

**Towards an effective provision of business services –
Strategies for Thai-German development cooperation**

Study on behalf of GTZ Thailand, project:
Business Development Service Networks for SMI

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Bonn, July 2003

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Introduction

Thai-German development co-operation is focussing on two focal programme areas: “Improving Services and Business Environment for Small to Medium-sized Enterprises” and “Stimulating Eco-efficiency of Industry”. Both programmes aim at providing better business services for small, mainly manufacturing firms, assuming that an adequate provision of such services is a key factor to enhance the dynamics of the private sector and especially of Small and Medium-sized Enterprises (SME).

At the international level, especially among donors involved in development cooperation, there is an intense debate on the best way of achieving a widespread, high-quality and affordable supply of services which help to improve the performance and consolidate the competitiveness of SME. These services are called *Business Development Services* (BDS). This discussion is gaining momentum as the availability of public funds decreases while the pressure for modernization of SME in developing countries rises. The obvious failure of governments and donor agencies to significantly improve the supply of services for SME 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.

Thailand’s SME services are still largely being provided by public agencies. These institutions by and large show many of the deficiencies – low quality, high cost, limited outreach, lack of customer orientation, market distortion, etc. – typically attributed to state bureaucracies. What’s more, several donor agencies, especially the Japanese, but in part also the Thai-German programmes, are subsidizing the old bureaucratic and market-distorting service institutions. Thai-German government negotiations addressed this problem, but it is quite clear that it won’t be possible to change things in the short run. Implementing a market-oriented policy for SME services will require a long process of raising awareness, changing habits and incentive systems and building capacities. As stated in the respective mission report:

The new paradigm “... poses a challenge for the [Thai-German] programme, whose projects all cooperate with government counterpart institutions in compliance with the explicit requirement of DTEC, but are, however, not yet clearly geared toward a market-oriented institutional policy. Under the present circumstances, the first best option in development-policy terms – developing efficient private markets for SME services – is a very long-term goal at best. A realistic aim as part of the programme, though, is to contribute to professionalizing the management capabilities of the government partners by systematically catering for principles such as customization, competition neutrality and financial sustainability in new services (second best option).”¹

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

1 Altenburg / Reinecke / Weihert (2002)

- how to confront the phenomenon of “public goods”, where market forces cannot be expected to provide the socially optimal solution; what can be done in real world-conditions, where the first-best solution of an efficient and differentiated market for business services has not yet developed;
- how the transition from a government- and supply-side oriented, bureaucratic system to high-performance private BDS markets can be managed;
- how practitioners deal with the fact that support programmes use to be superposed by political interests.

The present document has been written on request of GTZ Thailand. It takes up the conceptual debate on BDS market development and discusses its usefulness for the Thai case which is – like most developing countries – characterized by a very traditional state-led approach to BDS provision. This exercise allows us to address the issues raised above and test the relevance and scope of BDS recommendations in the real world. For instance, we will take a differentiated look at the types of services that shall be provided. This helps to single out situations where BDS may indeed be provided on a pure market base, and where donor intervention should thus be limited to assist the creation of these markets. On the other hand it helps to understand that with respect to a series of highly important BDS, especially those related to SME, market failure is a reality and not only a lame excuse for governments to maintain an expensive and inefficient public service sector. Moreover, the article addresses the political dimension of BDS provision which is important to understand why governments and donors do not always follow the recommendations derived from technical best-practices and discusses what practitioners can do in those (quite common) situations where BDS markets already are distorted and where politicians and bureaucrats are not willing to leave BDS provision to market forces. All in all, our study thus highlights the difficulties to translate the textbook recommendations to the real world. This leads us to policy conclusions which may not be as spectacular as the “new paradigm”, but more realistic for implementation in the given institutional and political context of contemporary Thailand and other countries with similar institutional settings.

