ECONSTOR
Make Your Publications Visible.

A Service of
ZBW
Leibniz-Informationszentrum Wirtschaft
Leibniz Information Centre for Economics

Altenburg, Tilman; Stamm, Andreas

Working Paper

Towards more effective provision of business services. Conceptual considerations and practical examples from Thai-German development cooperation

Discussion Paper, No. 4/2004

Provided in Cooperation with:
German Institute of Development and Sustainability (IDOS), Bonn

Suggested Citation: Altenburg, Tilman; Stamm, Andreas (2004) : Towards more effective provision of business services. Conceptual considerations and practical examples from Thai-German development cooperation, Discussion Paper, No. 4/2004, ISBN 3-88985-277-7, Deutsches Institut für Entwicklungspolitik (DIE), Bonn

This Version is available at:
https://hdl.handle.net/10419/199228

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

WWW.ECONSTOR.EU

Mitglied der Leibniz-Gemeinschaft

Deutsches Institut für Entwicklungspolitik

German Development Institute

d·i·e

4/2004

Discussion Paper

Towards a More Effective Provision of Business Services

Tilman Altenburg / Andreas Stamm

Towards a More Effective Provision of Business Services

Tilman Altenburg Andreas Stamm

Discussion-Paper 4/2004

German Development Institute

Bonn 2004

Altenburg, Tilman: Towards a more effective provision of business services : conceptual considerations and practical examples from Thai-German development cooperation / Tilman Altenburg ; Andreas Stamm.
– Bonn : Dt. Inst. für Entwicklungspolitik, 2004. – (Discussion Paper / Deutsches Institut für Entwicklungspolitik ; 4/2004)
ISBN 3-88985-277-7

© Deutsches Institut für Entwicklungspolitik gGmbH
Tulpenfeld 4, 53113 Bonn
☏ +49 (0)228 94927-0
🖷 +49 (0)228 94927-130
E-Mail: die@die-gdi.de
http://www.die-gdi.de

Dr. Tilman Altenburg, economic geographer, member of GDI`s research staff since 1995; Head of the department “Private Sector Development and State Reform”
E-Mail: tilman.altenburg@die-gdi.de

Dr. Andreas Stamm is GDI staff member since 1998. His research and policy advice covers different aspects of private sector promotion and technology policy in developing countries. The regional focus of his work is Latin America.
E-Mail:andreas.stamm@die-gdi.de

Table of contents

Introduction **5**

1 The New Paradigm of BDS Markets **6**

2 Shortcomings of the New Paradigm **8**

3 Business Services between Public and Private Goods **10**

3.1 The Role of Market Failure 10

3.2 Towards a Differentiation of Business Services 11

3.3 Operational Business Services 11

3.4 Strategic Business Services 13

3.5 OBS and SBS: A Gradual Difference Rather than a Clear-cut Distinction 15

4 Speeding up the Development of Markets: A Public Role for the Transitional Period **16**

5 The Political Economy of BDS **18**

6 Reforming Public Service Providers **20**

7 Practical Conclusions for Development Co-operation **21**

Boxes

Box 1: Shortcomings of government-driven BDS provision in Thailand 7

Box 2: Non-appropriability: the examples of training and information services 14

Box 3: Examples of operational and strategic business services according to their character as public and private goods 15

Box 4: Creating a market for environmental management systems in Thailand 17

Box 5: Development co-operation in Thailand: between unfair competition and BDS market creation 18

Box 6: Political “pet projects” in Thailand 19

Box 7: Market-based service delivery as an underlying rationale for Thai-German development cooperation 21

Box 8: What performance should be measured? 24

Graphic 1: “The performance triangle” – a tool to visualize outcome dimensions of BDS 25

Abkürzungsverzeichnis

AOS	Advanced Operational Services
BOS	Basic Operational Services
CIM	Centrum für Internationale Migration und Entwicklung
DTEC	Department of Technical Cooperation
EMS	Environmental Management Systems
ERP	Enterprise Resource Planning
FhG	Fraunhofer Society
GDI	German Development Institute
GTZ	Gesellschaft für Technische Zusammenarbeit
ICT	Information and Communication Technologies
ITAP	Industrial Technology Assistance Program
ITB	Invigorating Thai Business
LROS	Legally Required Operational Services
NGOs	Nichtregierungsorganisationen
OBS	Operational Business Services
OTOP	One Tambon – One Product
SEs	Small Enterprises
SMEs	Small Medium-sized Enterprises

Introduction

At the international level, especially among donors involved in development cooperation, there is an intense debate underway on the best way to achieve a broad-based, high-quality and affordable supply of services designed to help improve the performance and consolidate the competitiveness of SMEs. These services are referred to as *Business Development Services* (BDS). This discussion is gaining momentum at a time when public funds are growing increasingly scarce and the pressure to modernize SMEs in developing countries is rising. The obvious failure of governments and donor agencies to significantly improve the supply of services for SMEs has led to a paradigm shift. The new paradigm calls for the development of undistorted private service markets rather than highly subsidised services provided by government agencies or international donors.

As regards the new paradigm, a number of key issues – both conceptual and practical – remain unresolved, leaving the practitioner with serious difficulties when it comes to designing and implementing support programmes, e.g.

What is the best approach to addressing the phenomenon of "public goods" in situations where market forces cannot be expected to provide the socially optimal solution; what can be done under real-world conditions, where no first-best solution has yet developed for an efficient and differentiated market for business services?

What is the best way to manage the transition from a government- and supply-side-oriented, bureaucratic system to high-performance private BDS markets?

How are practitioners to deal with the fact that support programmes have tended to be overlaid by political interests?

The present document has been written on the request of GTZ Thailand. It takes up the conceptual debate on BDS market development and discusses its usefulness for the Thai case, which is – as in most developing countries – characterized by a highly traditional state-led approach to BDS provision. This exercise has allowed us to address the issues raised above and to test the relevance and scope of BDS recommendations in the real world. For instance, we take a differentiated look at the types of services to be provided. This helps to single out situations where BDS may indeed be provided on a purely market basis, and where donor intervention should thus be limited to assisting in the creation of these markets. On the other hand, it may also help us to understand that as far as a number of highly important BDS, and especially those related to SMEs, are concerned, market failure is a reality and not merely a lame excuse for governments to maintain an expensive and inefficient public service sector. Moreover, the present paper addresses the political dimension of BDS provision, a factor important to understanding why governments and donors do not always follow the recommendations derived from technical best practices, and discusses what practitioners can do in the (quite common) situations in which BDS markets are already distorted and politicians and bureaucrats are unwilling to leave BDS provision to market forces. All in all, our study thus highlights the difficulties involved in translating textbook recommendations into the real-world scenarios. This leads us to present a number of policy conclusions which, perhaps not as spectacular as the "new paradigm," are nevertheless more realistic when it comes to implementation in the given institutional and political context of contemporary Thailand as well as in other countries with similar institutional settings.

The study is based on desk research on the BDS concept as well as on the available empirical evidence. In addition, we conducted a number of interviews with GTZ project managers and Thai counterparts during the spring of 2003. In coming up with our general assessment of Thailand's institutional performance in business services, we draw on a parallel GDI research project with a much broader empirical base.[1]

1 Altenburg et al. (2003).

Chapter 1 summarizes the new BDS paradigm, presenting the four principle arguments that cast doubt on the traditional path taken by state- or donor-led service provision as well as the policy conclusions made by proponents of the BDS market approach. Chapter 2 then identifies four conceptual and practical limitations of this school of thought. Chapters 3-6 go on to elaborate on these four critical arguments. Chapter 3 discusses the distinction between public and private goods, arguing that some business services are, at least in part, public goods, and concluding that there is a case for subsidizing them. In Chapter 4 we show that the evolution of private service markets is a slow process of interaction between customers and service providers. These interactions serve to increase specialization and deepen the division of labour, thus contributing to productivity growth, innovation and competitiveness. Government action aimed at accelerating this process may thus be assumed to spur economic development. Chapter 5 demonstrates that service provision for SMEs is a political issue. Some politicians and bureaucrats clearly pursue self-interests which may not be compatible with the new paradigm of undistorted private service markets. Development of such markets is therefore not a technocratic project but one that requires political bargaining. In Chapter 6 we point out that the development of service markets never starts from scratch. Usually there are already a number of established subsidized, and often bureaucratic, service providers. This leads us to discuss the challenge of how to propel these service providers towards business-like modes of service delivery. Finally, Chapter 7 draws some practical conclusions for development co-operation.

1 The New Paradigm of BDS Markets

One crucial condition for competitiveness of SMEs in developing countries is their ability to link up with other companies or institutions that can provide them with assets which they cannot produce themselves, i.e. support that permits them to increase flexibility and reduce costs. This is one of the most important findings of the "systemic competitiveness approach," but also of the research focusing on industrial clusters and districts.[2] Many of these external linkages include provision of some kind of *services* to SMEs.[3] During the last few years a new paradigm has emerged with regard to *who* should provide these business services and *how* these services should be provided. The main contributions to this new paradigm have come from the Committee of Donor Agencies for Small Enterprise Development, which published the study "Business Development Services for Small Enterprises – Guiding Principles for Donor Intervention."[4]

The Donor Committee criticizes the traditional approach involving provision of services by public or semi-public entities. The most important alleged weaknesses are:

— *Lack of financial sustainability*. Most services are delivered on a highly subsidised basis. Service providers thus depend on continuous public support. In view of the fact that most countries are cutting back on public expenditure, they are forced to cancel or substantially reduce many support measures.

— *Insufficient outreach*. Even in times marked by high government revenues or deficit spending, or substantial inflows of foreign aid, business services usually only reach a relatively small percentage of the target group.

