2015

BUSINESS DEVELOPMENT FOR POVERTY REDUCTION

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NORWEGIAN CHURCH AID
actalliance

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Year of publication: 2015

PHOTO: Hege Opseth/Norwegian Church Aid

Foreword

PUTTING AID INTO WORK

600 million new jobs worldwide are needed by 2020 to avoid higher unemployment. In Sub Saharan Africa it is estimated that around 25 million youth will join the labour market each year the next 15 years (ADB 2015).

Many developing countries have experienced strong economic growth in recent years. Greater political stability, high commodity demand and prices and improved economic policies are among the reasons given. A major challenge will be to ensure inclusive and shared growth. This has not been the case in many countries and inequality seems to be increasing.

Through our work, NCA and partners see the profound impact that creating jobs and providing livelihoods can have on the people we work with. This effect goes way beyond just income. It is a key part of our work in transforming lives, communities and gender relations. In Somalia we work with local communities on vocational training programmes, where we create new economic opportunities for former pirates and youth at risk of being recruited to piracy. In Afghanistan Norwegian Church Aid support women farmer's cooperatives - that provides micro finance, learning opportunities and greater economic independence and safety for women. In Palestine, access to vocational education creates employment opportunities and stronger sense of belonging to community/society for youth. In Tanzania, we see that pooling of capital combined with business skills trainings in groups stimulate and economically empower people to invest and develop micro and small enterprises.

Having a good job means income, dignity, security, a role in society and the audacity to imagine a future - for oneself and for the next generation. Without work or a means of income life becomes difficult and without enough jobs an end to poverty and aid dependency becomes even more so. Through our work, Norwegian Church Aid sees the opportunities that creating jobs can mean for people. The private sector is the largest creator of new jobs with nine out of ten jobs created in the private sector in developing countries. It is our belief that there is a great potential in effectively using development assistance in strategically developing the private sector in sectors and areas with large potential effect on poverty alleviation and job creation. It follows that strengthening the private sector in ways that create decent jobs for the poor therefore is the business of aid. It is key to reducing inequality and to narrow the gap between the poor and the very rich.

Aid to the private sector thus far has focused on providing finance for businesses and on large scale investments in sectors such as renewable energy or agriculture. However, on the ground, our experience is that there is a large unmet need for financing opportunities and support for small and medium sized local businesses. This gap is often called "the missing middle". It includes small- and medium-sized businesses and entrepreneurs with capital needs that are too large for micro-finance, yet are too small for them to be relevant for the business financing opportunities that are available for large enterprises.

To make capital available and lower capital cost for the "missing-middle" is regarded as crucial. Micro-, small- and medium sized enterprises are the largest job creators in developing countries, according to the World Bank. More ideas are needed on how to support such businesses either directly or through policy changes. Norwegian Church Aid commissioned this report as a contribution to that need for ideas and policies.

Key recommendations of the report are:

- To promote structural transformation of economies and industrial policies based on individual analysis of binding constraints. Aid could pay for such analysis.
- To support entrepreneurs in discovering unexploited profitable opportunities. Key would be to identify a niche that holds growth potential for a large number of businesses.
- A special focus on the missing middle.
- To identify the MSMEs with growth potential. This could be done by organising business contests.
- To focus traditional entrepreneurship training on businesses with growth potential rather than a catch-all approach. Not all people are entrepreneurs.

A word of caution, business does not become aid simply by taking place in poor countries. Aid and business have different roles that often don't match. The merit and opportunity cost, or development effect, of using limited concessional aid-financing on private sector development must be measured. Safeguards must be in place and country ownership ensured.

A core concern is additionality. Are we subsidising market actors who would do business anyway? Or are we creating new opportunities for poor people and boosting the market as a whole? Without recognising the importance of the state, the role of regulation and taxation, focusing on the private sector will yield few returns beyond the business itself and the individual jobs. We expect companies to pay a fair amount of tax and respect human rights. The UN Guiding principles on Human Rights for multinational companies are useful, but not sufficient, in this regard.

Win-win is a phrase often used about aid to the private sector. The goal is of course to create beneficial results for the donor and the recipient – developmental effects plus profit for a Northern company. It is often a target, sometimes also for regular aid. For the Danish development finance institutions it is a requirement. This goal is sometimes problematic. It can cause moral hazard. In Norway the most famous example is the Ship Export Campaign in the 70s and 80s in which Norway exported shoddy ships that often were not needed to developing countries. The motive was to prop up the Norwegian Ship building industry during a crisis. We must not let the potential of a win on our side blind us to missing or weak developmental effects for the poor.

Looking at how aid can work together with, and develop the private sector, is one of the tools available to help address the massive challenge of unemployment and contribute to inclusive growth. It is the subject of this report.

Finally, Norwegian Church Aid would like to thank Espen Villanger and Lars Ivar Berge Oppedal for the work they have put into the report. We hope it will generate a fruitful debate that will put Norwegian aid into work.

Enjoy the report!

Anne-Marie Helland, General Secretary of Norwegian Church Aid

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1. INTRODUCTION

It is widely recognized that having productive employment is a key dimension of human wellbeing. One of the most important functions of such employment is that it generates income that may be used for vital necessities such as food, shelter and health services and hence be instrumental in poverty reduction. However, for most people there is also an intrinsic value of being productive and an associated strain of being idle and unemployed (see for example the Stiglitz-Sen-Fitoussi Commission). The importance of creating high-productive employment and in particular jobs is highlighted by the fact that a full World Development Report (WDR 2013) was devoted to the theme and that it is a key theme in the agenda about the post-2015 Global Development Goals (UN 2014).

High-productive employment is also a key element in long term development and an essential feature of the transformation from a poor to a rich country. The most successful countries in terms of recent development and poverty reduction are those that have experienced a transfer of labor and capital to more productive sectors (McMillan et al. 2013). Examples include countries such as China, India and those that were termed the Asian tigers; South Korea, Taiwan, Hong Kong and Singapore. In practice, their transformation has been from a low-productive agricultural based economy towards a high-productive economy based on manufacturing and services. This changed the shares of the labor force in the sectors, the type of work that is performed and the labor productivity.

The transformation has two dimensions important for development and poverty reduction. The first is the flow of capital and workers to the high-productive sectors. This increases economic growth and reduces poverty even if the productivity within the sectors does not change. For many poor countries, this is important as the wheel does not have to be invented again: their expansion of the existing profitable sectors can foster the transformation. The second dimension is that investments in improved technology increases productivity and expand working opportunities within the existing modern sectors and increases salaries and economic growth. However, if there are few high-productive jobs, then there will be no flow of workers towards the more productive sectors and transformation is hampered. This has spurred most governments with development ambitions to put employment creation on their agenda, in particular the generation of high-productive jobs.

More generally, governments with developing ambitions have also been active in promoting broad economic growth. Economic growth, including that which arises from the structural transformation, is found to be good for the poor on average across countries: Empirically, there is a consensus in the research literature that higher economic growth is associated with higher reductions in absolute poverty across countries (Ravallion 2012). Moreover, economic growth on average across countries increases the incomes of the poor at the same rate as for the non-poor. This implies, however, that the income differences between the poor and the rich will increase over time, but also that absolute poverty will be eradicated with persistent growth.

Nevertheless, in some countries the poor are not taking part in the growth and most of the additional wealth is accumulated by the richest segments. Hence, the influence of growth on poverty, and the associated policy implications, should be assessed at the country level. For countries where growth does not lift the poor, more targeted interventions are required. Under any circumstances, the creation of high-productive jobs can be part of the answer.

There is a broad consensus on many of the main policies conducive for economic growth. These includes some basic rules of thumb at the overall level that seems important for private sector growth, like maintaining basic macroeconomic stability, well-functioning institutions and rule of law, property rights,

market competition and the provision of infrastructure and public goods including education. Establishing a sound investment climate should enable the private sector and the entrepreneurs to invest in the high-productive opportunities. This should by itself create the structural transformation, without any direct government interference. However, some researchers and many policymakers argue that a sound investment climate is not enough; more direct stimuli are necessary to attract investments and create jobs. Nevertheless, more direct interventions to create employment like industrial policies and subsidies are much more controversial than general macro policies, sometimes for good reasons (Pack and Saggi 2006).

It takes many generations to achieve a structural transformation with economic development and the shift from producing simple goods based on traditional activities to more complex goods applying new technologies and methods. Moreover, in many poor countries there is a concern that the structural transformation is not taking place despite conducive policies. McMillan et al. (2013) show that a structural transformation has largely been absent in sub-Saharan Africa and Latin America despite decades of high economic growth: Most of the population remains in agriculture and the growth has been relatively evenly distributed across sectors.

Recent research indicates that there may even be a de-industrialization taking place in the developing countries, mainly resulting from the low relative prices internationally of manufacturing goods (Rodrik 2015). These trajectories stand in sharp contrast to the recent transformation that has taken place in China, India and some other Asian countries where employment intensive manufacturing played a key role in their economic development. The implication may be that it is not possible for the late-comers to achieve the structural transformation through labor intensive manufacturing. The re-allocation of capital from low-productive to high-productive activities may follow a different path than the industrialization strategies that have received so much attention.

The challenge to African transformation is enlarged by the large cohorts of young entering the labor market with increasingly more education, and small cohorts retiring. There is a profound concern about the mismatch between the entrants and available jobs/employment opportunities. Even in the scenario that a developing country is able to achieve structural transformation, the availability of jobs for a broad segment of the population takes generations to create. Policymakers have thus raised the question of how to promote productive employment for the current generations. This has triggered a focus on sectoral and direct interventions as a supplement to the general macro policies for long term growth and transformation. However, government interventions at the sectoral, industry or company level are much more controversial compared to general non-targeted interventions. There is a continuous and heated debate about governments' role in fostering within-sector growth and employment, from "picking winners" and sector-specific infrastructure development to direct subsidies to individual companies.

Many large donors are involved in huge aid programs for structural transformation and for fostering the private sector as an engine for economic growth and poverty reduction along lines believed to be necessary (but not necessarily sufficient) for economic growth. The large donors include USAID, which is heavily involved in trade. Moreover, trade policy is also of high interest to many donor countries due to their own foreign policy interests and is thus an arena where aid policies would play the second fiddle. Similarly, IMF has overwhelming competency and funding to support monetary policy while the World Bank plays a similar role in macroeconomic policy, business regulations and large infrastructure projects.

The density of large influential donors in important areas of private sector development circumscribes the available options for making a difference. This is important for Norway to take into consideration in the new debates about directions of the country's PSD policies. Finding the niches where small donors can contribute seems to be a viable strategy. Alternatively, supporting well-functioning programs of the large and competent donors can also be a viable strategy for Norwegian PSD funds where add-ons or trust funds are among the available instruments.

One policy area that has received a lot of attention among donors is microfinance. Research has found that microfinance is not suited as a general tool to raise the incomes of the poor, and definitely not an instrument for employment generation. The poor are similar to other people in that *few* are entrepreneurs in the sense that they start and grow a business - even if they had the chance of doing so. However, there are clear indications that *some* people are highly entrepreneurial, they have a strong desire to do business and some of these succeed in growing their business and also in employing other people. Those who grow exceptionally much are often labelled as gazelles.

