed countries. This paper argues that there are good reasons for preferential support towards small scale – irrespective of whether ones starting point is sceptical or pragmatic or strongly enthusiastic toward SMEs. There are many potential advantages and disadvantages to small scale in achieving broad sense well-being which this paper assumes to be the main aim of development. Three areas of further multi-disciplinary action are held out as useful entry points to improving the impacts of SMEs.

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For further information on IIED's cross cutting work on SMEs please contact  
Duncan Macqueen  
IIED, 4 Hanover Street, Edinburgh, UK, EH2 2EN  
Email: [duncan.macqueen@iied.org](mailto:duncan.macqueen@iied.org)  
Tel: +44 131 226 6860

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