— *Lack of business orientation*. Public service providers often operate on the logic of public administration, e.g. budget allocation is not linked to programme performance, employees do not act in a business-like fashion, and beneficiaries are not treated as clients. Incentives – both for

2 See e.g. Esser et al. (1996), Altenburg / Hillebrand / Meyer-Stamer (1998), Malmberg / Maskell (2001).

3 In fact it is difficult to define what a "service" is. The term is used for a wide range of (beneficial) relationships between two entities that are not based on the exchange of physical goods.

4 For details, see the Preface of: Committee of Donor Agencies (2001).

support institutions in general and for the personnel working within these institutions – are often not designed to actively search for linkages with the business sector and to strive for client satisfaction.

— *Poor quality.* Since service providers and clients work in accordance with different incentive systems, operational routines, and even different mindsets, service supply is often not tailored to the needs of clients. In addition, products delivered at low cost or for free may "induce a debilitating dependency and cynicism over quality and value."[5]

— *Crowding out of private competitors*. Service delivery at highly subsidized rates distorts markets and hampers the emergence of commercially viable service providers.

As Box 1 shows, Thailand is no exception to this general picture.

Box 1: Shortcomings of government-driven BDS provision in Thailand
Government BDS programs in Thailand are mainly driven by bureaucratic decisions, a fact that reflects weak private sector involvement in program design as well as incentive structures within implementing agencies which serve neither to create a service mentality nor to enhance networking with industry. Many subsidies are allocated to hire university professors, even though the latter are usually without much private-sector experience and are generally viewed as not being sufficiently business-minded and lacking a "hands-on" mentality. Despite generous subsidies, a significant number of firms drop out of BDS programs. This casts serious doubts on the quality of and appreciation for these programs. The lack of business orientation in policy design and delivery results in low program outreach and impact. Even the most prominent SME programs, including Invigorating Thai Business (ITB) or the Industrial Technology Assistance Program (ITAP), cater to a few hundred SMEs only and therefore reach only a very small percentage of their potential target group. The same applies, for instance, for lab services (e.g. under the Electrical and Electronics Institute) or the few existing business incubators. Programs and implementing agencies are almost never financially sustainable, which means that activities suddenly terminate when agencies run out of funds. The ITB program subsidizes 90 % of consultancy costs, and its predecessor, the Miyazawa program, which was funded by the Japanese government, even covered 100 % of these costs. In the case of ITAP, donor countries provide senior experts to SMEs, requiring the host companies to cover air fares and per diems only, and ITAP even subsidizes this minimum contribution. If at present there are hardly any functioning markets for business services in Thailand (except for routine services like tax consultancy or accountancy), this circumstance may in part be attributed to the fact that generous subsidies tend to undermine the willingness of customers to pay for services. The current government is committed to improving the delivery of public services. It has required some institutions to substantially raise service fees in order to reach financial sustainability. Moreover, for the first time in Thailand, the government plans to introduce performance-based budgeting that calls for definition of performance indicators and introduction of monitoring and evaluation systems. Implementation, though, is still in its infancy.
Sources: Altenburg et al. (2003); The Brooker Group (2002)

High cost and low impact may be seen as the major factors propelling the paradigm shift in BDS provision towards a demand-led and market-based approach. The consensus within the Donor Committee expressed in the "Guiding Principles" reflects the conviction that mobilising market forces may be the most powerful tool to achieve impact, outreach and (financial) sustainability in the provision of BDS to SMEs:

5 Gibson (1999, 4).

> *"The ultimate vision for BDS, on which these Guiding Principles are based, is of a well-functioning market with a diverse array of high-quality services that meet the needs of a large proportion of SEs* [small enterprises] *affordably."*[6]

The new BDS market paradigm highlights the need for services to be provided at cost-covering rates and by providers who operate in a demand-driven and business-like manner. Service providers should either be private companies or public entities organized like firms in terms of their incentives systems, personnel, culture and attitudes. Services should be regarded as commercial products, and the companies that receive services should be regarded as customers rather than beneficiaries. Providers should therefore always charge fees, and these fees should usually be high enough to secure the provider's financial sustainability. This presupposes that BDS organizations use cost-analysis systems that enable them to determine the total cost and the adequate price of each service product they provide. Competition among service providers should serve to induce them to constantly improve on performance. In any case, the aim should be to avoid intervention in well-established service markets that deliver subsidized products which may distort markets and jeopardize other providers. Wherever no service markets have yet evolved, governments (or donors) should seek to develop commercial BDS firms rather than delivering services on their own. This shift is in line with a generalized "new thinking" in development cooperation. As Goldmark (1999) states,

> *"the spread of capitalist principals throughout the world has affected even the most insulated governments and donor institutions. The view that market forces are positive and should be used to stimulate growth and development has spurred a wave of "market-based" development projects and initiatives, including demand-led intervention."*

2 Shortcomings of the New Paradigm

There is no doubt that the potential of market forces has been underestimated, or even neglected, in development co-operation in the past. The new paradigm expressed in the "Guiding Principles" has important merits in that it shows that BDS systems should operate as closely as possible to the market if they are to avoid misallocation of resources, optimise cost-benefit ratios and avoid any crowding out of private service providers. Yet it is still unclear how realistic the new paradigm is and whether it will actually guide development cooperation towards more effective, efficient and sustainable interventions. We will argue that the "Guiding Principles" are too 'market-optimistic,' underestimating the degree of market failure, and neglect the political dimension of service provision. As a result, they are not very helpful for development practitioners who

— need to identify which services are fully private goods the provision of which should be left to market forces, and to determine where government (or donor) intervention may be needed, and

— want to know how to manage the transition towards a more demand-oriented supply of services in a real world which is characterized by political interference, the existence of bureaucratic institutions that provide market-distorting service programs, and SME customers who are used to receiving government services for free.

It is necessary to take into account four points that limit the leeway for implementing the new paradigm:

1. **Some business services are "public goods," and there is a case for subsidizing them.** In the case of public goods markets cannot be expected to provide the socially optimal solution. Governments are willing to subsidise many BDS schemes as they expect the social benefits to outweigh the costs. Therefore even in industrialised countries, where service supply is usually of quite good quality and firms are able to pay sizable fees, many services are not provided on a

6 See Committee of Donor Agencies (2001, 1).

cost-covering basis.[7] In developing countries market failure may be even more pervasive. Thus it is important to carefully identify which services are actually pure private goods and may and should be provided on a market base, and cases in which governments should intervene to maximize welfare. One fact that makes things more complicated is that textbook distinctions are not very helpful. The "public good" content inherent in a given service depends on the specific local and historical context, e.g. the size and maturity of markets.

2. **The development of private service markets is a slow and difficult interactive process. Public intervention may be needed to speed it up.** In most mature economies a highly diversified private service sector has developed over time. This is the result of a cumulative and interactive process in which increasing product differentiation, shorter product cycles, emphasis on customer-specific solutions etc. have spurred the development of business services, and vice versa. In the case of less developed countries, we often observe a vicious circle in which scarcely differentiated, simple non-service sectors do not create demand for advanced services, and lack of such services restricts competitiveness. The relevant questions here are thus: Even if a certain type of service could and should in the long run be delivered under market terms, is there not still a case for temporary market intervention in order to develop markets and get the above-mentioned dynamics going? Can SMEs in developing countries wait for service markets to be created, considering the pressures they are facing in times of market liberalisation and globalisation?

3. **Service provision for SMEs is a political issue.** Governments sometimes provide BDS for political reasons, e.g. as a show of public action and to gain support of local communities or certain target groups for the government or the ruling party. In such cases they may not be pursuing the goal of developing BDS markets, even if this is the most efficient option. The negative impacts of market distortion or lack of financial sustainability are in this case traded off against the political advantages offered by increased legitimacy. Moreover, bureaucrats working at the level of implementing agencies may act as rational and selfish agents who are mainly interested in maximizing the budgets of their offices and securing their jobs and salaries. It would therefore be naïve to believe that political decision-makers, funding agencies and implementing bodies would change their behaviour once the optimal degree of market intervention has been defined in technical terms.

4. **Reforming public service providers may be a more promising approach than trying to substitute private competition for them.** Donors and government agencies that wish to improve SME services never start from scratch; instead, they are always forced to deal with established traditional, and often inefficient, service systems that distort markets. Even if private providers were able to guarantee an efficient and massive supply of services, in view of the above-mentioned interest-group politics and inertia of bureaucracies it would not be realistic to assume that these institutions would quickly disappear. For the development practitioner, this raises the question of how to manage a gradual transition from bureaucratic, supply-driven and subsidized provision to business-like modes of service delivery. The practical challenge is therefore often not to substitute government services but to improve them in accordance with the criteria of the new paradigm.

In the following chapters we will elaborate on these four points. As much of the BDS dilemma is due to the unclear distinction between public and private goods, we will place emphasis on this aspect, developing criteria aimed to help the BDS practitioner to assess the "public good content" inherent in different types of business service. The other three arguments will be discussed in less detail.

7 See e.g. the case of Italy in Pietrobelli / Rabelotti (2002).

3 Business Services between Public and Private Goods

3.1 The Role of Market Failure

The "Guiding Principles" are unambiguous in stating that the majority of BDS can be provided as private goods on a commercial basis and that all public intervention should be subordinated to this vision. At present, however, no empirical evidence can be found that a broad and smoothly functioning provision of high-impact services within a purely market-based system could be achieved within an appropriate period of time. The relevant studies show, on the contrary, that cost-recovery rates are usually low, even in industrialised countries. In many cases even BDS provided by business-like suppliers are highly dependent on institutional clients, e.g. donor-financed NGOs. We will therefore start out by asking why, if "the majority of BDS are private goods," BDS markets are still highly underdeveloped or non-existent. There are of course many transitional market failures and artificial distortions that may explain this situation; these include:

— an insufficient flow of information within societies that may tend to prevent new market opportunities - or other urgent challenges (e.g. the need to adapt to international standards) – from being quickly identified and to impede appropriate action;

— insufficiently developed skills and physical capacities needed to provide services of an adequate quality;

— crowding out of private suppliers by highly subsidized government (or donor) services.