Moreover, in poor countries we often find very few medium sized firms in conjunction with a large number of micro and small companies and some large firms. In high-income countries, small and medium enterprises are responsible for over 50% of GDP and over 60% of employment, but in low-income countries they are less than half of that: 30% of employment and 17% of GDP. The key question for policymakers is then whether they can stimulate the growth of the MSEs so that the distribution of firm size is more like that found in the developed countries. Since productivity and wages are highly correlated with firm size, a sound growth of MSE production and employment at the firm level can be expected to generate higher incomes and economic growth.

We are particularly interested in the potential represented by the gazelles, or fast growing companies. Again the key policy issue is whether government or donor support can make gazelles grow more than they would in the absence of support, and perhaps if other MSEs or entrepreneurs can be turned into gazelles with the adequate support. Can gazelles be created, or are fast-growing small companies only a result of "survival of the fittest" where there is no room for policy interventions? In this report we assess the role of policy in stimulating high-potential small- and medium sized enterprises in order to create jobs for the poor.

The aim of this report is to discuss some selected policies for increasing the incomes of the poor through the private sector development approach, with a particular focus on the issues where Norway might contribute through own initiatives. We assess the role of the private sector policies and provide a research-based account of private sector development, structural transformation and the recent findings about deindustrialization. We explore the options for some niches where strategic use of Norwegian private sector development aid can generate catalytic effects. Building on our previous work in the area, we have identified some promising areas for such interventions. The ToR for this study spells out two of these policy areas that we think have the highest potential for Norwegian PSD.

- The first policy area is on how to engage in a constructive way in countries trying to stimulate structural transformation. How does deindustrialization influence such efforts? Is industrial policy to stimulate manufacturing no longer a viable option? We assess the role of strategic search for high-profitable opportunities and how a small donor can support such processes.
- The second policy area focuses on a more short term solutions to the unemployment/ underemployment situation is these countries: Policies to make small and medium enterprises (SMEs) grow. Given the lack of impacts of microfinance and entrepreneurship training, should donors abandon the SME support or is there a potential that is still not on the policy agenda?

This is a desk review of the research literature and the evaluation literature on growth, entrepreneurship, structural transformation and poverty reduction. We do not go in detail about methodological issues in this report as we would like to keep it short and straight onto the issues. In a companion report, we have already provided substantial input on the methodological side to Norad's work on private sector development policies (Berge and Villanger 2014). The aim of this report is to complement our previous work.

Some cautionary words on methodology are still warranted. It is important to recognize that in selecting which work to include, judgments have to be made underway. In particular, what is the evidence that provides credible conclusions that can be used to inform policy? For many questions of how policies and

programs work and their effects on beneficiaries, the researchers have huge challenges in identifying the impacts. This is especially the case in private sector development where the natural way that markets and competition function can lead to incorrect conclusions if based on inappropriate methodologies. This also leads us to be cautious in using self-evaluation and experiences from practitioners since what you observe in the field are not necessarily the true effects.

In order to exemplify the challenges, we can use the literature assessing impacts of programs to support microbusiness. Research published in the most renowned and highest ranked international journals assess the impacts of microfinance on income growth of microbusinesses by creating a comparison group that the microfinance participants are measured against (McKenzie (2010). However, by not taking into account the market that these microbusinesses are working in, the observer can be led to think that the impact is positive if the microfinance clients grow more than a comparison group. However, if the market is saturated, the entry of one microbusiness can have the effect of crowding out another. In the market for tomatoes, for example, the effect of having one more women selling tomatoes because she got a loan can lead another tomato-seller to go out of business as the demand for tomatoes is not changed. Such effects may not be captured by comparison with a small control group, and much of the literature on microbusiness may overstate the impacts of these programs. We do not discuss the credibility of the evidence in this report. Rather, we have selected the literature that with a high degree of certainty provides credible evidence.

In order to structure our analysis, we first review the basic framework for understanding how economic growth affects poverty in various ways and the role played by the private sector. This is then used to assess the potential role of various policies to influence these relationships. This is then applied to detail some niches for Norwegian private sector aid policy as spelt out above.

2. CAN ECONOMIC GROWTH ERADICATE POVERTY?

2.1 The relationship between economic growth and poverty reduction

During the last two decades, there has been a tremendous reduction in material poverty. Estimates suggests that the share of people living below USD 1.25 a day has declined from 42 to 16 percent between 1990 and 2010 (Figueiredo and Laurini 2015). This has largely been due to the economic performance of the developing countries and the high economic growth in the period, almost by definition: The definition of GDP is "the monetary value of all finished goods and services produced within a country's borders". This value accrues to the people in the country (some of it is sent abroad, but assume that away to simplify), in terms of income in the form of wages/salaries to workers or profit/interest to business/capital owners and farmers.

It follows from this that GDP growth is then by definition equivalent to income growth for the country as a whole. Hence, for poverty indicators based on income or consumption cut-offs, like the well-known USD 1.25 per day, we will see a decline in the share of people living below this poverty line when GDP is growing if some of the income growth accrues to some of the poor in an amount sufficient to lift tem over the poverty line. The effect of economic growth on poverty is thus dependent on how much of the income reaches the poor, and on how far the poor are from the poverty line (i.e. how much income the poor need to climb out of poverty – above the poverty line).

In other words, the relationship between the growth in GDP and poverty reduction depends on the income distribution of the country and who benefits from the growth. If the economic growth is concentrated in activities owned and run by the more affluent, then there will be low or zero effect of growth on poverty irrespective of how the remaining income is distributed. On the contrary, if the growth is evenly spread across all income groups including the poor, then the impact on poverty will depend on the income distribution in the lowest segments. If all the poor are far from the poverty line, then a given growth will increase their incomes in such a way that few will be lifted out of poverty. On the contrary, if large shares of the poor are just below the poverty line, then the same growth can lift many of them out of poverty. These facts have given rise to concepts such as pro-poor growth, which can be defined as growth that reduces poverty (Martin Ravallion) or growth that raises incomes of the poor more than it raises incomes of the non-poor (Nanak Kakwani). Obviously, the definition of poverty matters a lot to how economic growth will influence the incidence, even if we go for one or the other of the pro-poor definitions.

Moreover, it is generally accepted that poverty is multidimensional and that concepts and indicators such as education, health, general living conditions and voice and participation should be included in order to provide a more complete picture. However, for our purposes, to analyze how the private sector can contribute to poverty reduction, it makes more sense to focus on economic poverty as the direct link between private sector growth goes through employment with the associated salary/wages. Hence the command over the salary/wages can in turn be translated into better living conditions and (perhaps to a lesser extent – we return to this below) into improved, nutrition, health and education.

The empirical evidence on the relationship between growth and poverty is in accordance with the conceptual understanding explained above. The research confirms that economic growth generally reduces poverty and also that faster growing developing economies see more progress against poverty Ravallion (2012). However, it is not the case that the countries with the highest poverty rates are catching up with the others in terms of poverty; countries starting with higher poverty rates do not see higher proportionate rates of poverty reduction. Ravallion suggests that the high initial poverty rates has an

adverse effect on consumption growth and also makes growth less poverty reducing. High incidence of poverty is thus a disadvantage, and causes lower economic growth.

Nevertheless, it is clear that economic growth has played an instrumental role in reducing economic poverty across the world. The alternative – a stagnant or contracting economy would make it more difficult to reduce poverty both because the incomes of the poor would likely suffer and because the resources available for redistribution would not be increasing or shrinking. The main policy question for reducing poverty is first and foremost how to maintain high growth over long time horizons – over decades. Improving the income distribution and making sure that the poor can take part in the growth should then come as an additional aim, particularly in countries where the effect of growth on poverty is low. If successful, reducing inequality in the form of lifting the "bottom" population will in turn make economic growth more effective in reducing poverty.

2.2 Growth and access to work and jobs

A typical characteristic of developed countries with less poverty is to have a high share of the work force in formal, salaried employment. Developing countries, on the other hand, are characterized by a high share of the workforce being involved in subsistence farming and various forms of informal, low productive, low paid employment. Structural transformation is the process when capital and labor from low-productive sectors flows to high-productive sectors, resulting in high-paid jobs and reduced poverty rates. Labor intensive manufacturing has played an important role historically in such transformations; as in particular seen lately in China and India where millions of poor farmers have been pulled to the manufacturing industry in the cities. However, even if general trends are positive, aggregated numbers may conceal different trajectories of sub-groups in the economy, suggesting there may still be a need for attention on groups that may lag behind. In particular, Job creation and economic development may occur in "pockets" like urban areas or in growth corridors.

GDP growth has been high in many developing countries during the last decade, accompanied by relatively high rates of job-creation (IMF 2013). Nevertheless, the job-creation in these countries is not anywhere near what is needed for the transition from economies largely based on agricultural low-productivity farming towards high-productivity economies where a substantial share of the workforce has jobs (Filmer and Fox 2014). McMillan et al. (2013) show that such a structural transformation has largely been absent in sub-Saharan Africa and Latin America despite very favorable trajectories in countries such as China, India and some other Asian countries. Even more worrying are Rodrik's findings that there are fewer jobs in manufacturing on average in developing countries today than 20 to 30 years ago.

The growth and employment trajectories during the last decades, especially in sub-Saharan Africa, have shown that there may not be a straight forward relationship between economic growth and employment creation, as several African countries have grown with high GDP rates without managing to absorb the large shares of unemployed or underemployed workers. In countries with a balanced growth over sectors, agriculture grows as much as the other sectors, and the growth in agriculture may or may not create more employment – it depends on the degree of diffusion of labor-saving technologies.

This is an essential element in the structural transformation: Modern agriculture is mechanized and can produce much more food with only a fraction of the workforce as compared to traditional agriculture. In theory, since fewer hands can produce more food, this makes industrial production relatively cheaper, as one have to give up less agricultural production for producing the same amount of manufacturing goods. However, in practice, even though farming labor becomes available, making the relative wages for the manufacturing sector lower, one have seen many times in Africa and Latin America that not many jobs have been created in the manufacturing sector.

In fact, the literature suggests that economic growth can be job-less for the local community and/or for poor people. The best examples are probably those from the literature on enclave economies. An illustration from Mozambique is informative. Arndt and Tarp (2009) finds that although the manufacturing sector has doubled in terms of GDP between 1992 and 2008, much of this owes to capital intensive mega-projects established by international investors, such as the Mozal aluminum plant. Despite this, very few jobs have been created illustrating that the extraction industry in the country is highly capital intensive and thus creates very few jobs in relation to the huge investments. In general, this sector is typically dominated by large mining companies and a few huge processing plants.

The discussion about industrial policy centers around structural change: in order to develop economically, and perhaps also along other dimensions, it is required to produce new goods with new technologies and transfer resources from the traditional activities to new modern ones (Rodrik 2007). The first transformation in developing countries is hence often referred to the move out of subsistence agriculture and into manufacturing where labor and capital movement into industry yields much higher productivity and wages as compared to traditional agriculture. This structural change results in higher incomes, higher shares of employment in manufacturing and services and lower poverty.