The study is based on desk research about the BDS concept and the available empirical evidence. In addition, interviews have been conducted with several GTZ project managers and Thai counterparts during spring 2003. For the general assessment of Thailand’s institutional performance concerning business services we draw on a parallel GDI research project with a much broader empirical base.²

Chapter 1 summarizes the new BDS paradigm, presenting the main arguments that question the traditional way of state or donor-led service provision as well as the policy conclusions made by the proponents of the BDS market approach. Chapter 2 then identifies four conceptual as well as practical limitations of this school of thought. The following chapters 3-6 elaborate on these four critical arguments. Chapter 3 discusses the distinction between public and private goods and argues that some business services are at least partially public goods, 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 pro-

2 Altenburg et al. (2003)

viders. These interactions increase specialization and deepen the division of labour, thus contributing to productivity growth, innovation and competitiveness. Government action to accelerate this process may consequently spur economic development. Chapter 5 demonstrates that service provision for SME is a political issue. Some politicians and bureaucrats pursue self-interests which may not be concordant with the new paradigm of undistorted private service markets. The development of such markets is therefore no technocratic project but requires political bargaining. In chapter 6 we state that the development of service markets never starts from scratch. Usually a number of subsidized and often bureaucratic service providers are established. Therefore we discuss the challenge of how to propel these service providers towards business-like modes of service delivery. Finally, chapter 7 draws some conclusions for Thai-German development co-operation.

1 The new paradigm of BDS markets

For SME in developing countries the ability to link with other companies or institutions that provide them with the assets they cannot produce themselves and that permit to increase flexibility and reduce costs is a crucial condition for competitiveness. This is one of the essential findings of the “systemic competitiveness approach” but also of the research on industrial clusters and districts.³ Many of these external linkages include the provision of some kind of *service* to the SME.⁴ 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 came 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.”⁵

The Donor Committee criticizes the traditional way of providing services through public or semi-public entities. The most important alleged weaknesses are:

- *Lack of financial sustainability.* Most services are being delivered on a highly subsidised basis. Service providers thus depend on continuous public support. As most countries are cutting down public expenditure, many support measures have to be withdrawn or substantially reduced.
- *Insufficient outreach.* Even in times of 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 function according to the logics of public administration, e.g. budget allocation is not linked to programme performance, employees do not behave like business persons, and beneficiaries are not treated as clients. Incentives – both for the supporting institution in general and for the

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

4 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.

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

- personnel working within these institutions – are often not designed to actively search linkages with the business sector and to strive for clients’ satisfaction.
- *Bad quality.* As service providers and clients work according to different incentive systems, operative routines, and even with different mindsets, service supply is often not tailored to the needs of the clients. In addition, products delivered at low cost or for free may “ induce a debilitating dependency and cynicism over quality and value.”⁶
 - *Crowding-out of private competitors.* Service delivery on a highly subsidized rate 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
<p>Government BDS programs in Thailand are mainly driven by bureaucratic decisions, reflecting weak private sector involvement in program design as well as incentive structures within implementing agencies which neither create a service mentality nor enhance networking with industry. Many subsidies are allocated for hiring university professors, although these usually don’t have 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 esteem for these programs.</p> <p>The lack of business orientation in policy design and delivery results in low outreach and impact of programs. Even the most prominent SME programs, such as the Invigorating Thai Business (ITB) or the Industrial Technology Assistance Program (ITAP), cater for a few hundred SME only, thus reaching a very small percentage of their potential target group. The same applies for instance to lab services (e.g. under the Electrical and Electronics Institute) or the few existing business incubators.</p> <p>Programs and implementing agencies are almost never financially sustainable, which means that activities suddenly expire when agencies run out of funds. The ITB program subsidizes 90 % of consultancy costs, the preceding Miyazawa program, funded by the Japanese government even covered 100 %. In the case of ITAP, donor countries provide senior experts to SME, asking 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, such as tax consultancy or accountancy), this may partly be attributed to the fact that generous subsidies undermine the willingness of customers to pay for services.</p> <p>The current government is committed to improve the delivery of public services. It obliges some institutions to substantially raise service fees in order to become financially sustainable. Moreover, for the first time in Thailand it aims at introducing performance-based budgeting which requires the definition of performance indicators and introduction of monitoring and evaluation systems. Implementation, though, is still in its beginnings.</p>
<p>Sources: Altenburg et al. (2003) ; The Brooker Group (2002)</p>