We agree that if market failure is only transitional, or due to previous distortions, donor intervention should indeed focus on activities aimed at creating private BDS markets, as outlined in the "Guiding Principles" and related documents. Still, we question the assumption that all types of services provided to businesses may be considered as purely private goods. The fact that we pose this question is in no way meant to defend the traditional system of public service provision, even though in the past "market failure" and the "public goods character" of business services have often been used as a lame excuse to establish and maintain paternalistic and top-down systems of service provision. However, there is no "way back" to the old model and the old way of thinking, and a sober and in-depth analysis of the potential and limits of market relations would appear to be the only "way out."

Concluding (as we will in fact do) that many BDS have in part public goods character does not at all mean that they should necessarily be provided by public organisations or that these organisations should decide on their own what kinds of services should be provided and in what way. On the contrary, the governments of developing countries would be best advised to limit their interventions to activities in which the risks of government failure are lower than the costs of market failure. In many cases, governments should pull out of direct service provision and pay more attention to creating an enabling environment for the development of SMEs.

However, in cases in which a sober analysis indicates that market failure is apt to impede a market-based provision of BDS to SMEs, a long-term engagement of public agents could prove necessary, including a carefully designed and demand-led transfer of funds. Governments may therefore decide to establish or maintain a system of service provision that is not fully market-based. Nevertheless, efforts should always be undertaken to avoid any crowding out of private service suppliers, and public funds should be used in such a way as to maximise the social benefits of these scarce resources. The system therefore has to be as demand-led and business-like as possible.

3.2 Towards a Differentiation of Business Services

Notwithstanding the intense debates within the donor community, there is still a lack of clarity concerning the term "BDS." Review of the literature[8] as well as some unpublished case studies reveals that the projects and programmes implemented by the international donor community operate with a wide range of different business services. Although the following list is far from complete, BDS may include:[9]

— training of entrepreneurs and employees,

— consultancy and advisory services geared to management capabilities,

— marketing consultancy and marketing of products on a commission basis,

— provision of information in a broad sense,

— accounting and legal services,

— technology development and transfer,

— provision of basic or specialised services in information and communication technologies (ICT),

— access to specialised instruments and tools (technology access service),

— business linkage promotion,

— design of products and packages,

— packaging of products, transport and logistics.

Given this wide range of services, with their different characteristics, it is necessary to group these services before we can discuss whether or not they can be provided appropriately on a commercial basis. The Donor Committee proposes a differentiation into *operational* and *strategic* services, with the operational services being those needed for day-to-day operations, while strategic services are used by enterprises to address medium- to long-term issues aimed at improving the performance of an enterprise, its access to markets, and its ability to compete. This provides a useful first approach to the issue. Yet to come up with a more detailed differentiation,[10] and to discuss some characteristics relevant to the marketability of the respective group of services, we consider it important to look more thoroughly at the reasons why an enterprise may be willing to seek a service and to pay for it.

3.3 Operational Business Services

In keeping with our differentiation, operational business services (OBS) are mainly private goods that have a direct and predictable outcome on a firm's performance. Most of them are necessary for day-to-day operations. These characteristics imply a relatively high degree of marketability. It is useful to distinguish three different OBS:

— Practically every enterprise needs access to some services to carry out its basic functions. These services, which we term **basic operational services** (BOS), vary in time and space but can quite easily be defined in any given situation. BOS may be subdivided into services that necessarily have to be obtained externally (telephone, grid electricity) and those that may also be provided

8 See for instance the BDS documents listed on the CEFE homepage (http://cefe.gtz.de).

9 We believe, however, that some transactions dealt with in a number of BDS papers should *not* be labelled "services", e.g. the commercialisation of a small enterprise's (A) products by a marketing company (B), when the underlying transaction is the selling of the good from A to B and B's utility is based on a mark-up on the buying price. This transaction may *include* service provision by B to A (e.g. advice in design or quality management, see e.g. Mikkelsen 1999), but in itself it amounts to the formation of a value chain and not a service.

10 A similar structure is presented in Mifflín (2001, 7f.).

internally, like the transport of inputs and final products. In the second case the question of whether a service linkage will emerge depends on a (sometimes complex) "make or buy" decision.

— A second, rather small group of OBS are those which an enterprise (usually from a certain size upwards) is obliged to contract to comply with laws and regulations. The most important of these "**Legally Required Operational Services"** (LROS) are legal/notary and accounting services as well as the use of certain laboratories and certifying agencies. For SMEs, contracting external providers is usually the only viable way to obtain these services, since the volume of their operations does not permit them to permanently employ specialists in these areas.

— A third group of OBS - even though they may not be strictly necessary for the operation of an enterprise - will have a *direct* and *predictable* outcome on its productivity, efficiency and ability to compete. Typical examples of this kind of "**Advanced Operational Services"** (AOS) would include the contracting of a specialist in product design, the introduction of an enterprise resource planning (ERP) software or access to specialised instruments or tools for the production process.

With respect to the three groups of OBS, we largely share the assumptions of the Donor Committee that they constitute private goods. The main characteristics of private goods are that they have *clearly identified owners* and that they are *rival and excludable*, i.e. that the owner can prevent others from using or consuming a good or service in question. These characteristics are clearly given. When a company buys a telephone line, it will be the registered as owner of the line and be able to exclude others from using it (BOS). The time an attorney dedicates to make up a contract for an individual company cannot be shared by another company unless it shares the costs (LROS). And when a small textile company contracts for a number of hours of work with a specialized piece of equipment to make high-quality buttonholes or computerized embroidery,[11] this will add value to its products (AOS). Any competitor who wants to do the same will have to pay for the service individually.

A second characteristic of the three groups of OBS is that they are, in their majority, "*search goods*," i.e. the contractor knows in advance what the concrete *result* of his investment will be, even though he may not always be able to predict the *outcome* on his enterprise's performance. Therefore the two parties may define relatively clearly – prior to contracting the service – the terms of reference of the relationship as well as the criteria for client satisfaction. In many cases the supplier of the service may provide samples of earlier work done (e.g. in package design) or give the client an opportunity to talk to previous clients (as in the case of customised ERP software).

Due to the private and search character of such goods, the Donor Committee is basically right in stating that "with appropriate product design, delivery and payment mechanisms, (these services) can be provided on a commercial basis even for the lowest-income segment of the entrepreneurial SE sector."[12] Still, we argue that there is market failure even in OBS, and that there may be a case for government (or donor) intervention. Where such interventions are considered to be necessary, they should usually be temporary and geared to market creation, and it should be borne in mind that in principle these OBS should be marketable. OBS provision may not be adequate and affordable because:

— Due to their low consumer density and purchasing power, rural areas are often under-supplied with OBS, e.g. with basic telephony and grid electricity. The same is true, of course, for high-end OBS such as Internet access or services that permit the outsourcing of complex business functions (call centres etc.). With regard to the grid-dependent OBS, a combination of liberalisation, market regulation and selective subsidies is usually adequate to improve the density of service supply, even in remote areas of developing countries.

11 See the case of INSOTEC, Colombia; mentioned in Goldmark (1999).

12 See Committee of Donor Agencies (2001, 1).

— Information about the supply and demand of OBS is often inadequate. Several information-related problems can be identified that limit the functioning of OBS markets within the SME sector of developing countries, mainly with regard to AOS. The potential client may not be informed about the services that are currently offered and basic market conditions. He may misjudge the potential benefits of the acquisition of a special service. Finally, he may not be aware of the costs related to providing the BOS internally and *not* contracting an external supplier.[13]

— With respect to some OBS, SMEs may suffer from indivisibility problems on the supply side. Specialised laboratories, packaging or warehousing services may need a minimum of product movement to cover their fixed operation costs. In these cases it may be difficult for SMEs to find an adequate supply of services in their area of operation.[14]

3.4 Strategic Business Services

Strategic business services (SBS) are services that enhance the long-term capacity of an enterprise to compete, mainly by enriching its knowledge base and/or by increasing its capability to acquire, process and apply information. This group is mainly composed of training, consultancy and advisory services, provision of information, research and development, and some forms of technology development and transfer. Moreover, the outcome of SBS is *indirect* rather than direct, *long-term* rather than short-term, and, finally, *uncertain* and in many cases *unpredictable*. The following characteristics make market failure evident, and here it is unlikely that the market creation approach will work:

— Many SBS suffer from *non-appropriability*. The social return from investment is for this reason generally higher than the private return. In other words: If it relied exclusively on private decisions, investment in these services would be lower than socially desirable. This is true for R&D services, training and information provision, where private investments may even benefit competitors by dint of labour turnover or leakage of know-how. In some cases, the expected positive impact is related less to the individual enterprise than to collective entities (e.g. cluster policies, promotion of given locations) or even to public goods (e.g. introduction of environmental management systems).

— Some SBS, i.e. consultancy and business advisory services, have a highly uncertain and unpredictable outcome that cannot be assessed prior to the transaction. This means that the decision-maker (in contrast to the case of the above-mentioned *search goods*) not only faces risks – as he does in each and every investment decision – but that he faces risks without being able to assess the potential benefits and dangers. Either he must rely on the service provider, believing that the expected outcome will actually be reached (*trust goods*), or he may be willing to contract for the service because of positive results in the past (*experience goods*).