Finally, in many African countries, the shares employed in subsistence and small-scale agriculture is so large that even if the jobs created is reasonably well distributed across income groups, we will still have a large challenge with unemployed and underemployed poor and large fractions of the workforce in agriculture for many decades to come.

2.3 Growth, income and basic services

The question in this section is whether the economic growth and associated poverty reduction also will reduce poverty through other dimensions such as health and education. From the above discussions, it is obvious that economic growth can arise from many different sources in the economy and follow different trajectories with different distributional implications. When it comes to the relationship between growth, income and basic services (i.e., not the service sector as such), some of the same patterns can arise. Economic growth in some sectors can increase the incomes of those working there. Some of the extra earnings may in turn be used for basic services, and we typically see a strong relationship between income growth and the provision of such necessities. So for basic services that are typically provided in the market, the increases in provision are reflecting the demand.

However, in the poorest areas and in times of crisis in vulnerable areas, money may not be instrumental in in covering basic needs such as health services. For example, the literature on safety nets firmly establishes that hand-outs of money in food-deficit areas where access to food is a problem may only increase prices and not enhance food coverage (Villanger 2008). Similarly, income increases in a population will usually lead to increased demand for medical services. However, in poor rural areas the increased demand may not transform into increased health service provisions for many reasons. For countries where medical services are publicly provided, the local demand and willingness to pay may not influence decisions to start or increase service provision. In cases where such services are privately provided, the demand and willingness to pay may not be large enough to establish the necessary medical center for the desired medical services. In most countries, highly qualified personnel require a relatively large premium to be willing to live and operate in poor rural areas. The problems of retaining qualified medical personnel in remote areas in most countries[1], and the schemes ensure medical personnel are willing to be stationed in remote areas illustrate the challenges.

[1] See for example http://www.vg.no/nyheter/innenriks/helse/vil-beordre-legene-til-distrikts-plikt/a/10138313/

Even in areas with relatively high purchasing power among the lower income groups there can be important market or governance failures that can prevent the market from supplying the demanded services. This is often the case with what economists define as public goods, i.e. goods where one person's consumption of the good does not influence another person's consumption of the good and where it is not possible, or very costly, to prevent someone from using it. Even if there is a demand, and people have the money to purchase the service in a market, the market failure leads to under provision of the service – or no service provided at all.

The cost of producing the above-mentioned public goods is not related to usage. Hence, if the price of a public good should have been determined by the standard efficient solution where it equals the marginal cost of provision, then it would be equal to zero. In that case, it would not be in the interest of anyone in a market to supply such goods since they will not get paid.

In practice, public goods may have capacity constraints, making them "public" under some circumstances while considered "private" under other circumstances. For example, consider the provision of clean water through a borehole and mechanic water pump in a poor village. For low amounts water provided, it means that anyone accessing the pump is not preventing others from using it. If it is relatively costly to require payment for using the pump, one can argue that the provision of clean water is a public good when the usage is low. [2] The implication can be that no-one is willing to invest in the borehole and pump since it is not possible to make consumers pay for the water usage. If that is the case, this is a typical case where government intervention is warranted to ensure the provision of water.

Finally, for public goods that are dependent on the government's provision there can be many political reasons for why the income growth may not translate into service provision (see Keefer and Khemani 2005 for a review). For example, the relatively famous cases of the highly divergent trends in the states of Uttar Pradesh and Kerala in India. Keefer and Khemani (2005) argues that the lack of voter information, greater social polarization, and the non-credibility of political party platforms in Uttar Pradesh explain its poor performance on social services compared with Kerala. So even if the GDP growth makes the public revenues grow, the public services in a given area may not change. Urban areas may be favored over rural or some groups may be favored over others.

Many dimension of poverty rely on access to particular services such as the provision of health services and education. Since access to such services may not be purchased, for the many reasons discussed above, there is not a straightforward relationship between income growth and service provision. The literature finds large differences between such key services across countries with similar levels of GDP. The trajectory of service provision relevant for poverty reduction requires a careful analysis of the particular service under scrutiny, and of the mode of providing that service to the population.

Although the application of voucher schemes and other public-private arrangements can be effective in making the markets work to deliver health services, the main challenge for the provision of basic health services seems to be the willingness, commitment and hard work of the country's leadership to ensure the poor receive such services (Sen, 2015). This challenge is the same for public and private health services as the initiation, regulation and quality assurance have to be conducted by the government. Moreover, as argued by Amartya Sen recently, basic health services rely heavily on health workers who are quite affordable in poor countries due to their low wages.[3] Hence, it is possible even for the poorest countries to provide universal healthcare. Countries such as Rwanda, Thailand and Bangladesh have

[2] In the case where the pump is used well above its capacity constraint, it can be defined as a private good: If there are long queues of users and some users are prevented from using it, then the water access is more similar to a private good.

[3] See The Guardian article and the references therein: http://www.theguardian.com/society/2015/jan/06/-sp-universal-healthcare-the-affordable-dream-amartya-sen

shown that it is feasible for a poor country to roll out basic services to its population, if there is strong political willingness and good administration.

3. PRIVATE SECTOR GROWTH AND THE TRANSFORMATION IN POOR COUNTRIES

3.1 The empirical evidence of industrialization, jobs and transformation

The view that manufacturing growth is necessary for structural transformation has been dominant for many decades and stems from the experiences of the developed countries and fuelled by the more recent trajectories of the East Asian "growth miracles". However, recent research has triggered a new discussion about a deindustrialization that seems to take place in the poor countries (Rodrik 2015). Deindustrialization is a label for the trajectory that has taken place in many rich countries during the last decades where the share of workforce in manufacturing, and the value produced in that sector as a share of GDP, have decreased. In the rich countries, services have taken over in terms of employment and value produced.

Deindustrialization has been a major concern in most rich nations for several decades because the jobs lost were perceived as high-quality employment with decent salaries. The concern was not only about the welfare losses of the workers and their families from attractive jobs in the industry being replaced by lower-paying jobs in the service sector. In addition, the inequalities in the society would rise from this process since there would be fewer people in the middle (industry) segment and more people in the low-income segment. Moreover, it was argued that the innovation capacity of the economy would stifle since it was assumed that the future technological innovation would take place in the manufacturing sector.

In addition to all these reasons, the observed decline in the share of the manufacturing sector in poor countries is seen as extra problematic since it could slow down economic growth that in turn could lead to severe political consequences (Rodrik 2015). The concern that deindustrialization is taking place in developing countries before they even became industrialized has led researchers to indicate that the decline is premature. Data suggests that manufacturing is shrinking at levels of economic development (GDP per capita) that are only fractions of those at which the advanced economies started to deindustrialize. In Africa, for example, 23 countries had negative manufacturing value added per capita growth during the period 1990-2010 despite their very low levels of economic development (UN 2011). What is happening in many poor countries is that the service sectors are growing turning them into service economies (Rodrik 2015).

The deindustrialization in developing countries has been manifested through a declining share in both employment and real value added manufacturing, particularly since the 1980s. Many of these countries applied protective walls and policies of import substitution to build up a small manufacturing industry in the 1950s and 1960s, and these have since been diminished. The research finds that these patterns cannot be attributed to changes in demographic structures and economic development.[4] For example, the low-income economies of Sub-Saharan Africa have experienced a similar deindustrialization as the more developed middle-income economies of Latin America even though there was less manufacturing to begin with in the former group of countries.

[4] Manufacturing typically experiences an inverted U-shaped relationship over the course of development and hence a high GDP growth over a long time period could be associated with deindustrialization. But this is not what is happening to the developing countries, the experienced income growth cannot explain the diminishing manufacturing sectors.

Given that labor intensive manufacturing has been one of the most important drivers of employment and job creation and economic growth in the developed and middle income countries, it is obviously a reduction in the available opportunities that the manufacturing sector is shrinking in the poor countries. This trajectory reduces the economic growth potential of these countries and the available opportunities for catching up with the rest of the world. Of particular concern is the finding that formal manufacturing tends to be technologically the most dynamic sector where the countries that are lagging behind tend to grow faster than those that are ahead (Rodrik 2013).

The research finds convincing trends in deindustrialization. Figure 1 shows the declining shares of employment in manufacturing over the last four decades adjusted for population, per capita income and country for each period, relative to the pre-1960 period.

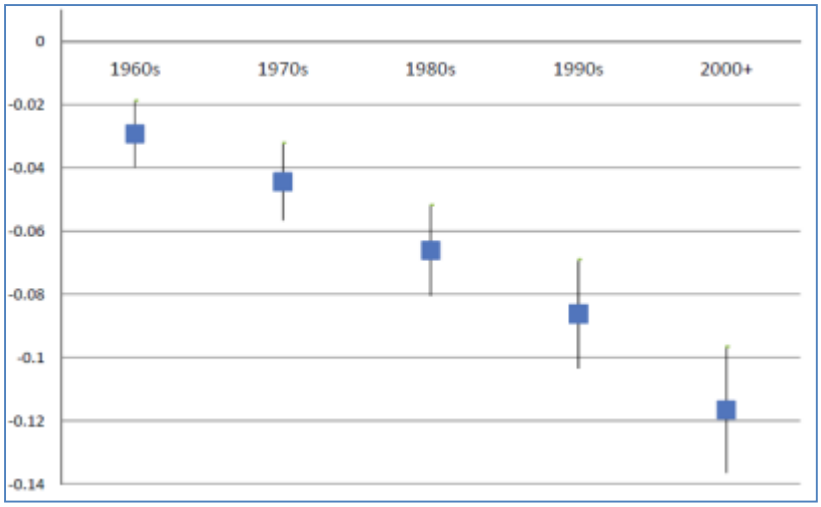

Fig 1. Declining manufacturing in shares of employment. Non-manufacturing exporters. Estimated period coefficients (with 95% confidence intervals)
Source: Rodrik (2015).

3.2 Implications of deindustrialization in poor countries

The summary of the data and literature has at least three implications that are important to our focus. **First**, the declining manufacturing shares across countries *on average* do not imply that none of the developing countries can be successful in achieving structural transformation in the traditional way. On the contrary, several developing countries are *not* experiencing deindustrialization, most of them in Asia but also some in Latin American and sub-Saharan Africa. For example, Ethiopia is one country that seems to follow the structural change trajectory where manufacturing plays an increasingly important role in attracting labor from agriculture (McMillan et al. 2013). Hence, the comparative advantage of having low salary levels can still trigger foreign investment in large scale labor intensive manufacturing in some poor countries, depending (of course) on other factors important for the investment decision such as the conduciveness of the investment climate. This has important implications for Norwegian private sector development policies. In some countries such as Ethiopia it makes sense to support the positive trend of industrialization and growth.