High cost and low impact can 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 SME:

6 Gibson (1999), p. 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.”⁷

The new paradigm of BDS markets highlights the need for services to be provided at cost-covering rates and by providers who act in a demand-driven and business-like manner. Service providers should either be private companies or public entities which are organized like firms in terms of their incentives systems, their personnel, culture and attitude. 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 financial sustainability of the provider. This presupposes that BDS organizations dispose of systems of cost analysis which enable them to determine the total cost and the adequate price for each service product. There should be competition among service providers in order to oblige them to constantly improve on performance. In any case it should be avoided to intervene in well established service markets delivering subsidized products that distort markets and jeopardize other providers. Where service markets have not yet evolved, governments (or donors) should try 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

Without doubt, the potential of market forces has been underestimated or even neglected in development co-operation in the past. The new paradigm as expressed in the “Guiding Principles” has important merits for showing that BDS systems should operate as closely as possible to market relations to avoid misallocation of resources, to optimise cost-benefit ratios and to avoid crowding out of private service providers. Yet the questions remain 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 that they neglect the political dimension of service provision. As a result, they are not very helpful for development practitioners who

- need to distinguish which services are fully private goods the provision of which should be left to market forces, and where government (or donor) intervention may be needed, and
- want to know how to manage the transition towards a more demand-oriented service supply in a real world which is characterized by political interference, the existence of

7 See Committee of Donor Agencies (2001), p.1.

bureaucratic institutions providing market-distorting service programs, and SME customers which are used to receive government services for free.

Four points need to be taken into account that limit the scope 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 substantial fees, many services are not being provided on a cost-covering basis.⁸ In developing countries, market failure may be even more pervasive. Thus it should be carefully distinguished which services are actually pure private goods and may and should be provided on a market base, and where governments should intervene to maximize welfare. What makes things more complicated is that textbook distinctions are not very helpful. The degree of “public good” 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 very diversified private service sector has developed over time. This is the result of a cumulative and interactive process, where increasing product differentiation, shorter product cycles, the emphasis on customer-specific solutions etc. have spurred the development of business services, and vice versa. In the reverse case of less developed countries we often observe a vicious circle where scarcely differentiated, simple non-service sectors do not create demand for advanced services, and lack of such services restricts competitiveness. The questions are thus: even if a certain type of service could and should in the long run be delivered under market terms, isn't there a case for temporary market intervention in order to develop markets and get the above mentioned dynamism going? Can SME 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 SME is a political issue.** Governments sometimes provide BDS for political reasons, e.g. to demonstrate public action and gain support of local communities or certain target groups for the government or the ruling party. In such cases, they may not pursue the goal of developing BDS markets, even if this was the most efficient option. Negative impacts of market distortion or lack of financial sustainability would then be traded for the political advantages of increasing legitimacy. Moreover, bureaucrats working at the level of implementing agencies may act as rational and selfish agents who are mainly interested in maximizing the budget of their bureaux and secure their jobs and salaries. It would therefore be naïve to believe that political decision-makers, funding agencies and implementing bodies would change

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

their behaviour once the optimal degree of market intervention in technical terms has been defined.

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

In the next 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 which 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.