Donor intervention often seeks to respond to the problem of uncertainty either by generating trust relationships between service providers and recipients or by subsidising the first use made of a special service, anticipating repeated transactions based on the experience generated. Both measures are useful when there is a sufficient number of service providers that merit trust and may actually be able to provide high-quality services at an affordable price. However, coming up with an accurate assessment of this may be very difficult not only for the SME itself but for donors and service facilitators as well, especially when new kinds of services are to be offered and new service providers are expected to enter the market. In the case of misjudgements or a severe discrepancy between promised and real outcome, facilitation of personal contacts or first experiences may, contrary to what is intended, result in disincentives to further service contracting.

13 Phansalkar / Sriram (2001, 54).

14 There are, however, exceptions from the “size rule,” e.g. technology access services may be especially in demand from SME that cannot afford own specialised equipment. See Goldmark (1999).

Box 2: Non-appropriability: the examples of training and information services

Training is an important SBS product in international development cooperation. It enhances the capacities of the entrepreneur or of his employees to meet their functions in an effective, efficient and quality-oriented way. When employees attend a training course, the additional knowledge will subsequently remain incorporated in the trained person – but there is no guarantee that this person will remain with the company that contracted for the training. It is evident that in countries that suffer from a lack of qualified human resources and in which personnel fluctuation tends to be high, the risk that trained people may switch to a better-paying organisation is higher than in the industrialised world. In many cases, due to a lack of adequate legislation or problems with law enforcement, there is no possibility for the company to recover the training costs when this occurs. So in deciding whether or not to train his personnel, the entrepreneur has to take into account the highly realistic risk that he will be paying for training while his competitor benefits from the results. This is an obvious case of "non-appropriability," and thus of market failure.[a]

Even if the trained person stays with the organisation, the company may face additional costs due to his enhanced bargaining position and higher salary expectations – an additional reason why many enterprises are reluctant to train their employees. This partly explains the preferences given to internal on-the-job training that endows the employee with additional knowledge without providing him with a formal title that he might use in subsequent bargaining processes. In some countries, e.g. in Mexico, companies are legally obliged to train their personnel. Here, in some ways, training could be seen as a legally required operational service (LROS). This may easily lead to a bias in the market towards low-cost and generic training, with costs easy to recover, like language courses. (see e.g. Adler 2000).

While the private benefit of training may be low due to problems of non-appropriability, it is obvious that in developing countries there is an urgent need to enhance capabilities and training levels of the labour force and the population in general. Thus the social benefit of training is higher than the private benefit, and there is a strong case for investing public money in the establishment of a properly functioning training system.

A similar situation can be found with regard to information provision to SMEs. This may take on very different forms, extending from provision of generic information to client-specific R&D-contracts. What they have in common is that the recipient of the information can not be sure that the information he is acquiring will only be available to him. This may not be a problem when the client only has to pay the marginal costs of reproducing generic information. But it definitely is a problem when the information he pays for is high-cost and of strategic importance, as in the case of specialised market surveys or technological information gained through R&D contracts. In these cases the costs of acquiring the desired information externally are high, while the probability that the client will remain the only beneficiary of the information is rather low. Even in the industrialised countries it is very difficult to keep strategic business information secret; usually it is not possible to avoid "know-how drain." This is even more the case in countries where intellectual property rights are not effectively enforced.

a An exception can be seen in the case in which the business owner and contractor of the training measure is identical to the trained person. In this case, the decision-maker can be sure that he will benefit from the investment. This may explain the relative success of training programmes such as CEFE, which are oriented towards the capabilities of the entrepreneur himself; see also the examples in Tomecko (2000, 51f).

As for the strategy of subsidising first service contracts and subsequently outphasing public or donor support, this may give rise to additional problems because many BDS, and especially high-end ones, cannot – due to their character and content – be used repeatedly, in particular in the case of SMEs. A small company may e.g. contract for a consultancy for the purpose of re-engineering its production process. Once this is accomplished, there will probably be no need for any second re-engineering for quite a long time. This may be very different in the case of large branch firms that may subsequently restructure their processes, thus capitalising the experiences of foregoing consultancies when contracting for the next one. We find similar conditions with regard to a series of other BDS such as R&D contracts or market surveys. So the approach involving "market creation through the generation of positive experiences" may find its limits in the low demand for repeated service provision.

3.5 OBS and SBS: A Gradual Difference Rather than a Clear-cut Distinction

The distinction between different types of OBS and SBS makes it easier to discuss the private or public goods character of each of these services, the possibility that they thus may be provided on a merely commercial basis and the need for and possible approaches to donor intervention. Nevertheless, the above classification by no means draws a clear-cut division between different categories of services. The following examples show that in practice there may be difficulties in assigning special services to one of the groups mentioned above:

— How would we e.g. classify the advisory service provided to prepare an enterprise to be certified as per ISO 9000ff? On the one hand, the process clearly enhances the long-term internal capacities of the company, thus suggesting classification as "SBS." On the other hand, once obtained, the certificate itself is a tangible outcome of the process that may under certain conditions enhance the market position of the enterprise in a very direct way. So it would also fit under the category of "AOS."

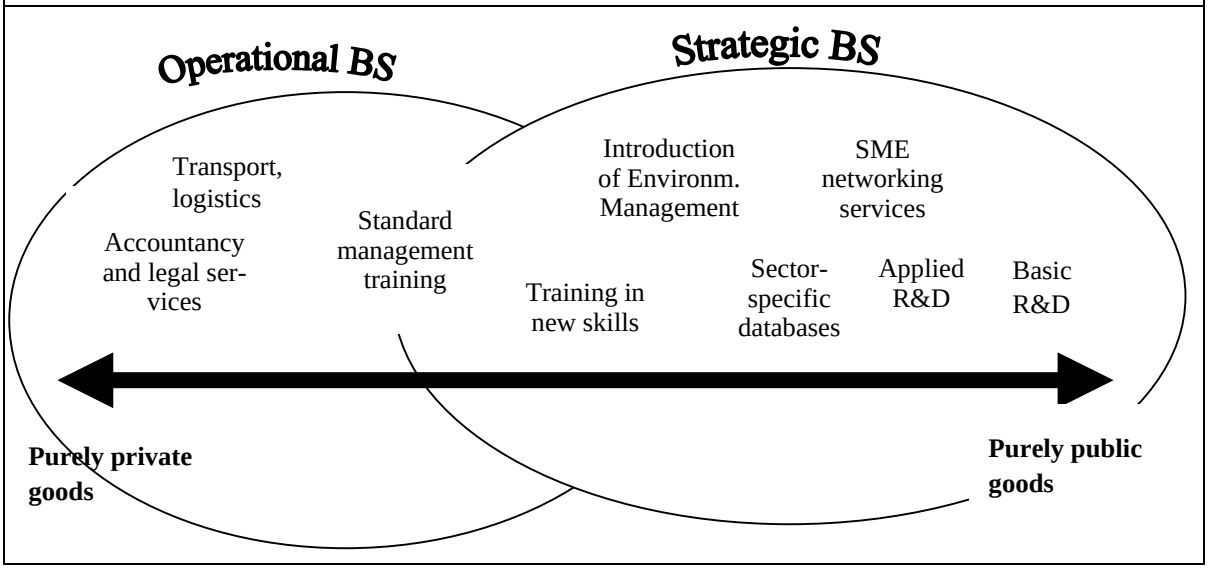
— Equally, it is quite evident that the dividing line between BOS and AOS will not remain unaltered over time. To cite an example: Many services, like grid electricity or access to a telephone that may today be considered as basic at least for formal enterprises of a given minimum size, may have been regarded as "AOS" only few decades ago.

— The same may turn out to be true for Internet access, today clearly an AOS in most parts of the developing world, but one that is likely to have become a basic and indispensable business tool in only a few years.

— Transport may be considered a BOS for all goods-producing enterprises, but it may just as well contain marked elements of an AOS when it is bundled with warehousing, data processing etc. by a modern logistics company.

Obviously, the proposed categorization cannot be applied as a simple one-size-fits-all solution. Firstly, because differences are gradual rather than clear-cut. This is explained in Box 3. Secondly, because the categorization – and thus the inherent public good content as well as the marketability of a given business service – depends on many specific circumstances, e.g. on general development levels as well as on locational factors. Nevertheless, it does provide elements which may help us to determine where market-led BDS provision is likely to work.

Box 3: Examples of operational and strategic business services according to their character as public and private goods



4 Speeding up the Development of Markets: A Public Role for the Transitional Period

Competitiveness, productivity growth and economic welfare require continuous innovations which make possible product differentiation, shorter product cycles and the development of new markets. Innovation is a cumulative and interactive process. As economic structures become more differentiated, and intangible assets (such as knowledge, experience, brand image) grow increasingly important, the innovation process becomes far more complex and involves an increasing number of firms and institutions. To name only a few manifestations: supply chains become more integrated; increasingly complex standards are introduced; user-producer interactions increase in number and scope; companies form strategic alliances to engage in joint research or marketing; linkages emerge between the private sector and public research centres, regulatory bodies and other institutions grow far more dense; and the "turbulence"[15] in enterprise structures increases - all of which becomes evident when we look at the figures for mergers, acquisitions and spin-offs. Under these dynamic conditions network coordination – e.g. knowledge flows, harmonization of interests, management of logistical interfaces – assumes crucial importance. This calls for differentiated and efficient BDS, which may be termed the lubricant of modern production structures, providing important externalities for the rest of the economy.

It is one of the key features of underdevelopment that the differentiated and interactive economic structures typical of industrialized countries have not yet developed in most countries of the South. Developing countries typically lack competitive firms, and the degree of interfirm and institutional specialization is low. This leads to a vicious circle in which scarcely differentiated, simple non-service sectors do not demand advanced services and the lack of such services restricts competitiveness. Under these conditions, the increasing competition emanating from market liberalization and globalisation may destroy the few promising "germ cells" for economic development that exist in developing countries.