The **second** implication arises if the deindustrialization-forces lead to continued reduction in manufacturing jobs in the country of interest to Norwegian PSD aid. In that case, the aid should probably be directed at alternative growth strategies instead of manufacturing promotion. Rodrik (2015) suggests that such economies may need to develop alternative growth models as compared to the traditional manufacturing-led structural change trajectory. Moreover, he suggests that one viable route could be a

service-sector led growth. Services such as the booming IT (information technology) sector and business process outsourcing sector in India, China and Philippines and finance have high productivity and are tradable (generates foreign currency) and could hence replace manufacturing as the driver of change. The sector can generate higher-paying jobs, be labor intensive and also large in terms of labor demand. However, the high labor skills required poses a great challenge to many developing countries, particularly the poorest with the lowest levels of skilled workforce.

Moreover, in contrast to the labor intensive manufacturing industries, the service industries may not have the capacity to generate the sufficient number of jobs for a structural transformation to occur. Many services cannot replace manufacturing in a structural transformation since they are not capable of developing into higher-productivity activities. If, for example, the service sectors are not dynamic in the sense that they can continuously apply more productive technologies, then the growth will stop at a certain point in time.

The challenge can be exemplified by the recent experiences of the horticulture industry in several African countries. Once the land is developed and the high-value crops have been produced, few opportunities for further growth can be expected. However, the large gains from moving from subsistence farming to horticulture exports should not be discarded. That change can play a role in structural transformation from low-value goods to high-value goods and lay the foundations for agro-industries that can create valuable jobs. Box 1 below uses the rose farming industry in Ethiopia to exemplify this point.

A final shortcoming of many types of services as a replacement of manufacturing in a growth strategy is that they are not tradable. Hence, the service providers' expansion and growth are constrained by the incomes, productivity of the national economy. To exemplify, the manufacturing of shoes (as Ethiopia has started) can serve the world market and seems thus to have almost unlimited growth potential. Private provision of services such as health care will for most poor countries follow the trajectory of the income growth of the domestic middle and upper class and hence have a growth potential that is limited by the growth of incomes (and members) of these classes.

The **third** implication is that the developing countries experiencing deindustrialization will also likely expand the already huge informal, low-productivity sector. This has potentially negative effects as self-employment in general only pays a fraction of that of formal firms as their value added per employee is only 15 % of formal employees' value added. La Porta and Schleifer (2014) finds a strong inverse relationship between economic development and share of people who have to be self-employed (self-employed is synonymous with a microbusiness employing only the owner). Figure 2 (page 17) shows that the poorer the country, the higher is the share of self-employed.

Box 1. The case of the Ethiopian horticulture industry and the role of industrial policy.

There has been a tremendous growth of commercial horticulture farming in a short period of time in Ethiopia, fuelled by international capital inflows and access to the global market for flowers. At the time of the take-off, in 2002, only three commercial flower farms were in operations, one international and two domestically owned companies. Investment increased exponentially over the years – from 10 farms in 2004 to 67 in 2007 (Gebreeyesus and Sonobe 2012). Recent figures shows that the growth has continued and that there are now more than 100 horticulture farms producing for export and employing around

180.000 people (EHPEA 2013). Today Ethiopia is the second largest flower exporter in Africa, and fourth largest non-EU exporter to the EU market. For the overall Ethiopian economy, the sector has become important and is now among the three top export commodities for the country earning 34 percent of the foreign exchange (CSA 2013).

How did this happen? The take-off did not occur until the Government introduced an industry-specific support policy in 2003. Before that, a few local investors started up commercial rose farming, in the mid-1990, but ceased after a short period of production. The first horticulture farm that was sustained over time was the Dutch-owned Golden Rose that was established in 1999. They were soon accompanied by a couple of locally owned rose farms, but the level of production was low and there was little interest in the sector both from the investors and the government's side. Nevertheless, the role of the private companies in discovering the profitability of the sector and starting up was a necessary condition for the expansion (Gebreeyesus and Iizuka 2011).

The experiences of the how the Ethiopian government contributed to unleashing the potential of the horticulture sector is well documented (Gebreyyesus and Iizuka 2011) as well as the enormous effects on poverty in the areas of rose farm cultivation mainly from salaried employment at the farm for the poor (Villanger et al. 2014). The expansion of the industry was strongly backed by the government in the initial phase due to its potential for generating foreign exchange which is crucial for the national development agenda. The 2003 policy to attract investors to the sector included measure to improve the main bottlenecks for the horticulture industry: logistics were reformed and air freight coordinated, tax holiday introduced, access to finance facilitated and a specific land policy with leasing arrangements guaranteeing the security of their investments.

One example of a market failure that the government addressed is transport. A key obstacle that no single farm company could handle was the availability of refrigerated air freight. The government took the role of a coordinator and induced the Ethiopian Airlines to lease cargo planes. Hence, this is typically a coordination failure: Since few companies could not afford to invest in refrigerated air transport, the unavailability of this service prevented the establishment of rose farms since. Once the government took the investment to ensure such freight, there was a boom in investments in the sector.

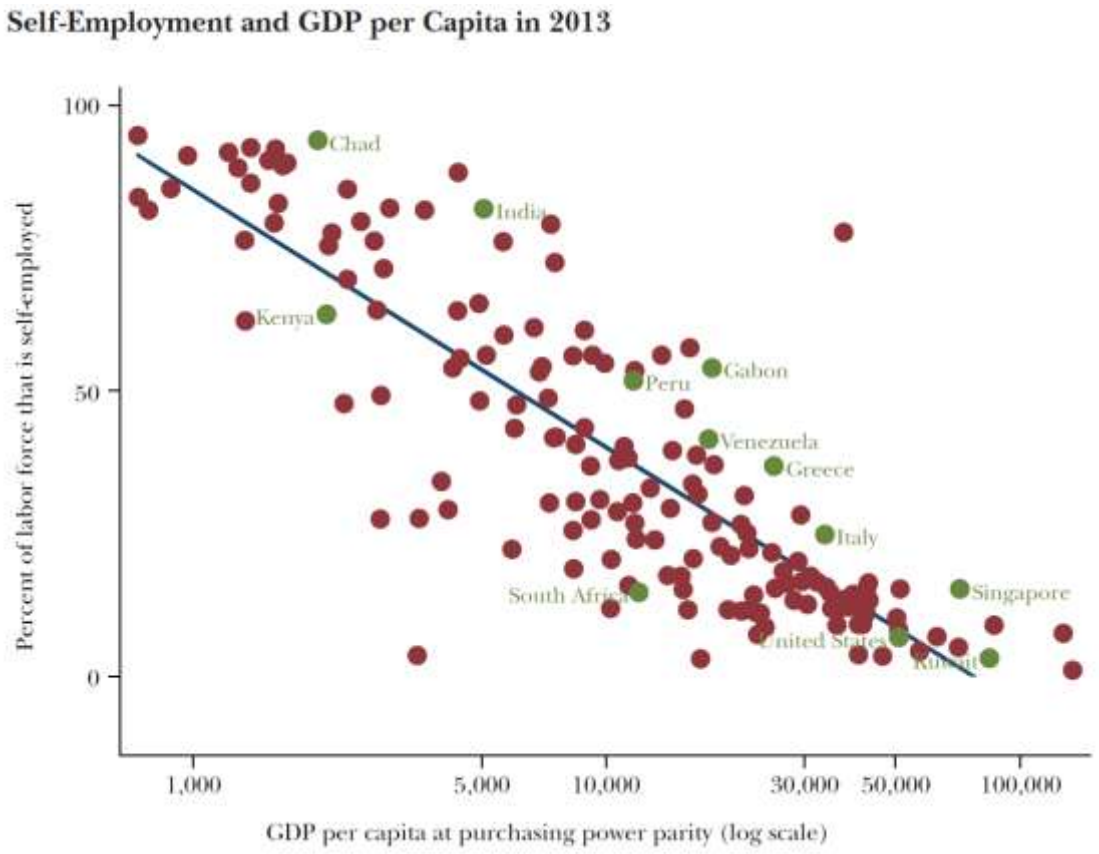

Fig 2. The relationship between self-employment (microbusiness) and development
Source: La Porta and Schleifer (2014).

Figure 2 also shows that in many of the poorest countries, self-employment accounts for more than 50 percent of total employment. Moreover, with deindustrialization, the route out of the low-productive and low-wage informal sector seems less achievable than ever before. Given that self-employment and microbusiness are also associated with the highest poverty rates, it makes sense in the short run, and perhaps also in the longer run, to apply private sector development strategies for productivity increases and job generation directly in this segment. But what interventions can create jobs in this segment? This is the topic of the Section 4 below.

3.3 The promotion of transformation

The discouraging findings of the role of manufacturing in many developing countries should not prevent donors from supporting developing countries to achieve a structural transformation. From the above discussions of the evidence, we have that both manufacturing and services can play a crucial role in such a transformation. Moreover, even higher-value agriculture can generate the pathways out of poverty and at least to some extent contribute to a transformation out of the worst living conditions of subsistence agriculture.

The policies for stimulating specific economic activities and promoting structural change are hence not necessarily about industry in itself –despite being labelled *industrial policies*. Such policies may include interventions and promotion within all three broad sectors – agriculture, manufacturing and services (Rodrik 2008). For example, government or donor interventions to support the introduction and diffusion of high-yielding agricultural production, of crops such as cut roses, herbs, or oil-seeds, would fall under the umbrella of industrial policies. Hence, the horticulture promotion described in Box 1 above falls into this

category. Similarly, incentive schemes and support to establish service provision such as call-centers, business outsourcing facilities and IT support services are also labelled as industrial policies.

Moreover, many general economic policies would be classified as industrial policies, such as export promotion, industrial parks, promotion of foreign direct investment, special economic zones and various forms for centers of excellence in certain industries. So despite some controversies[5] about whether governments should embark on, most governments actually apply industrial policies in practice. We adhere to Rodrik's (2008) arguments that there indeed is a strong case for applying industrial policies as the market failures in the relevant markets (credit, labor, products and knowledge) are well documented. His position is that the argument against the application of industrial policies concerns practical difficulties with its implementation and not about the conceptual foundations. It is all about how to do it, not about whether it should be done.

A key challenge is that there is no standard solution to the transformation across countries. On the contrary, each economy is likely to have its own binding constraints – i.e. the constraints preventing growth and transformation to "take off". Rodrik (2010) provides some guidance on how to proceed with the systematic process for identifying binding constraints and prioritizing policy reforms, an approach that was labelled "growth diagnostics". The approach became very popular and is perceived to be a useful tool to guide policy to support transformation and growth. Policymakers interested in these tools can now build on a large database of studies to see what is applicable to their situation and ideas.[6]

The definition of industrial policies is helpful for several reasons, but particularly for how to understand the implications of the recent findings of a premature deindustrialization in many developing countries. If the deindustrialization forces in a particular country are strong, the implication is not that one should abandon the aim of a structural transformation and accept having an economy based on subsistence agriculture. Rather, the implication of strong negative trends in manufacturing is that other industrial policies may have more effect in agriculture or services.