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. Until now, however, no empirical evidence can be found, that a broad and well-functioning provision of high-impact services within a merely market based system might be achieved in an appropriate period. 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 our considerations 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, such as:

- an insufficient flow of information within the societies that may impede that new market opportunities or other urgent challenges (e.g. the need to adapt to international standards) be quickly identified and action be taken accordingly;
- insufficiently developed skills and physical capacities to provide services of an adequate quality;
- the crowding out of private suppliers due to 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 to create private BDS markets, as outlined in the “Guiding Principles” and related documents. Still we question the assumption that all kinds of services provided to businesses may be considered as purely private goods. Posing this question does in no way imply to defend the traditional system of public service provision, even if in the past “market failure” and the “public goods character” of business services were often used as a lame excuse to establish and maintain paternalistic and top-down systems of service provision. There is no “way back” to the old model and to the old way of thinking, however, avoiding a sober and profound analysis of the potential and limits of market relations is not promising either.

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 should autonomously decide which kind of services to provide and in which way. On the contrary, it is recommendable that developing countries’ governments limit their interventions to those activities where 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 SME.

However, in those cases, where a sober analysis indicates that market failures will impede a market-based provision of BDS to SME, a long-term engagement of public agents might be 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, crowding out of private service suppliers should always be avoided and public funds should be utilised in a way that maximises 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”. A revision of the literature⁹ and unpublished case studies reveals that the projects and programmes implemented by the international donor community work with a wide range of different services provided to businesses. The following list is by far not complete, but BDS may include:¹⁰

- training of entrepreneurs and employees,
- consultancy and advisory services geared towards management capabilities,

9 See for instance the BDS documents listed on the CEFE-Homepage (<http://cefe.gtz.de>).

10 We consider, however, that some transactions treated in a series of BDS-papers should *not* be labelled “services”, e.g. the commercialisation of Small Enterprises’ (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 of B to A (e.g. advisory in design or quality management, see e.g. Mikkelsen 1999) but in itself constitutes the formation of a value chain and not a service.

- marketing consultancy and marketing of products on a commission basis,
- provision of information in an ample 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 different characteristics it is inevitable to group these services before we can discuss whether they are likely to be provided on a commercial basis or not. The Donor Committee proposes a differentiation in *operational* and *strategic* services, where the operational services are those needed for day-to-day operations while strategic services are used by the enterprise to address medium- to long-term issues in order to improve the performance of the enterprise, its access to markets, and its ability to compete. This provides a useful first approximation to the issue. Yet we consider it important to look more thoroughly at the reasons why an enterprise may be willing to obtain a service and pay for it in order to come up with a more detailed differentiation¹¹ and discuss some characteristics which are relevant for the marketability of the respective group of services.

3.3 Operational business services

Operational business services (**OBS**), according to our differentiation, are mainly private goods and have a direct and predictable outcome on the 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 label **Basic Operational Services (BOS)**, vary in time and space but can quite easily be defined in any given situation. The BOS may be subdivided into services that necessarily have to be obtained externally (telephone, grid electricity) and those that may also be provided internally, like the transport of inputs and final products. In the second case it depends on a (sometimes complex) “make or buy”-decision whether a service linkage will emerge.
- A second, rather small group of OBS are those which an enterprise (usually from a certain size upward) necessarily has to contract to comply with laws and regulations. The most important of these “**Legally Required Operational Services**” (**LROS**) are notary and accounting services as well as the use of certain laboratories and certifying agencies. Usually for SME the contracting of external providers is the only viable way to ob-

11 A similar structure is presented in Mifflln (2001), p. 7f.

tain these services since the volume of their operation does not permit the permanent employment of specialists in these areas.

- A third group of OBS, even if 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 for this kind of “**Advanced Operational Services**” (AOS) are the contracting of a specialist in product design, the introduction of an Enterprise Resource Planning software or the 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 a private good 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 the good or service. These characteristics are clearly given. When a company buys a telephone line, it will be the registered owner of the line and can 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 without also sharing the costs (LROS). And when a small textile company contracts some hours of work with a specialized equipment to make high quality buttonholes or computerized embroidery¹² 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 will be the concrete *result* of the investment, even if he may not always know the *outcome* on his enterprise’s performance. Therefore the two parts may define relatively clearly – prior to contracting the service – the terms of reference of the relationship and what will be 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 the opportunity to talk to previous clients (as in the case of customised ERP software).