Viewed from this perspective, a minimalist approach towards government action in support of BDS may not be adequate. Considering the long periods required for interactive productive systems to develop, as well as in view of the often adverse framework conditions prevalent in developing countries, it is obvious that the establishment of efficient and sustainable BDS provision systems and user-producer interaction can hardly be expected to mature as an organic, purely market-driven process in the short run. Carefully directed government or donor intervention may be needed to ensure a high-quality service supply that contributes to the development of highly specialized, interactive and innovative firms which in turn generate demand for more differentiated and efficient business services. Setting this virtuous circle in motion may justify an integrated proactive approach, including the setting of national standards, enforcement of laws and regulations, organization of consumer interests to create pressure to improve performance, training of future private service providers, temporary subsidies for customers who use innovative services, etc. It may be too short-sighted to overstate the need for financial sustainability at the level of the BDS provider without looking at the productive system as a whole. Box 4 gives an example of how GTZ, together with its counterparts in Thailand, is seeking to create the conditions required for a new service market in a situation where both supply and demand are still negligible.

15 Audretsch (2001, 11 ff).

Box 4: Creating a market for environmental management systems in Thailand
One component of Thai-German development cooperation aims at developing environmental management systems (EMS) in Thai companies. EMS are an important tool for eco-efficient production and should in principle contribute both to reducing negative environmental impacts and increasing the competitiveness of firms. Yet many of the necessary measures, e.g. pollution control, do not pay off immediately. Consequently, as long as environmental regulations are not in place (or not enforced), there is no incentive for business owners and managers to implement EMS. As a result, demand for EMS and related services is almost nil, and there are hardly any specialized service providers available in Thailand. At the firm level, GTZ is currently working with only 12 "pilot companies." Outreach is thus negligible. Service fees are graduated, with decreasing subsidies for successive services. Moreover, government subsidies for consultancies, e.g. the ITB programme, are being used as well. All in all, the introduction of EMS does not conform to the Guiding Principles of BDS. Nevertheless, this may be an important integrated contribution to developing a new market for EMS-related services, including measures to improve the general framework conditions as well as supply-side and demand-side elements. GTZ activities include awareness-building; high-level policy advice tailored to improving environmental laws and regulations (e.g. "Economic Instruments Act"); formulation of technical guidelines for EMS; development of sector-specific EMS tools and pilot testing in factories; establishment of an EMS certification system as well as an accredited training institute for EMS auditors, consultants and emission control officers at the company level; development of curricula; and establishment of a complaint centre where citizens can report environmental offences, thus generating pressure for companies to adopt cleaner technologies. If this approach succeeds (which will depend mainly on the political will to pass and enforce stricter environmental laws) it will create demand for, among other things,: laboratory services, auditing and certification services, engineering services, emission control, monitoring, and management training. Already at this early stage, GTZ is seeking to train and work together with private local service providers wherever possible.
Source: Interviews with GTZ program staff

Many public service providers in Thailand justify their intervention on the grounds that they are deepening and upgrading the productive structure. The specific services needed for these new and more demanding activities are not yet locally available. In these cases, providers argue that their services – although heavily subsidized – contribute to creating future demand, e.g. when they convince customers of the benefits of counselling, when they contribute to making BDS markets more transparent, or when they serve to develop new BDS products. In principle, this argument is convincing, although it may sometimes be used as an excuse for superfluous and market-distorting interventions. In practice it is often difficult to determine whether the alleged long-term market-creating effects outweigh the possible negative effect of non-sustainable market interventions. Box 5 gives some examples of donor interventions which address this trade-off.

As we have seen, there often is a trade-off between a "politically correct" market orientation of government action or donor intervention and the urgent need to shape conditions and create resources that enhance competitiveness and economic welfare. Support for BDS may be needed to accelerate a cumulative process of industrial deepening and upgrading. Moreover, there may be other highly respectable reasons to deviate from the course of market creation, e.g. to seek to guarantee adequate employment and living conditions in peripheral regions and to avoid rural-urban migration.

Box 5: Development co-operation in Thailand: between unfair competition and BDS market creation
Donors in Thailand intervene in many service markets. German donor agencies are usually aware of the risks of crowding out local competitors and seek to avoid this effect. For example, the Senior Expert Service and CIM state that they second experts only if the respective expertise is not available locally. Yet in practice it is impossible to verify this condition, and customers have a strong incentive to hire international experts through these programs because their service fees are heavily subsidized. Moreover, several international expert services are competing in the Thai market, seeking to place experts from their respective home countries. This situation does not favour due diligence. Companies may even turn to different agencies to obtain several successive consultancies for next to no cost. Still, programme providers may argue that consultants often convince hesitant customers of the benefits of business services and identify needs for further services. This induces additional demand which may at least in part be provided by local service providers. The net effect of the primary intervention would then be market-creating. GTZ projects in Thailand appear to be quite careful about market distortion. Even so, strongly subsidized service provision is the rule, partly because the projects are tied to government counterparts that lack a business-oriented attitude. In some cases, though, projects prepare business plans before launching a new service, including a thorough market assessment and cost analysis. Moreover, project managers can normally argue plausibly that their interventions have net market-creating effects, with induced demand outweighing possible crowding-out effects. Finally, most GTZ managers seek to convince their counterparts of the need to adopt a more market-oriented approach and to establish good practices in line with the principles of the International Donor Committee.
Source: Interviews with staff of the relevant institutions

5 The Political Economy of BDS

BDS provision is a political issue, and the public sector groups involved, e.g. politicians and bureaucrats, as well as the beneficiaries in the private sector usually pursue self-interests which may not be fully in line with the goal of improving the efficiency of service delivery.

Politicians, political parties and governments sometimes design and implement BDS programs with a view to enhancing the legitimacy of their rule. Legitimacy is needed to convince the public to support or at least accept the rulers and their programs. In addition to discursive appellations, this usually implies using government resources to provide public goods, especially in areas which are highly visible to the public. Besides construction of infrastructure, programs in support of small local enterprises are often used for this purpose. If we assume that a government succeeds in applying the new BDS model, i.e. completely privatises BDS markets, thereby improving the efficiency and outreach of services while cutting down on public expenditure, this will at the same time reduce its visibility. Politicians may therefore wish to continue providing some services which allow them to improve their image as strong supporters of private-sector-led economic development. The higher the subsidies transferred to beneficiaries, the more determined the latter's political backing for the government will usually be. This may deter politicians from pursuing a market-oriented BDS approach. Box 6 provides examples of such political "pet projects" from Thailand.

Moreover, politicians may gain legitimacy by supplying ideological wants. For instance, governments which owe their rule to a leftist (or more generally: public-minded) electorate will usually be more inclined to provide public BDS schemes than governments subscribing to a liberal discourse.

Box 6: Political "pet projects" in Thailand

In Thailand, politicians have launched some BDS programmes which have obviously been designed to gain political support rather than to achieve maximum efficiency. Some programmes completely disregard the need for financial sustainability and do little to improve the respective services and performance of BDS providers. While ministries and public BDS institutions are increasingly obligated to introduce performance indicators and monitor them with a view to increasing the efficiency of service delivery, higher levels of government often interfere with politically motivated, ad hoc decisions, sidestepping questions about the policy coherence and long-term commitment of programmes that have been decided on.

After the recession following the 1997 financial crisis, the government initiated a deficit-spending strategy to stabilize internal demand, partly supported by donor contributions like the Miyazawa Initiative. A considerable portion of this money was channelled through SME programs and initiatives for local economic development, thus "flooding" the market for SME services, crowding out market-based services and frustrating efforts to increase the degree of cost recovery and financial sustainability. What is more, government funds were mainly allocated to ministries and "tambons" (= districts) loyal to the ruling Thai-Rak-Thai party.

One such political "pet project" is the "One Tambon – One Product" OTOP initiative, with an annual budget of nearly US$ 20 million. OTOP is a top-down support program for local handicrafts which encouraged production but failed to give due attention to marketing and completely neglected aspects of financial and organizational sustainability. OTOP thus has repeated the errors of many donor-financed programs of past decades. The OTOP budget was allocated for only two years, and it is completely unclear whether or not the program will receive renewed government inputs. Other "pet projects" include support for five sectoral clusters and the ITB program. The latter encourages university professors to provide consultancies for SMEs (see above). Some observers stated that the programme's main effect is to increase the personal income of these academics, thus contributing to politically co-opting this potentially critical group.

Sources: Altenburg et al. (2003)

Apart from politicians, **bureaucrats** working at the level of implementing agencies may operate as rational and selfish agents who are mainly interested in maximizing the budget of their offices and securing their jobs and salaries. It is important to recognize that political decision-makers, funding agencies and implementing bodies are not only driven by the desire to increase efficiency in service delivery and that they also seek to maximize political gains or particular benefits for their institutions. As a result, bureaucrats may produce such services in quantities that are more than socially optimal.[16]

Especially in federal political systems where different administrative levels offer support for SMEs, this often results in a proliferation of dozens or even hundreds of supporting institutions and programmes. Lack of coordination between these levels is then not primarily a matter of inability but rather pursuit of self-interest.

Finally, **beneficiaries** gain from subsidized services. Especially in a policy environment where beneficiaries have long been accustomed to receiving services for free, it will be difficult to switch towards a system of market-based service provision. Any steps aimed at withdrawing public subsidies from government schemes may face strong opposition and entail a high political price.

For the sake of efficiency, political interference on the part of these three groups should be contained as far as possible, but it would be naïve to ignore it. For this reason, a critical policy dialogue has to be established in order to convince politicians, bureaucrats and beneficiaries alike of the efficiency gains to be expected from market-friendly approaches. The current Thai government, for instance, appears to be committed to introducing performance-based budgeting in public administration in general. This provides a good opportunity to review incentive systems and governance structures for funding and implementing agencies involved in BDS provision.