Several concrete approaches to the promotion of the desired transformation can be found in Hausman and Rodrik (2005). One particularly promising candidate for Norwegian aid is their proposal of a co-financing facility to subsidize the costs of "self-discovery." The key rationale is that there may not be growth unless the entrepreneurs in the country know or find out what are the profitable investments to undertake, i.e. that there is sufficient self-discovery. Since self-discovery is costly for entrepreneurs who undertake it, and the benefits of actually discovering a profitable opportunity will accrue also to the other entrepreneurs in the country, there is a typical situation of a market failure where there are positive externalities of searching. If the discovery, in turn, leads to more innovation and growth in the country, then the benefits may accrue to even larger groups of people through job creation and rising incomes.

This approach is a viable model for Norwegian PSD aid and we have already elaborated some features of this approach in a previous report (Berge and Villanger 2014) and are hence not repeating the details here (we do, however, provide an excerpt in Annex 1, below). However, a new proposal is to combine the strategic self-discovery with the SME development policies. As an additional instrument, Norway can initiate business idea contests where promising entrepreneurs compete for funds to assess the opportunities for investment and growth-related ideas that can foster an expansion of their enterprise into the middle-size segment. Then if the growth diagnostics is elaborated and analysis of promising opportunities conducted, the MSE entrepreneurs may be guided in their search. This instrument will complement the industrial policy approach to support of self-discovery that would fit well in a

[5] See for example Pack and Saggi (2006) and Anne Krueger, Dani Rodrik, and Joseph Stiglitz's response to Chief Economist of the World Bank, Justin Lin's proposals on Government support to manufacturing, Krueger et al. (2012).

[6] A list of country studies using the approach with links to the original papers can be found at http://www.hks.harvard.edu/fs/drodrik/GrowthDiag.html

programmatic approach to Norwegian private sector aid to foster structural transformation. We will return below to what is called "the missing middle" in the size distribution of companies in poor countries.

However, it is important also for the MSE approach that identifying the new activity should be process of 'self-discovery' and 'ongoing learning' whereby the entrepreneurs themselves conduct the search and assessment. In exports, for example, Hausmann and Rodrik (2003) define 'self-discovery' as the process of establishing the cost structure of an economy for the production of goods, already available in the world market. To be successful, policies need to focus on specific activities as the analysis of the general factor endowments and comparative advantage approach is too broad to be useful for practical policies as hundreds or even thousands of products may be included in its categories.

The approach is likely to be relatively costly and involves large risks, particularly because the trial-and-error approach necessarily leads to some failures and hence economic losses for the entrepreneurs. In all discovery processes there may be more failures than successes that in turn may discourage the individual entrepreneur's' experimentation. Hence, the strategy should be to stimulate the discovery process and ensure that potential for profitable activity is explored (Hausmann and Rodrik 2006), especially for the products that are associated with higher productivity levels (Hausmann et al. 2007). Here donors can play an important role both in terms of covering the costs of searching and for strategic knowledge generation and facilitation of the entrepreneurial experimentation and search.

4. MICRO, SMALL AND MEDIUM ENTERPRISES: SUPPORT FOR EMPLOYMENT AND INCOME GENERATION

4.1 Developing micro, small and medium enterprises

Micro, small and medium sized enterprises (MSMEs) are widely recognized as being very important in creating jobs and reducing poverty. Unfortunately, however, very few of the smallest enterprises actually do grow – most of the micro and small enterprises employ only themselves and never achieve any income or employment growth (Nichter and Goldmark 2009). Moreover, a large fraction of the employment created in the smallest segment is very low-paid, temporary in nature and with fewer paid working hours than desired by the workers. Much of this segment is characterized by having few entry barriers resulting in fierce competition and low profit margins. The point is illustrated by observing such markets, for example the myriads of small shops in cities selling almost identical gods.

The most recent evidence (La Porta and Schleifer, 2014) confirms that the productivity and wages in self-employment and informal firms are very small compared to the wages in the formal sector. Some researchers therefor argue that we do not need more of these firms, and that one rather should tax them and thereby forcing them out of the market (See e.g. Levy 2008 or Farrel 2004). On the other hand, a low-paid job may be much better than no job, especially for the poorest people who may not have any other alternative income generating opportunities. We therefore do not exclude self-employment and microenterprises in our assessment of this segment, despite the apparent low growth potential in terms of employment generation for others than the owner of the microbusiness.

A key issue for policy is whether MSMEs and entrepreneurship in general can be supported or whether successful entrepreneurs have innate abilities that, in combination with their own experiences and learning, lead them to become successful in business. In this section, we will discuss various policies aiming at promoting entrepreneurship and supporting SMEs.

However, before discussing these policies, one should note that using public resources to support firms to grow is different from other usage of public money. When supporting the growth of private companies, one has to expect many firms to fail and exit because that is how all market works under normal conditions. The best companies grow, and those that fail go bankrupt and cease to exist. This is particularly the case in the MSME sector as there is considerable churning. Many entrepreneurs start up such a business, and many close it down after a short period of time (Nichter and Goldmark 2009). One therefore has to accept trial and error when designing policies towards the SME sector, which also implies that also some of the companies that have received aid in order to grow will actually fail. However, in the long run, the benefit of the successes obviously needs to outweigh the losses from the failures. These types of programs can be shut down at the end of a natural cycle, for example after a training sequence has been completed and/or when a loan portfolio has been repaid or written off. The incremental nature of support implies that there is no need for a particular exit strategy.

Another caveat one should have in mind is that although many interventions may have improved entrepreneurs businesses; the administration and development of such programs may have been expensive. The personnel required to develop and administer such programs is often very costly and could make administrative cost high compared to the value of the services provided to the MSES. It is often the case that the donors financing the programs also have parallel staff that monitors the intervention.

Note also that definitions of micro, small, and medium sized firms differ. In this chapter, we think of micro-entrepreneurs as entrepreneurs with very small firms, often without any fixed premise, and almost

exclusively operating in the informal sector, most often with no employees apart from family members helping out at times of need. The distinction between micro and small enterprises is obviously not clear-cut, but we typically think of small enterprises as entities with a few employees, having more often fixed premises, and more often having some kind of public license/permission. With medium sized firms, we think of firms with around 10 or more employees, who typically have capital requirements well above what microcredit institutions (MFIs) can provide and where almost all are formal.

In this chapter, we first review policies and initiatives targeting micro/small-scale enterprises. Such firms are often huge in numbers in most developing countries, and are typically informal in nature. Thereafter, we discuss policies and potential interventions geared towards the medium-sized firms. While there is quite some research on the smallest segment, much less exists on how one best can support medium-sized firms in developing countries. The obvious reason for this is that there exist much fewer such firms – giving birth to the term "the missing middle" – hinting at the fact that compared to developed economies, developing countries have a much lower share of medium sized companies[7]. When we discuss policies towards such firms, we therefore have to rely more on less robust research designs and experiences from developed countries.

4.2 Supporting the smallest firms to grow

Microenterprises, in addition to subsistence farming, are in many developing countries the most important source of employment. Developing such firms into more productive firms is therefore a key policy concern in most developing countries where they employ more than half of the labor force (Hipple, 2010; de Mel et al., 2007).

Evidence on microcredit

Lack of access to financial capital has in received a lot attention amongst donors and practitioners last 10-20 years, as witnessed by the rise of the microfinance movement (de Aghion and Morduch 2010). In fact, there used to be a lot of optimism about the power of microfinance to enable the poor to lift themselves out of poverty through entrepreneurship – the prevailing view was that the poor were natural entrepreneurs who would grow out of poverty if they only got a chance (Banerjee and Duflo 2011). A growing literature shows that this is likely not the case.

Early evidence on the impact of microcredit was often anecdotal and based on impact studies that failed to disentangle causation from correlation (Banerjee et al, 2015). While there a few years ago existed basically no convincing evidence upon the impact of microcredit, several randomized control trials have been conducted the last years, and in a special edition of the American Economic Journal: Applied Economics (January 2015), six new randomized evaluations are published. These studies uses a wide range of methods, experimental design and econometric strategies, and are conducted in both rural and urban areas on four continents. Also the microcredit programs evaluated varied substantially, with different types of loan products and borrowers.

The evidence confirms that microcredit seems not to be a miracle cure for poverty; it is far from as transformative as many microcredit proponents have argued. Moreover, they also find that on average, microfinance is not negative for the poor. Hence, the arguments proposed by some academics and

[7] Hsieh and Olken (2014) disregards the term "missing middle", on the grounds that they find no bi-polar distribution of firms in their sample of Mexican, Indian and Indonesian firms. They therefore claim that both mid-sized and large firms are missing in these economies.

practitioners that microfinance hurt the poor, such as in the NRK-documentary "Trapped in microdebt", is not supported by the evidence. [8]

Furthermore, the studies also reveal that pick-up rates of microcredit are modest. Most households/entrepreneurs do not want to borrow, indicating that microcredit is not a general instrument suited for everyone. When it comes to job-creation, the existing evidence suggests that microcredit is not a useful tool for creation of such employment. In fact, in one of the most high-profiled evaluations conducted recently, published in Science (Karlan and Zinman 2011), receiving a microloan made the entrepreneurs less likely to have any paid employees.

Another lesson is that while many microcredit clients climb to the top of the microcredit institutions loan ladders and continues to take the maximum loan amount offered. Moreover, few of the microfinance clients graduate into formal banking and the larger loans offered by those institutions.

Why microbusinesses do not grow?

Why do microcredit clients not grow their businesses? One reason may be that the benefits of microcredit are different from those described by many proponents (business growth, job creation, and so forth). Obviously, borrowers must get some benefits, as they would not have spent several hours per week in loan-meetings and transport to meetings if they had not benefitted in some way. Research do also suggest a host of behavioral-rooted reasons for borrowing; some borrow to pretend that they are poor (and thereby avoiding social pressure of sharing), some "borrow down" because they are unable to "save up" due to social pressure, some borrow to cover emergencies, and others may borrow to get customers or increased business networks through being part of loan groups.

In accordance with such mixed motives of borrowing from a microcredit institution, anecdotal evidence also suggest the following: A small fraction of entrepreneurs seem to benefit substantially and are able to create a living for themselves, their family and perhaps a few external employees. Another small fraction over-borrow and gets into trouble. However, the large majority is only moderately positively impacted (by for instance coping better with risk or smooth consumption over time). Given that many surveys and studies – both in developed and developing countries - concludes that most people first and foremost want a steady job, and not to become entrepreneurs, this may not be very surprising. Or put in another way; only a small majority of self-employed are "real entrepreneurs", with relevant business competence, ambitions and personal drive.

Another reason for the lack of impacts may be that the microloans are too small to spark off substantial changes in business models and usage of modern technology. In the much acclaimed book "Poor Economics", Banerjee and Duflo (2011) argue that most poor entrepreneurs with microloans, no matter how much of their profits they reinvest, will never be able to accumulate enough capital to be able to get enough collateral to get a formal loan that would enable them to invest in modern production technologies. For instance, no matter how hard the tailor with three employees work, he will never be able to accumulate enough capital to be able to invest in modern production equipment that could allow him to reach economies of scale, and to export products outside his home market. Take the microfinance organization PRIDE Tanzania as an example. In PRIDE, the biggest group loans the bank offer is 1 million shillings, or around 3500 NOK. This is enough to buy a few sewing machines and some fabrics, but very far away from the costs of putting up a small factory. And if entrepreneurs realize or believe themselves that they will not be able to make it big, why then reduce current consumption to save for such large, future investments?

[8] Beaman et al. (2014) evaluate savings-groups in Mali, and find that access to savings group improves consumption smoothing and food security. However, there are no impacts on the levels of consumption (i.e. poverty), health or female empowerment.

Some researchers also argue that the existence of microcredit could crowd out such larger investments, as the sweatshop owners with modern technology may be outcompeted in early stages by the crowds of self-employed tailors.

Anecdotal evidence also suggest that many micro-entrepreneurs diversify into new activities instead of "deepening" their operations; such as the kiosk owner opening up a small restaurant, or the tailor entering into second-hand clothing. Diversifying (instead of deepening) may reduce overall risk for the entrepreneur, but is less likely to create much growth, as is more likely when investments are made in production technology that reduces costs and improves quality.

To summarize, two main explanations stands out why so few microcredit clients/ microentrepreneurs grow their business and do not create jobs. Firstly, only a small minority of borrowers are "real entrepreneurs", lacking motivation, knowledge and capabilities to grow. Secondly; loans are in general to small too enable (the few) "real entrepreneurs" to invest in modern production facilities.

Subsistence entrepreneurs and business training

In addition to bridging the gap between microcredit and formal banking (discussed more below), an important policy issue is therefore whether policy initiatives should target "real entrepreneurs", and whether training could motivate and enable more microentrepreneurs to become "real entrepreneurs".

Likely reflecting the fact that few microentrepreneurs grow much, and that physical capital alone may not be enough, business training programs for microentrepreneurs have become increasingly popular among NGOs and donors over the last years. The aim is build the human capital necessary for growth and several such programs have recently been evaluated with credible research designs. In an overview article, assessing several studies, McKenzie and Woodruff (2014) conclude that training programs may help prospective owners launching new businesses, but that few studies find significant impacts on profits or on job creation or employment.

However, some of the studies deserve attention in our setting. First, in a study involving both training and an infusion of additional capital, Berge et al. (2015a) study microentrepreneurs in Tanzania and find that only the combined effect of training and capital has an impact on microcredit clients' performance. However, the effect is only on male entrepreneurs and there is no impact on female entrepreneurs. This study illustrate that many entrepreneurs are constrained by both knowledge/motivation and capital, and that lifting only one of these constraints may not be enough. In addition, only males benefitted from the interventions, which confirms what is found in several other studies; that it is often much easier to raise male entrepreneurial income than that of females (see for instance de Mel et al, 2009).

Given that females have dominated microcredit, this is somehow a paradox. On the other side, since poor females often are less educated, have less collateral and have lower (if any) prospects on the general labor market than their male counterparts, one would expect that there are more "survival" entrepreneurs among females. In this respect, Berge and Pires (2015) notes an interesting pattern when re-analyzing the experiment of Berge et al. (2015a) that females on average report to work much less in their businesses than what males do. When they instead look at females who work as much as the typical males, they do also find that these females benefit to the same extent, if not more than males from the training and the capital. This may both indicate that many females are constrained by domestic obligations enabling them from concentrating 100% on their businesses, and that more females than males are "survival" entrepreneurs. However, Berge et al. (2015b) find positive impacts of providing younger females with entrepreneurial training. Perhaps it is easier to influence motivation and knowledge the younger the recipients are, when they are not yet married and settled into traditional gender roles and social norms.

A lesson from both the studies evaluating microcredit and business training is therefore that success cannot be taken for granted, and that impacts may crucially depend on the entrepreneurs' initial

motivation, skills and abilities. Microcredit and other institutions should therefore probably to a larger extent tailor products and services to the specific needs. For instance, instead of treating all borrowers as "real entrepreneurs", one should consider to develop so called household-finance products, in order to overcome issues of saving and meeting urgent needs (coping with risk), and on the other hand develop credit products with larger loans enabling the "real entrepreneurs" to grow more. Similarly, providing business training to all microentrepreneurs, or all borrowers at microfinance institutions, may not be an effective strategy.

A growing literature is therefore seeking to identify the characteristics of entrepreneurs with high growth potential, becoming so-called "gazelles" (see e.g. Fafchamps and Woodruff, 2014). This literature suggests that it can be possible to predict who would be good entrepreneurs and who are likely to develop gazelles. There are also studies indicating that psychometric screening can be used to replace collateral, and we return to this below. This could potentially be very beneficial for high-potential entrepreneurs without collateral, who struggle to get access to finance, as microfinance institutions and larger banks normally put very little weight on business ideas as compared to collateral.

To sum up so far, several evaluations of microcredit programs have concluded that its impacts are much more moderate than what many proponents argued during the last two decades. In particular, many practitioners and researchers now argue that most microentrepreneurs/microcredit clients are "survival" entrepreneurs, lacking ambitions, talent and knowledge to grow their businesses. "Real" entrepreneurs, on the other hand, often struggle when reaching the ceilings of microcredit schemes, receiving far too small loans to graduate their businesses into the formal economy. Policies and support enabling microfinance institutions to more efficiently screen and identify high-growth entrepreneurs and gazelles, and providing these with larger loans, could unleash more entrepreneurial growth, and bridge some of the gap between informal (such as microcredit) and formal banking. We return to this below.

4.3 Supporting small and medium-sized firms to grow

While many donors and governments have had a strong focus on microentrepreneurs and microcredit in particular, less attention has been paid to the segment of slightly larger companies - the small and medium sized firms. These companies employ some workers and operate more steadily, often at the "fringe" or within the formal economy. Unfortunately, high-quality research is scarce on how one can support such firms to grow. In this chapter, we therefore also draw heavily on evaluation reports, experiences of practitioners and semi-formal research.

In many developing economies there are very few medium-sized firms, and the term "missing-middle" is often used to describe this situation. In comparison with developed countries, most developing countries definitely have much smaller shares of medium sized firms. The entrepreneurs behind such firms have by definition climbed the first, difficult ladder, and have been successful in growing their business into a relatively large and advanced organization where many complicated issues require the owner/entrepreneurs' attention.

Lack of access to capital

Why are there so few SMEs in many developing countries? One likely answer is lack of access to finance. Lack of financial development in many developing countries may affect firms and also, in turn, economic growth. In particular, proper financing allows firms to exploit growth and investment opportunities, and to reach efficient levels of production. Research also shows that that availability of external finance is positively associated with number of start-ups, which may be a good proxy for innovation (see e.g. Aghion, Fally and Scarpetta, 2007).

While microcredit in many settings have improved access to finance for microentrepreneurs, small - and in particularly medium sized firms are often severely credit constrained in most developing countries.[9] Microcredit loans are literally too "micro", and have typically very rigid structures of immediate repayment, which is a challenge for the borrower when cash flows are not immediate after investment.

Formal banks, on the other hand, often perceive the costs of screening and evaluating loan applications to be too costly, given the moderate loan sizes and risks involved. Lack of proper id-numbers and credit registers / credit bureaus also makes screening more difficult in many developing countries. Few traditional banks have also separate SME-departments, which may also hinder banks from developing knowledge about the sector.[10]

"Scaling up"

What may be done to close the gap between microcredit and formal banking, so that SMEs can get improved access to finance? Firstly, microfinance institutions should seek to "upscale" and provide larger, individual based loans.[11] Given that many microfinance institutions have become more profit-oriented over the last decade, many of them are likely to be interested in entering this market. However, given that small and medium sized firms/entrepreneurs have different needs, business models and risks compared to the traditional customers of microcredit institutions (microentrepreneurs, including many survival entrepreneurs), this surely poses a serious challenge for microcredit institutions. As a first requirement for "scaling up", microfinance institutions must have access to enough capital themselves. This could be achieved by governments or donors lending capital to the MFIs, requiring that the capital being directed towards the SME-sector.

Another challenge for MFIs interested in scaling up is to assess entrepreneurs' creditworthiness and the viability of their projects. Traditionally, credit officers of MFIs have typically been trained to assess collateral for individual loans to individual entrepreneurs.[12] An entrepreneur may want to borrow to invest in a machine, but in order for the bank to get something back in the event of default (and to give the entrepreneur more incentives not to default), the bank requires an liquid asset as collateral. This asset could be a house or a car or something else with a formal title that identifies a unique ownership of the asset and that enables the bank to sell it for cash in the event of default.

However, in many developing countries, the opportunities for contract enforcement can be poor so that the bank often would struggle to acquire ownership of the collateral in case of default. In addition, there are often not any credit-registers with overviews of the degree to which an asset is collateralized. Hence, borrowers can borrow multiple times suing the same asset as collateral. Due to this risk, many banks and financial institutions may only consider half or less of the assets real value as collateral. For example, if the entrepreneur needs a 10 000 dollar loan, she may need to provide collateral with a real value of 20 000 dollar (i.e. 200% collateral).

Given this backdrop of both a general lack of collateral (entrepreneurs are poor), and that collateral is not valuated by its real value, psychometric screening of borrowers have gained a lot of attention. The idea is that screening, by revealing personality traits, would enable the banks to predict whom that are trustworthy and good borrowers, so that the bank to a larger extent can lend to entrepreneurs where

[9] http://www.hks.harvard.edu/centers/cid/programs/entrepreneurial-finance-lab-research-initiative/the-missing-middle

[10] See http://www.hks.harvard.edu/centers/cid/programs/entrepreneurial-finance-lab-research-initiative/the-missing-middle

[11] While Grameen Bank and a few other big microfinance institutions have moved away from traditional group lending with joint liability within loan groups, this practice is still common in many regions, in particularly in sub-Saharan Africa.

[12] Most loan applications are based on assessments of collateral; that is, the valuation of the asset the entrepreneur borrows against.

collateral is lacking, but where the proposed investment project is good. According to the experience from the Entrepreneurial Finance Lab at Harvard University, such screening, in a similar way as screening job-applicants with psychometric tests, have helped many financial institutions to better select borrowers.[13]

A particular advantage of psychometric screening compared to traditional loan-assessments, once it is implemented in the organization, is that it can be conducted in a standardized way. This keeps screening costs low, as opposed to relying solely on individual screening of each entrepreneur/project.[14]

"Scaling down"

Furthermore, and perhaps with even larger potential, is the scope for formal banks to "downscale", i.e. to enter the SME market. This rests on both the banks themselves, and the regulatory environment/governmental policies. Competition among banks in many developing countries is often weak, putting less pressure on the banks to enter new markets like the SME-segment, as well as to innovate and experiment with new products.

What policies can be conducted in order to motivate and enable formal banks to also target SMEs? The perhaps biggest donor in private sector development, the World Bank, discusses in a recent report the prospects of SME-financing in Ethiopia, take on a holistic approach on SME-financing, and discuss several SME-enhancing strategies.[15] It is argued that banks need incentives to serve the SME-market, and that international best practice in promoting downscaling in commercial banks is by combining lines of dedicated credit and technical assistance. Dedicated credit could be from the central bank or donors. Such lines of credit would still give the banks incentives to screen and make maximum efforts in following up clients, something which would be more blurred when the government sets up guarantee schemes.