16 Chang (1996, 22 ff).

6 Reforming Public Service Providers

In many countries BDS provision is mainly (or even almost exclusively) considered to be the duty of government agencies. Competition from the private sector is almost non-existent. As we have shown in the previous chapter, politicians as well as bureaucrats have good reasons to leave this situation as it is. In Thailand for instance, the Department of Technical Cooperation (DTEC) is reluctant to permit international donors to establish BDS cooperation with private sector entities.

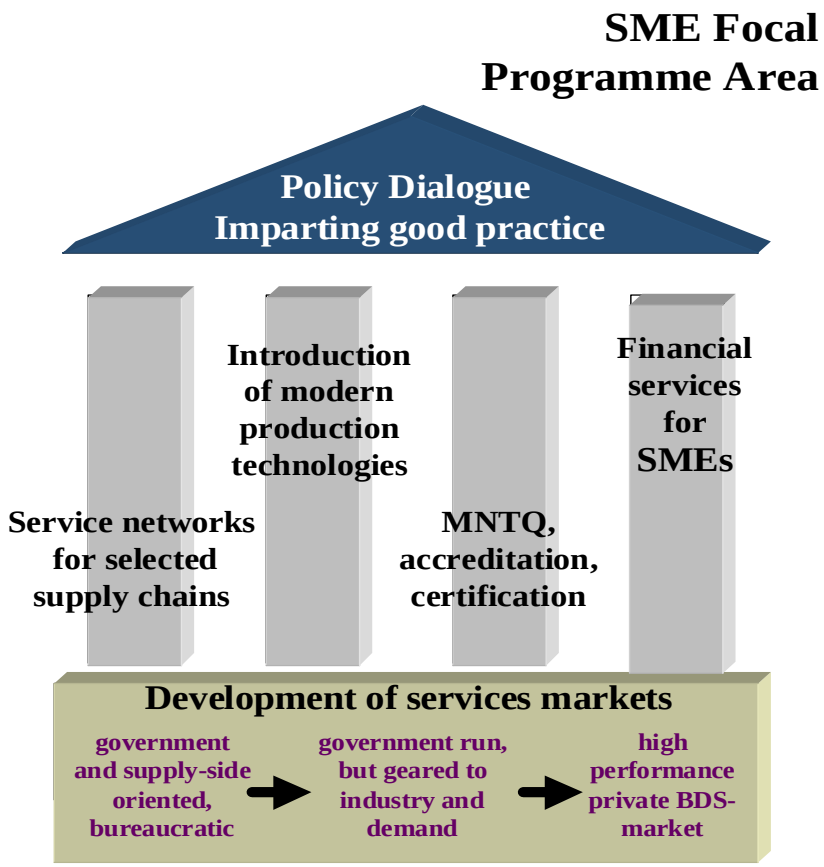
In such conditions, any effort to develop undistorted BDS markets faces serious constraints. Government agencies will eye new entrants to the service market with distrust rather than support them; these entrants will have to compete against heavily subsidized schemes; and customers will not easily be convinced to pay cost-covering fees. Donors should thus decide whether to withdraw cooperation in SME promotion altogether or to work with government agencies in order to make the system of public BDS provision more responsive to private sector needs, improve service delivery, induce competition, etc.

The latter option makes sense only if counterparts are seriously committed to implementing a number of necessary changes. In many countries, this commitment cannot be taken for granted, and antagonistic interests of bureaucracies that stand to benefit from the status quo are well-organized. Yet under certain circumstances windows of opportunity do exist. In Thailand, the Prime Minister himself has put administrative reform high on the political agenda. Some BDS institutions are required to become financially self-sustainable, most public institutions are obliged to define key performance indicators and monitoring systems, and the government has announced that future budget allocations will be more closely linked to evaluation results.

In this situation donor contributions may be very helpful. International agencies may help in providing examples of good practices for BDS delivery, promoting public-private dialogue, both at the level of general policy-making and of individual institutions designed to define principles of subsidiarity and division of tasks, and providing advice on issues of organizational development, e.g. how to establish M&E systems and modify incentive systems. Thai-German development cooperation has therefore identified a need to move from public sector-led to market-based service delivery as a general principle cutting across its different services schemes for SMEs and eco-efficient industries (Box 7).

For BDS practitioners, this raises a number of questions, e.g. as regards how to gain access to the political level of policy-making, how to influence performance criteria and incentive structures within public counterpart institutions, how government schemes may be used to strengthen private BDS providers, how best to handle the phasing out of temporary market interventions, etc. The reality in most developing countries is marked by highly distorted markets as well as by politicians and bureaucrats who pursue selfish interests. The matter at hand is therefore to manage a gradual transition from bureaucratic, supply-driven and subsidized modes of service delivery to more business-like modes rather than to try to implement policies aimed at undistorted markets. The following chapter presents some practical conclusions for such a gradual transformation.

Box 7: Market-based service delivery as an underlying rationale for Thai-German development cooperation



Source: Altenburg / Reinecke / Weihert (2002)

7 Practical Conclusions for Development Co-operation

In order to maximize the impact of development cooperation, all service providers involved in a given programme should have a common understanding of BDS delivery. What is needed is a consensus to move towards a more business-like and demand-led provision of BDS and involve more private suppliers, without falling into an uncritical market-optimistic opposite. To create this consensus and reach agreement on the terms of BDS delivery (e.g. criteria for public support, rates of subsidy, sequencing for out-phasing), there is a need for policy dialogue, not only among local service providers but also among donor organizations.

If provision of concrete BDS products is supported, mainly in cooperation with individual BDS-providing institutions, we consider **six aspects** to be of paramount importance:

1. **Market assessment and reasoned justification of any public intervention.** As we have argued above, well-intended government interventions may be harmful for the long-term development of BS/BDS markets as they may distort prices, create bad habits and even crowd out private competitors. For this reason, intervention, rather than non-intervention, in BS/BDS markets has to be legitimised on the basis of a clear analysis of the given situation. Donors should only support service provision schemes if partners provide convincing arguments for market intervention, and donors should require detailed information regarding objectives, means and time-frames. Awareness on

this issue within private sector organisations (chambers, associations) may be enhanced to help them identify politically biased service schemes that may be detrimental to the private sector (poor service quality and crowding out of private suppliers). Monitoring of the respective service markets should be repeated from time to time in order to phase out public intervention as private suppliers emerge.

2. **Separating funding from service delivery.** Some major problems with subsidised service provision arise when the service provider and the organisation managing and administering the funds are identical. Without any more or less complicated external supervision it is nearly impossible to commit this "system" to an efficient and cost-sensitive execution of its tasks. Inefficiencies often result from an explicit or implicit obligation to spend available funds in a given period of time, disregarding aspects bound up with a careful direction of the measures and the best possible cost-benefit ratio. In some ways, moral hazard is a feature inherent to this kind of "closed shop" service provider. Thus, separation of the two functions is important to raising effectiveness. Moreover, separation of funding and delivery functions reduces the risk of crowding out private service suppliers. This is especially the case when private service companies are able to apply for public funding. Such competition increases the transparency of service markets, thus providing additional information bearing on whether there still is a case for public intervention.

   Problems may arise when suppliers offer services that combine commercial and "strategic" elements and are therefore eligible for public co-financing. In practice, this is often the case; e.g. most business associations provide both public goods (basic sector-specific information, SME networking) and commercially viable services. The latter may be important to gain the necessary clientele recognition and to update technical expertise about sector-specific needs, which in turn are preconditions for efficient advocacy. Some development practitioners argue that their counterpart institutions have to offer subsidized information services in order to gain access to new customers. In such cases, full cost recovery cannot be expected because the respective services are seen as unavoidable advertising costs for the development of new service markets. It is therefore difficult in practice to trace the "transferred funds" and to exclude unfair competition in commercial services. To handle this problem without creating a complex and expensive monitoring system, it would be possible to set up an appeals body to review reported cases of unfair competition, e.g. within the funding organisation or within the national competition board.

3. **Improved accountability.** Many service providers offer a more or less ample set of different services, often without having established an accountability system to measure the cost and the income generated by each service offered. This situation may be detrimental to the service provider himself, because important resources may be dedicated to services that are not really relevant for the target group. It may also be detrimental to other (private) service providers, because a lack of accountability may lead to unintended unfair competition. It is therefore highly important to improve accountability and enable service providers to monitor market success and cost-related aspects of each and every service offered. Service providers with a public function or mission may then decide to cross-subsidise different services in order to maintain important services that cannot be provided on a cost-covering basis.

4. **Monitoring and evaluation of performance.** Given the built-in inefficiencies of bureaucracies, which are not exposed to competition and sometimes are given to pursuit of self-interests, public service provision needs continuous, transparent and independent monitoring and evaluation of performance. The two sub-systems of service provision – funding and delivery – need to be evaluated according to different performance criteria. Within the organisation that manages the funds, the cost-benefit ratio of the previously established objective(s) should guide the evaluation. At the level of service delivery the evaluation should be centred around the proven impact and the efficiency of provider-SME linkages.

   In parallel to the conceptual debate on BDS provision systems, there have been intense discussions over what "good performance" means for BDS and how it can be measured. Although substantial

progress has been achieved with the Performance Measurement Framework put forward by McVay,[17] serious methodological problems remain unresolved, e.g. as regards obtaining the necessary data and especially the measurement of service impact on SMEs,[18] given that it is difficult to prove clear causal connections between inputs and outcome ("attribution gap"). Moreover, there are trade-offs between different dimensions of performance (see Box 8). The proposed "performance triangle" helps to define priorities and establish performance criteria, but the remaining challenge is to design a performance measurement framework that is both reliable and manageable, and thus does not require overly extensive data sets.