However, intervening in credit markets may be risky for governments, and there are surely many pitfalls, although research provide some evidence that it also can work out reasonably well (see e.g. (Larraín and Quiroz 2006, and Lelarge et al. 2008). However, a pre-requirement seem to be that the banking system is well developed, something which almost by definition is often not the case in the poorest countries.

Berg and Fuchs (2013) for instance report that dedicated programs towards the SME-sector have not been very successful in countries such as Tanzania and Nigeria, and argue that such programs often are too bureaucratic. For instance, in Nigeria, a guarantee scheme with the aim of increasing SME-lending was underutilize probably because banks where required to lend at an interest rate set by the central bank, while the banks would need to charge a higher rate to cover all costs (which often are higher for SMEs with relatively small loans). Banks also had to document exhaustive actions of recovering the loans before being compensated by the guarantee scheme, giving the banks less incentives to utilize the scheme (Berg and Fuchs, 2013). Similarly, in South Africa similar schemes where also underutilized, and Berg and Fuchs (2013) argues that scheme was too complicated to administer and conditions very stringent with a very long recovery process – discouraging banks to participate.

The mentioned World Bank report also argues that commercial banks need to establish separate SME-departments, and to provide products beyond lending, such as more advanced business training and advisory, as loan application often are based on the basis of poorly articulated business plans, and so forth. In particular, an SME-department inside the banks could enable them to build more competence and to understand SME-businesses better. In addition, the report also argue that the government needs to

[13] See http://www.hks.harvard.edu/centers/cid/programs/entrepreneurial-finance-lab-research-initiative / https://www.eflglobal.com

[14] According to the Entrepreneurial Finance Lab, banks in the US finally penetrated the SME segment in a large scale only in the 1990s, when they shifted focus from reading business plans to evaluating the entrepreneurs themselves, and were able to do it cheaply using individual credit histories.

[15] See World Bank (2015).

provide business skills to SMEs, as this would help to address the main weaknesses of SMEs, that often results in loan-rejections from banks.

Alternative financial products

Traditional lending may not always be the only option for ensuring that profitable business investment is being made. Particularly in settings were collateral or collateral-registers are not in place, a good alternative can be leasing. Leasing is asset-backed, and closely tied to the cash flow of the object (e.g. a machine). The advantage of leasing is that it provides the asset to the firm directly, while enabling the leasing institution to stay more in control, and to avoid that funds are diverted into non-investment uses. Often, other financial institutions than banks provide leasing, and in many developed countries, such as USA and Canada, there are no particular laws regulating leasing firms. However, since contract enforcement often is weaker in developing countries, the World Bank has recommended establishing separate laws guiding leasing.

However, it is important to note that financial innovation does not arise by itself, but is a consequence of a competitive financial system with regulation that is not overly burdensome (Beck and Cull, 2014).

Business incubators

Small and medium sized firms in developing countries not only face the challenge of lack of finance. Often, they also face non-existent or underdeveloped factor markets for other inputs than finance, such as technical expertise or general management skills, access to trade networks, or knowledge of formal rules and regulations. That is, many firms not only lack one input to succeed, but many, and different firms may have very different needs. One type of policy that have been quite common in many developed countries, are so called business incubators, which provide several different types of services aiming at supporting businesses in early growth-stages. Such incubators may take many forms, from more virtual online-services to fixed locations also providing entrepreneurs with business premises and diverse help-functions.

From developed countries there seem to exist both good and not so good experiences with such policies, but the nature of the interventions makes them difficult to evaluate formally. There are also business incubators in several developing countries, but no proper evaluations can be found.

However, the growing popularity of business incubators in developed countries may indicate that they can be valuable for entrepreneurs. But, establishing such policies in developing countries may be more challenging. In general, implementing policies in developing countries is often more difficult due to weaker bureaucracies, more corruption and less accountable decision makers. In addition, the very services that one wish to supply through the incubators, may be scarce and of low quality. On the other hand, since the supply of such services are so scarce (technical expertise, marketing skills, access to trade networks etc.), getting better access to them may be much more important than in developed countries, where most such services do exist.

Innovation promotion agencies

Another form of public support for entrepreneurship and innovation, are when centralized government agencies seeks to support innovative firms, such as Innovation Norway (Innovasjon Norge). Innovation Norway, and similar public institution in other countries, gives financial support to firms in order to promote investments in research and development that may not be conducted without governmental support. The idea is that such investments may be beneficial also for other firms, that is, that there exist so-called positive external effects.

Innovation Norway does not necessarily support the projects that may create the highest number of jobs, while job-creation itself often will be the most important objective in developing countries. However, an important caveat one should mention, is that agencies such as Innovation Norway are rather expensive to run, as compared to the funds they disburse (see report from Pøyry evaluating Innovation Norway). That is, the projects that are supported may not only yield positive impacts, the projects impacts must also cover "their share" of administrative costs.

Furthermore, many developing countries have bureaucracies that are not very well-functioning, and direct support to firms may always be prone to corruption and cronyism. One could perhaps organize such support through the World Bank and other international agencies/NGOs, but these agencies, on the other hand, would have very large costs as compared to the disbursed funds, making the cost-benefit calculations worse.

Reforming bank regulations

Furthermore, many developing countries, often with technical assistance from donors, have made efforts in reforming bank regulations with a particular aim of facilitating SME-lending.

In a detailed study of five developing countries' SME-financing, Berg and Fuchs (2013) document substantial differences with respect to legal and regulatory framework for the provision of loans to SMEs. For instance Rwanda, have conducted several reforms, including facilitating credit bureaus and better enforcement of claims, resulting in increased loans to the SME-sector. This illustrates that sound policies can result in big differences in loan-outcomes. As discussed above, credit guarantee schemes in many countries have failed, but seemingly not so in Rwanda, who have had guarantees giving banks 50% back of certain SME-loans. Here, processing of claims (i.e. when a banks client don't pay back, and the bank claims the guarantee) were improved, and banks where partially paid before all documentation was in place. The guarantee scheme was also targeted towards working capital, which often is a main constraint in the start-up phase of many SMEs. Another key characteristic of the Rwanda experience was that the scheme was closely developed in collaboration with private sector (Berg and Fuchs, 2011). However, Rwanda may be a special case in the sense that it is a quite small, well organized and transparent country. Conducting similar reforms in Tanzania or Nigeria would therefore not necessarily work as good.

Business entry reforms

Business startups and job creation may also be dependent upon the general investment climate and economic policies being conducted. In the last years, several countries have in particular focused on reforms easing the process of starting a formal business, with the aim of e.g. reducing the time, number of procedures and formal requirements (e.g. minimum capital) needed to start a firm. According to Gathani et al. (2013), such reforms are often easier to implement than other private sector reforms, partly because it is relatively easy to gain broad support for such reforms. In fact, Gathani et al. (2013) report that around 80% of the 183 economies measured by the Doing Business report had made business start-up easier since 2003.[16]

In particular, many countries have adopted so called "one-stop shops" for business registration. Such "shops" provide entrepreneurs with a single place where they can fulfill all the necessary requirements to start a business. The literature evaluating such reforms are quite positive, finding that one-stop shops are associated with more firms , and that firms experience lower registration costs.

In addition, preliminary evidence also suggests that significant business entry reforms also can encourage job creation. In fact, Gathani et al. (2013) report that in Mexico, the introduction of a one-stop shop for business registration was associated with an increase of 2 to 8 percent employment.

5. CONCLUSIONS AND RECOMMENDATIONS

[16] In an evaluation of the World Banks support to Investment climate reforms, the Independent Evaluation Group concludes that these initiatives have been successful in reducing firm costs of doing/starting businesses. However, IEG is critical to the World Bank's sole focus on reducing economic costs, and not improving social outcomes when designing and implementing these reforms. Available at http://ieg.worldbankgroup.org/Data/reports/chapters/investment_climate_final.pdf

In this report, we have elaborated some promising opportunities for Norwegian PSD aid along several pathways that has a potential for creating income and employment growth in developing countries in a way that support the structural transformation.

The first pathway is along the route of supporting structural transformation and economic growth. Despite the recent documentation of a deindustrialization in developing countries, which some take as discouragement for industrial policies, we arrive at the conclusion that the analyses of the forces at play will guide design of what industrial policies would be effective under the different circumstances. The finding that deindustrialization takes place in developing countries on average does not imply that policies to stimulate manufacturing should be abandoned in a particular country.

The promotion of structural transformation should be based on a careful analysis of the binding constraints of the particular country in focus. This is in itself a challenging and costly undertaking that needs to be conducted in each country of interest. In such an instrument is included in the Norwegian PSD approach, it would provide useful guidance to all the other PSD instruments.

A promising niche for Norwegian PSD aid is to support entrepreneurs in discovering profitable opportunities that are not exploited in the developing country. In this approach, the deindustrialization forces should be considered but should perhaps not have much influence on the strategy. What matters is the identification of profitable opportunities with a growth potential for a larger number of businesses.

Analysis of comparative advantages and feasible market opportunities could be another instrument to enhance the entrepreneurial search process. In addition, this can be coupled with various mechanisms to support the self-discovery itself, like providing additional incentives to entrepreneurs and companies to try out seemingly profitable opportunities new to the market in the developing country.

In promoting the strategic search and discovery of new profitable opportunities that can contribute to structural transformations and job-growth, we propose a special focus on the missing middle. This segment can be relatively capable of searching for such opportunities, and together with the recipient government, they can identify obstacles that can contribute to the growth of medium sized businesses. In countries where the links between the government and the private sector are weak, this approach to private sector aid can be coupled with support to the development of platforms for government – private sector dialogue.

In addition, Norway could fund partners that apply business idea contests for MSMEs where promising entrepreneurs compete for funds to assess the opportunities for investment and growth-related ideas that can foster an expansion of their enterprise into the middle-size segment. This rests on the notion that only a few of the MSMEs have the potential for growth and the role of aid is to unleash this potential. This instrument can be strengthened by linking it with the growth diagnostics and analysis of promising investment opportunities in the country of interest since it can guide the MSME entrepreneurs in their search for profitable opportunities. Such an instrument could complement support of self-discovery in the larger business segment that would fit well in a programmatic approach to Norwegian private sector aid to foster structural transformation.

The final pathway builds on recent research indicating that the traditional support to microbusinesses such as microfinance and entrepreneurship training for all does not seem to deliver the desired results in terms of income generation and employment creation. Although the research is still in the making, we believe there are compelling arguments in the literature for focusing on programs where growth-oriented microentrepreneurs can be supported for further growth. If one self-employed can increase productivity and scale enough to employ one other person at a wage higher than being self-employed, then the aggregated effect can be substantial if there are many self-employed with such potential. This can improve the situation in the increasing informal self-employment sector. The capital markets in the poor countries are clearly not reaching this segment, something that is worrying in terms of investment and job-generation.

Annex 1. Excerpt from Berge and Villanger (2014).