5. **Establishing a direct link between performance and resource allocation**. Monitoring and evaluation are not an objective in their own right but should be used to continuously improve the system. The most effective way to ensure the system's responsiveness is to link the allocation of funds directly to the performance of its agents. The success of effective service providers is largely based on incentive systems that provide financial rewards for good performers. In the case of the Fraunhofer Society (FhG) in Germany, those FhG research institutes that successfully forge links with private companies are given additional public funding.[19] We propose that the two subsystems of service provision (funding and delivery) be governed by internal incentive systems based on appropriate performance criteria:

   — This would imply that decision-makers and staff in the funding organization should not be paid for spending funds in a certain period but that their remuneration should be based in part on the ratio of provable outcomes to invested funds. Where this is not possible, e.g. due to traditional remuneration systems in the public sector, other tangible incentives should be established, e.g. incentives related to the ratio between the funds controlled by organization teams or individuals and past performance. This kind of outcome-based incentive would induce managers and decision-makers to select the most promising service provider in those areas where competition exists and always to monitor the compliance of service providers with the agreed tasks or output.

   — The most powerful incentive for good performance on the level of service provision is competition between providers. There is no reason why service providers – even public or semi-public organizations – should not compete against one another for funding.[20] Depending on the kinds of service to be provided, different forms of competition may be envisioned. To avoid moral hazard, there would have to be clear and transparent evaluation criteria, and whenever possible third parties should be involved in the selection process. Competition should in general be founded on previous performance and/or presentation of the best (most targeted, most innovative, highest-outreach or -impact) business plan or plan of action. A demand-led and carefully directed approach would in this case be the natural reaction of the service providers.

17 See McVay (1999) and McVay (2000).

18 Levitsky (2000, 60); Tanburn (2002, 62); Reichert / Lempelius / Tomecko (2000).

19 See http://www.fhg.de.

20 Where this is not possible, e.g. in specialised technology service provision, where a "natural monopoly" exists due to indivisibility of equipment and low density of demand in DC, a clear performance-based system of internal incentives should be introduced within the organization itself.

Box 8: What performance should be measured?

The existing concepts of performance measurement consider various dimensions, namely *scale/outreach*, *impact* and *cost-effectiveness/sustainability*.

These three dimensions are treated as though they could be reached simultaneously and independently, so that overall performance would be the sum of outreach, impact and financial sustainability. We consider it necessary, however, to analyse the trade-offs between the different dimensions as well as to define priorities.

1. Financial sustainability vs. impact: As we have shown in our discussion of different forms of market failure (Chapter 3), there is a trade-off between the marketability, and thus the financial sustainability, of services and their "strategic character," which in some ways is the basis of its impact on target groups. It is evident that routine services, such as accountancy or laboratory testing, are easy to commercialise, either because their use is stipulated by law ("LRBS") or because the costs are relatively low and appropriability and predictability of results or outcome are high. Empirical observations indicate that former (non-sustainable) providers of high-end technology services may become (sustainable) providers of standardized services, e.g. in the area of consultancy, metrology and testing, once public funding is severely reduced. In fact, some of the Thai institutions that are obliged to become financially sustainable, like the Electrical and Electronics Institute, are increasingly focusing on standardized services, sacrificing specialized low-volume services. Without doubt, an adequate supply of standardized services is important for the competitiveness of industry. On the other hand, their impact on SMEs is limited to the resolution of day-to-day problems and easily perceived needs. Thus they cannot contribute to the "great leap" often necessary if firms are to be able to compete and survive under rapidly changing market conditions.

2. Outreach vs. financial sustainability: If we define outreach simply as the number of deliveries of a special service, outreach and sustainability may not be conflicting goals, because an increased number of deliveries gives rise to economies of scale and thus makes commercial success easier to attain. But outreach, the term used in BS/BDS related documents, has other connotations as well, and when it is used in this way, there definitely are trade-offs between outreach and financial sustainability. Let us first take the geographical connotation of the term. Many business services may be provided successfully in urban agglomerations, whereas they may remain far from the "break-even point" in rural areas, where solvent customers are rare and transaction costs high. In some markets, this problem may be resolved through concessionary models that oblige service providers to cross-subsidize from commercially attractive areas to areas that are required to be covered e.g. for social reasons. Outreach can also be defined with regard to special target groups. Empirical evidence shows that in pursuing a sustainability strategy service providers tend to target higher-income clients, "leaving a typical market gap in serving the poor".[a]

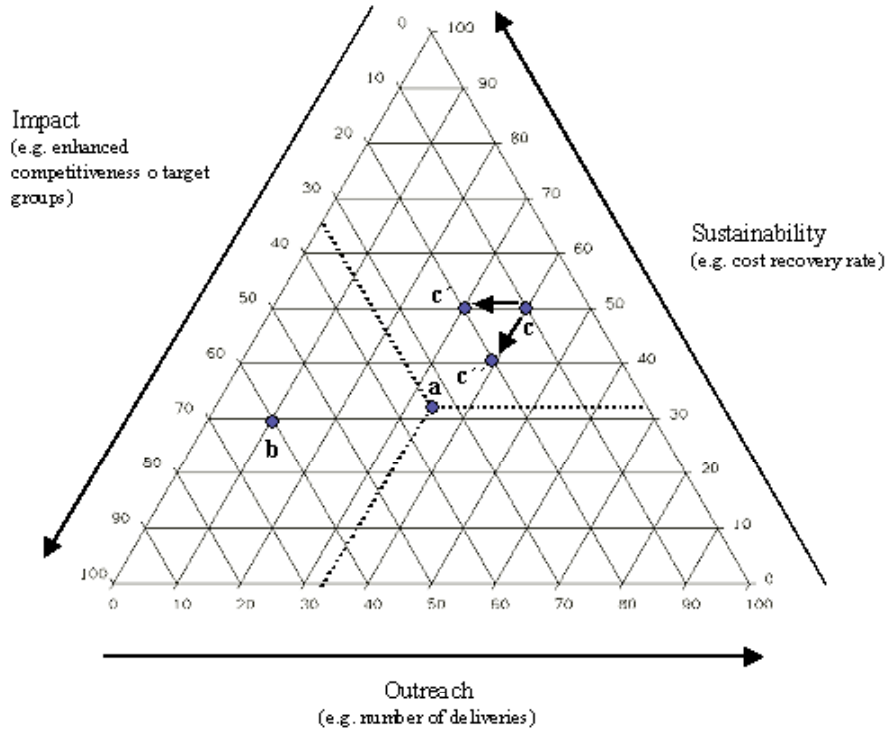
3. Outreach vs. impact: Finally, there often is a trade-off between the outreach of a service or a group of services and the expected impact on the target group. Many high-end services (e.g. technology generation and transfer) are highly specific in character and sometimes have to be developed and improved in close interaction with users. In this case, the outreach of the service (measured as the number of clients served or of "deliveries") will be limited as compared to more generic services, but impact may be high if the respective high-end services are essential for developing a competitive cluster of enterprises that generates substantial spillovers for the national economy.

Prior to any intervention in the local service market, objectives and performance indicators should be clearly defined. It should be kept in mind that the different dimensions of BS/BDS performance cannot be reached simultaneously and that priorities should be determined in advance. In most cases, this will not mean pursuing *only* impact or financial sustainability or outreach, neglecting the other dimensions, but it does imply a *weighted combination* of the three dimensions. We propose using the "performance triangle" as a tool helpful in visualizing priorities and establishing performance criteria in BS/BDS development. The instrument is useful in structuring discussions and reaching a common understanding of the priorities assigned to the three dimensions of performance.

a McVay / Miehlbradt (2000, 25); see also Tomesen / Gibson (1999)

6. **Compulsory co-financing.** To ensure ownership of the recipient SMEs with regard to the services provided, every transaction should be partly financed by the customer. The proportion of co-financing will depend on the character of the service and the final end of service provision. There are additional factors to be considered, such as the business environment and changes in the institutional setting. Services with predictable and appropriable outcomes should be largely financed by the customer, while in some strategic areas it will be necessary to step up the share of funds transferred. Also, external framework conditions are relevant: In cases in which the SMEs may be operating under conditions of economic growth, or at least stability, a higher proportion of private financing should be expected. On the other hand, whenever the macroeconomic conditions are changing rapidly, and competition is becoming life-threatening for many companies, governments or other funding organizations may opt for a higher share of subsidies, stressing short-term impact and outreach, and temporarily sidelining aspects of financial sustainability.

Graphic 1: "The performance triangle" – a tool to visualize outcome dimensions of BDS



How to read the diagram:
The "objective triangle" permits to visualize all possible combinations of priorities given to the three aspects of performance. Taking overall performance as 100% we break up this total into three fractions. Each combination is visualized as the intersection of the three respective percentage-lines. So, in the above triangle point a) represents a situation where the three aspects are given the same importance (33,3 %), point b) shows (high impact – low outreach, medium sustainability (60:10:30), point c) high outreach, high sustainability, but low impact (40:50:10).

Literature

Adler, I.. (2000): Spotty Training – By skimping on training, companies are paving the way toward expensive company losses, Mexico Connect Business, Commentary. http://www.mexconnect.com/ mex_/travel/ bzm/bzmadler26.html

Altenburg, T. et al. (2003): Strengthening knowledge-based competitive advantages in Thailand, Bonn

Altenburg, T. / W. Hillebrand / J. Meyer-Stamer (1998): Building Systemic Competitiveness. Concept and Case Studies from Mexico, Brazil, Paraguay, Korea and Thailand, Berlin (Reports and Working Papers 3/1998)

Altenburg, T. / D. Reinecke / U. Weihert (2002): Report on the Results of Preparations for the Programme "Improving Services and Business Environment for Small and Medium-sized Enterprises," Bonn, Oct. 2002

Audretsch, D.B. (2001): The Dynamic Role of Small Firms: Evidence from the U.S., World Bank Institute, Washington, D. C.

Chang, H.J. (1996): The Political Economy of Industrial Policy, Houndmills etc. (second edition)

Committee of Donor Agencies (2001): Business Development Services for Small Enterprises – Guiding Principles for Donor Intervention, Washington, D. C.

Esser, K. et al. (1996): Systemic Competitiveness : New Governance Patterns for Industrial Development, London, Portland (GDI Book Series No.7)

Goldmark, L. (1999): The financial viability of Business Development Services, in: *Small Enterprise Development* 10 (2), 4–16

Levitsky, J. (2000): Asian meeting on BDS for small enterprises, in: *Small Enterprise Development*, 11 (3), 58–60

Malmberg, A. / P. Maskell (2001): The Elusive Concept of Localization Economies. Towards a Knowledge-Based Theory of Spatial Clustering, paper presented at the 2001 Annual Meeting of the Association of American Geographers, New York

McVay, M. (1999): Measuring BDS performance – a Summary Framework, in: *Small Enterprise Development*, 10 (2), 17–29

McVay, M. (2000): SME Marketing Programs: Trends, Lessons Learned, and Challenges Identified from an Analysis Using the BDS Performance Measurement Framework, paper presented at: Business Services for Small Enterprises in Asia: Developing Markets and Measuring Performance, International Conference, Hanoi, Vietnam, 3–6 April 2000

McVay, M. / A. O. Miehlbradt (2000): Emerging Good Practices in Business Development Services. The First Annual Seminar Turin Italy, 4–8 September, BDS Seminar Reader

Mifflín, I. (2001): IV Encuentro Latinoamericano: "El Mercado de los Servicios de Desarrollo Empresarial para la Pequeña Impresa: Subsidio o Rentabilidad?, Documento Base, Antigua, Guatemala del 10 al 12 de diciembre del 2001

Mikkelsen, L. (1999): Marketing MSE products – Cases from Latin America. *Small Enterprise Development*, 10 (4), 16–26

Phansalkar, S.J. / M.S. Sriram (2001): Business development services for small enterprises – a study of Hyderabad, India, in: *Small Enterprise Development*, 12 (2), 32–54

Pietrobelli, C. / R. Rabelotti (2002): Business Development Service Centres in Italy: An Empirical Analysis of Three Regional Experiences – Emilia Romagna, Lombarda and Veneto, CEPAL, Productive Development No. 130, Santiago de Chile

Reichert, Ch. / Ch. Lempelius / J. Tomecko (2000): The Performance Measurement Framework (PMF) for Business Development Services (BDS) applied to CEFE projects in Laos, Thailand and Sri Lanka, Sri Lanka-German CEFE Program: information Series 25, Colombo

Tanburn, J. (2002): Developing commercial markets for Business Development Services – Highlights of the Turin Seminar, September 2001, in: *Small Enterprise Development*, 13 (1), 58–64

The Brooker Group (2002): Strengthening the Effectiveness of the Policy Formulation Process, Bangkok, mimeo

Tomecko, J. (2000): Using market-led tools in the design of BDS interventions in Nepal, in: *Small Enterprise Development*, 11 (3), 47–57

Tomesen, L. / A. Gibson (1999): AMKA, Tanzania – Export Market Development Services for SMEs, in:. *Small Enterprise Development*, 10 (4), 46–55

Schriften des Deutschen Instituts für Entwicklungspolitik (DIE) in der Nomos Verlagsgesellschaft

Brandt, Hartmut / Uwe Otzen: Armutsorientierte landwirtschaftliche und ländliche Entwicklung, 342 p., Nomos, Baden-Baden 2004, ISBN 3-8329-0555-3

Messner, Dirk / Imme Scholz (Hrsg.): Aktuelle Herausforderungen für die Entwicklungspolitik, 410 p., Nomos, Baden-Baden 2004, ISBN 3-8329-1005-0

[zu beziehen über den Buchhandel]

Schriftenreihe des Deutschen Instituts für Entwicklungspolitik (DIE) im Weltforum Verlag

116 *Neubert, Susanne*: Die soziale Wirkungsanalyse in armutsorientierten Projekten. Ein Beitrag zur Methodendiskussion in der Evaluationspraxis der Entwicklungszusammenarbeit, 139 p., Köln 1999, ISBN 3-8039-0487-0

117 *Scholz, Imme*: Nutzung natürlicher Ressourcen zwischen Raubbau und Nachhaltigkeit: Sozio-ökonomische Bedingungen und unternehmerische Handlungsmuster, 446 p., Bonn 1999, ISBN 3-8039-0492-7

118 *Ashoff, Guido*: Der Entwicklungshilfeausschuss der OECD und die deutsche Entwicklungszusammenarbeit: ein Verhältnis auf dem Prüfstand, 182 p., Bonn 2000, ISBN 3-8039-0497-8

[zu beziehen über den Buchhandel]

Berichte und Gutachten des Deutschen Instituts für Entwicklungspolitik

1/04 *Altenburg, Tilman et al.:* Strengthening Knowledge-based Competitive Adventages in Thailand, 116 p., Bonn 2004, ISBN 3-88985-262-9

2/04 Eldaw, *Ahmed Mohamed:* The Gezira Scheme: Perspectives for Sustainable Development, 60 p., Bonn 2004, ISBN 3-88985-262-9

3/04 Klingebiel, *Stephan / Katja Roeder:* Entwicklungspolitisch-militärische Schnittstellen. Neue Herausforderungen in Krisen und Post-Konflikt-Situationen, 50 p., Bonn 2004, **D:** ISBN 3-88985-263-7, **E:** ISBN 3-88985-265-3

4/04 *Rodenberg, Birte*: Gender and Poverty Reduction. New Conceptual Approaches in International Development Cooperation,. 73 p., Bonn 2004, **E:** ISBN 3-88985-264-5, **D:** ISBN 2-88985-257-2

5/04 Klingebiel, *Stephan / Katja Roehder*: Development-Military Interfaces. New Challenges in Crises and Post-conflict Situations, 48 p., Bonn 2004, **E:** ISBN 3-88985-265-3, **D:** 3-88985-263-7

6/04 *Grävingholt, Jörn*: Krisenpotenziale und Krisenprävention in Zentralasien. Ansatzpunkte für die deutsche Entwicklungszusammenarbeit, 74 p., Bonn 2004, **D:** ISBN 3-88985-266-1, **E:** ISBN 3-88985-273-4 (Studies 1)

7/04 *Leiderer, Stefan*: Öffentliches Budgetmanagement in Entwicklungsländern: Analyseinstrumente und Ansatzpunkte der programmorientierten Entwicklungszusammenarbeit, 81 p., Bonn 2004, ISBN 3-88985-267-X

8/04 Brandt, *Hartmut*: Probleme und Tendenzen der Agrarpolitik in Subsahara-Afrika, 87 p., Bonn 2004, ISBN 3-88985-268-8

9/04 *Goedeking, Ulrich*: Staatliche Regulierung des Engagements deutscher zivilgesellschaftlicher Organisationen und ihrer Partner in Entwicklungs- und Transformationsländern: Re-

striktionen und Reaktionsmöglichkeiten der deutschen EZ, 52 p., Bonn 2004, ISBN 3-88985-269-9

10/04 Qualmann, *Regine et al.*: Negotiating Economic Partnership Agreements with the EU. Opportunities, Risks, and Negotiation Options for Tanzania, 70 p., Bonn 2004, ISBN 3-88985-270-X

11/04 *Scholz, Imme et al.*: Sociedade civil e política ambiental na Amazônia. Os casos da berragem de Belo Monte e da rodovia federal BR-163, 85 p., Bonn 2004, **P:** ISBN 3-88985-272-6, **D:** ISBN 3-88985-260-2

[Schutzgebühr: 9,63 Euro; zu beziehen beim DIE oder über den Buchhandel. Diese Schriftenreihe wurde eingestellt und ab November 2004 durch die neue Schriftenreihe „Studies" ersetzt]

Neue Publikationsreihen ab November 2004:

Studies

1 *Grävingholt, Jörn*: Crisis Potentials and Crisis Prevention in Central Asia. Entry Points for German Development Cooperation, 122 S., Bonn 2004, **E:** ISBN 3-88985-273-4, **D:** ISBN 3-88985-266-1 (Berichte und Gutachten 6/04)

2 *Herrfahrdt, Elke:* Landwirtschaftliche Transformation, Desertifikation und nachhaltige Ressourcennutzung. Fallbeispiel Usbekistan, 134 S., Bonn 2004, ISBN 3-88985-274-2

[Schutzgebühr 9,63 Euro; zu beziehen beim DIE oder über den Buchhandel]

Discussion Paper

1/2004 *Stamm, Andreas*: Schwellen- und Ankerländer als Akteure einer globalen Partnerschaft. Überlegungen zu einer Positionsbestimmung aus deutscher entwicklungspolitischer Sicht, 33 S., Bonn 2004, ISBN 3-88985-272-6

2/2004 Scholz, *Imme*: Waldkonvention – ja oder nein? Stand und Perspektiven der weiteren Verrechtlichung internationaler waldpolitischer Vereinbarungen, 33 S., Bonn 2004, ISBN 3-88985-275-0

3/2004 *Faust, Jörg / Dirk Messner:* Europe's New Security Strategy – Challenges for Development Policy, 23 p., Bonn 2004, ISBN 3-88985-276-9

5/2004 *Roehder, Katja*: Entwicklungspolitische Handlungsfelder im Kontext erodierender Staatlichkeit in Subsahara-Afrika, 40 p., Bonn 2004, ISBN 3-88985-278-5

[Schutzgebühr: 5,35 Euro; zu beziehen beim DIE oder über den Buchhandel]

D: = Deutsch **E**: = Englisch **P**: = Portugiesisch

Eine vollständige Auflistung erhältlicher Publikationen des DIE finden Sie unter: **http://www.die-gdi.de**