Industrial policy

Industrial policy is often associated with large national programs involving enormous resources for developing special economic zones to reap potential benefits from solving market failures arising from coordination problems and externalities from learning across firms. Moreover, investment in infrastructure like roads, electricity, ports and so on can all be explained by market failures. However, these instruments usually entail very large investments, and there is thus a limited role for small donors. Other large donors, especially the World Bank, USAID and DFID, are heavily involved, and so are Norfund and similar investment funds. However, an important part of industrial policy involves strategic considerations and search processes where Norwegian PSD aid could play an important role.

Industrial policy aims to stimulate specific economic activities and promote structural change and is thus not necessarily about industry per se.[17] Moreover, the heated debate over industrial policies stem from the difficulty in assessing the evidence on the impacts on these policies. There are usually never any good counterfactuals available. When the heavy industrial policies of South Korea is considered a success, it is difficult to attribute the economic growth and development to that policy as it could well have fared similarly with a much lighter state involvement. Perhaps South Korea would have progressed even more with less industrial policies, or perhaps much worse. Hence, the rigorous empirical evidence on the impacts and effectiveness of industrial policy is scarce (Harrison and Rodrigues-Clare 2010). Nevertheless, much can be inferred from different countries experiences in conjunction with the existing research (Rodrik 2008).

The discussion about industrial policy centers around structural change: in order to develop economically, and perhaps also along other dimensions, it is required to produce new goods with new technologies and transfer resources from the traditional activities to new modern ones (Rodrik 2007). The first transformation in developing countries is hence often referred to the move out of subsistence agriculture and into manufacturing where labor and capital movement into industry yields much higher productivity and wages as compared to traditional agriculture. This structural change results in higher incomes, higher shares of employment in manufacturing and lower poverty.

The empirically observed relationship between material poverty and productive employment and structural transformation, particularly the recent experience in many Asian countries, has spurred many analysts to recommend industrial policies to remove the obstacles against capital moving to labor intensive manufacturing (Lin 2012). It is frequently argued that countries such as South Korea, Taiwan, and China have developed by implementing policies that overcame the market obstacles that their investors faced in modern tradable industries (see Rodrik 1995, 1996). However, there has been a fierce debate in economics over what role governments, donors and foreign aid have in stimulating these changes, particularly in picking winners and giving incentives/subsidies to sectors with high potential.[18]

Rodrik (2008) argues that there is a strong case for applying industrial policies as the market failures in the relevant markets such as credit, labor, products and knowledge are well documented. His position is that the argument against the application of industrial policies concerns practical difficulties with its

[17] There could be misunderstandings in relation to the meaning of industrial policy: the Norwegian word "industry" usually means "manufacturing" while in the debate discussed here industrial policies are policies to stimulate specific economic activities and promote structural change. Hence, policies regarding manufacturing, agriculture and services may all be part of this framework.

[18] See Anne Krueger, Dani Rodrik, and Joseph Stiglitz's response to Chief Economist of the World Bank, Justin Lin's proposals on Government support to manufacturing, Krueger et al. 2012).

implementation and not about the conceptual foundations. It is all about how to do it, not about whether it should be done.

Others argue that sector specific support discriminate against the other sectors and distort the efficient allocation of labor and capital. They argue that support should be horizontal – that it should not favor any one sector but be open to all. Rodrik (2008) counters this by arguing that in practice, even general and horizontal policies leads to favoring specific sub-groups that in turn can lead to ineffective allocations. If research and development (R&D) are subsidized because of spill-over effects, then companies that are more involved in R&D are favored over companies who, by nature, are not and could not be involved in R&D.

Arguments against industrial policy have several dimensions. The first dimension is in identification: governments are not able to identify the sector or sub-sector where there is a potential gain from implementing such policies. It is argued that governments are not able to identify the market failure or constraint that prevents the private sector from reaping these benefits themselves (Pack and Saggi 2006). Second, industrial policy is an invitation to corruption and rent-seeking. Providing public support to private firms leads to an environment where the private sector is used to interacting with the government in a way that may lead to subsidies and support, which in turn can open up for private sector to request and extract benefits that distort competition and transfer rents to politically-connected entities. So goes the argument - Entrepreneurs and businessmen spend their time in the capital asking for favors, rather than looking for ways to expand market shares, reduce costs and increase profit and employment. Nevertheless, the type of industrial policy that works in one context may not be efficient in another context due to political constraints. In countries with weak institutions the risk of rent-seeking can be reduced by having more general and transparent policies.

Hausman and Rodrik (2005) propose several concrete interventions, some of which are suited for smaller donors and limited geographical and sectoral coverage: One proposal is a co-financing facility to subsidize the costs of "self-discovery." They argue against the view that economic growth will ignite once the institutional framework in the country are proper, the prices are not distorted and economic policies are sound. Even if those conditions are in place, there may not be growth unless the entrepreneurs in the country know or find out what are the profitable investments to undertake, i.e. that there is sufficient self-discovery.

Since self-discovery is costly for entrepreneurs who undertake it, and the benefits of actually discovering a profitable opportunity will accrue also to the other entrepreneurs in the country, there is a typical situation of a market failure where there are positive externalities of searching. If the discovery, in turn, leads to more innovation and growth in the country, then the benefits may accrue to even larger groups of people through job creation and rising incomes.

Hausman and Rodrik proposes that the government and donors can initiate contests where private sector entrepreneurs bid for public support by proposing potential investment proposals that relate to substantially new activities with the potential to provide learning spillovers. The support could take many forms, although Rodrik recommends that such a scheme would typically co-finance feasibility studies aiming to discover new (for the country) economic activities.

Conceptually, however, there can be many forms of awards under such a contest that can take the form of public goods and hence be of use to others (a feasibility study can typically be regarded as private information). In order to structure such support and maintain a strategic role for the contests and awards, as opposed to financing feasibility studies and company support on an ad-hoc basis, a programmatic approach should be applied with resources on the donor side to ensure strategic use of the support. This can be structured as a strategic fund specializing in such contests.

Importantly, identifying the new activity should be a process of 'self-discovery' and 'ongoing learning' whereby private companies themselves conduct the search and assessment. In exports, for example,

Hausmann and Rodrik (2003) define 'self-discovery' as the process of establishing the cost structure of an economy for the production of goods, already available in the world market. To be successful, policies need to focus on specific activities as the analysis of the general factor endowments and comparative advantage approach is too broad to be useful for practical policies as hundreds or even thousands of products may be included in its categories.

The process of discovery requires entrepreneurial experimentation, such as was the case of the Ethiopian horticulture industry. However, experimentation can be costly and involves large risks, particularly because the trial-and-error approach necessarily leads to some failures and hence economic losses for the entrepreneurs. In fact, there may be more failures than successes in this approach, which in turn would discourage individual entrepreneur's' experimentation. Hence, the strategy for the government should be to stimulate the discovery process and ensure that potential for profitable activity is explored (Hausmann and Rodrik, 2006), especially for the products that are associated with higher productivity levels (Hausmann et al. 2007). Here donors can play an important role both in terms of covering the costs of searching and for strategic knowledge generation and facilitation of the entrepreneurial experimentation and search.

The instruments currently in use that can be applied under the industrial policy heading ranges from trade policies, export processing zones, foreign direct investment strategies and exchange rate management to micro interventions at the subsector level as highlighted for the rose farm industry in Ethiopia (Box 1, above). Hence, for Norwegian aid to PSD they key is to provide strategic support. For example, the potential for rose farm production in Ethiopia was first confirmed for one of the initial entrants (Golden Rose) after it hired a consultant to do a feasibility study. More broadly, the World Bank initiated a wide study based on comparative advantage models to analyze the profitability of various products comparing Ethiopia, Vietnam, China, Tanzania and Zambia (Dinh et al. 2012). To exemplify, the report presents a diagnosis of constraints in five manufacturing subsectors in Ethiopia (apparel, leather products, agribusiness, wood products, and metal) and proposes policy reforms to address these constraints based on the successes of other countries. For Norway, one strategy could be to tap into these broader efforts and finance some components, or initiate broad studies in themselves.

Given the importance of government support to ignite industrial growth under this framework, it is useful to institutionalize a close relationship between governments and the private sector. Hausman and Rodrik (2005) recommend the establishment or strengthening existing forums where businesses and sectoral associations come into close and regular dialogue with the government. This is important for the strategic aspect of supporting discovery: Once the companies have identified some obstacles for profitable investments, the government and donors needs to be involved in how to remove these obstacles and facilitate expansion, as illustrated in the Ethiopian case presented in Box 1 above.

It is evident that such a strategy is very different from the current Norwegian approach of supporting feasibility studies, pilot production and business matching. The difference is apparent both in internal documentation of the guides to the grant schemes (Norad 1998) and in practice (Odegard et al. 2013). These programs provides a subsidy to Norwegian companies for establishing joint ventures with companies in relatively advanced developing countries (in 2010 main recipients included South Africa, India, Vietnam and Sri Lanka). The aim has been to foster transfer of technology and exchange of management and business-skills between the companies. Any Norwegian company applying and satisfying some minimum requirements will get the support. The available evidence suggests that the programs have negligible impacts on employment and poverty (Norad 2010).

Nevertheless, some similarities exist between the Norwegian PSD and the strategic discovery that would facilitate the transformation of the current practice into a coherent strategic approach with potential for impacts beyond the direct recipients of aid. However, the knowledge to assess the relevant market and distinguish an innovative opportunity from one that merely enters an existing market must be outsourced from Norad, perhaps to private consulting firms that actually do feasibility studies and market analysis on

a commercial basis. Moreover, the function to compile evidence on obstacles as experienced through the assessment of feasibility study applications and the feasibility studies themselves should rest with the institution that handles those applications. In addition, there needs to be a strong commitment and interest from the recipient government's own side. If not, there is probably not likely that the government will take the necessary actions to remove the barriers and hence the whole strategy is at risk.

Finally, an important take-away from the literature is that the specific market failures that provides a rationale for industrial policy interventions are country specific and a careful analysis is required in each case (Rodrik 2010). The arguments are convincing that most developing countries should have an industrial policy in order to stimulate structural transformation and move out of poverty. Hence, the selection of countries under which Norway would like to contribute to industrial policies will in turn depend what market imperfections are hindering private sector expansion and thus which instruments should be used. Moreover, it is important that there are no requirements or implicit favoring of Norwegian companies in such a scheme. In contrast to how the Norwegian PSD aid was designed (see Norad 1998), the implementation should be open to all companies interested in the exploration and search. Perhaps the recipient country entrepreneurs are among those who are best placed to search for profitable opportunities in their own country.

Nevertheless, we point out a candidate where Norway can initiate the proposed strategic PSD approach outlined here – Ethiopia. A crucial condition is in place in the country in that the government will be an eager partner to remove barriers to private sector investment when identified. Moreover, the positive experiences of present industry expansion, in conjunction with the presence of large donors that can address the large-scale challenges (infrastructure and investment climate) there are likely large opportunities for Norway to play a strategic role in the country. Adding to this selection is the fact that Ethiopia is one among six stable developing countries chosen to be main partners in Norwegian development aid.

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