Due to the private and search good character, 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.”¹³ Still, we argue that even in OBS market failure exists, and 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 toward market creation, taking into account that in principle these OBS should be marketable. OBS provision may not be adequate and affordable because:

- Due to low consumer density and purchasing power, rural areas are often under-served 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

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

13 See Committee of Donor Agencies (2001), p.1.

combination of liberalisation, regulation of markets and selective subsidies is usually adequate to improve the density of service supply even in distant areas of developing countries.

- 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 about the basic conditions of the market. He may misjudge the potential benefit 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.¹⁴
- With respect to some OBS, SME may suffer from indivisibility problems on the supply side. Specialised laboratories, packaging or warehousing services may need a minimum of product movement to cover the fixed operation costs. In these cases, it may be difficult for SME to find an adequate service supply in their area of operation.¹⁵

3.4 Strategic business services

Strategic business services (SBS) are services that enhance the long term capacity of the 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, 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-termed* rather than short-termed and finally *uncertain* and in many cases *unpredictable*. Due to these characteristics, market failure is evident and it is unlikely that the market creation approach may work:

- Many SBS suffer from *non-appropriability*. Therefore the social return from investment is largely higher than the private return. In other words: Relying exclusively on private decisions, investment in these services would be less than socially desirable. This is true for R&D services, training and information provision, where private investments may even benefit the competitors due to labour turnover or leakage of know-how. In some cases, the expected positive impact is not so much related to the individual enterprise but to collective entities (e.g. cluster policies, promotion of certain locations) or even to public goods (e.g. the introduction of Environmental Management Systems).
- Some SBS, namely consultancy and business advisory, have a highly uncertain and unpredictable outcome that cannot be assessed prior to the transaction. This means, the decision maker (in contrast to the above mentioned *search goods*) is not only facing risks – as he does in each and every investment decision – but he faces risks without being able to assess the potential benefits and dangers. Either must he rely on the service provider that the expected outcome will actually be reached (*trust goods*) or he may be willing to contract the service because of positive results in the past (*experience goods*).

14 Phansalkar / Sriram (2001), 54.

15 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 fulfil their functions in an effective, efficient and quality-oriented way. When employees receive 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 the training. It is evident that in countries that suffer from a lack of qualified human resources and where the fluctuation of personnel tends to be high, the risk that trained people may change 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 when deciding about whether or not to train his personnel, the entrepreneur has to take into account the highly realistic risk that he will pay for the training while his competitor will benefit from the results. This is an obvious case of “non-appropriability” and thus, of market failure.¹⁶

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 way, training might 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 easily to recover, like language courses. (see e.g. Adler 2000).

While the private benefit of training might 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 working 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 well-functioning training system.

A similar situation can be found with regard to **information** provision to SME. This may happen in very different ways, reaching from the 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 be no 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, like 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 to remain the only beneficiary of the information is rather low. Even in the industrialised countries it is very difficult to maintain strategic business information as a secret; usually “know-how-drain” cannot be avoided. This is even more the case in countries where intellectual property rights are not effectively being enforced.

Donor intervention often tries to respond to the problem of uncertainty either by generating trust relationships between service providers and recipients or by subsidising the first utilisation of a special service, expecting repeated transactions due to the experiences generated. Both measures are useful when there is a sufficient number of service providers that deserve the trust and that may actually be able to provide high-quality services to an affordable price.

16 The exception can be seen in the case, where 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), p. 51f.

To accurately assess this may be, however, very difficult not only for the SME itself but also for donors and service facilitators, especially when new kinds of services shall be offered and new service providers enter the market. In the case of misjudgements or a severe discrepancy between promised and real outcome, the facilitation of personal contacts or first experiences may, contrary to what is intended, result in disincentives for further service contracting.

Regarding the concept of subsidising first service contracting and subsequently outphasing the public or donor support, additional problems may arise because many, especially high-end BDS are – due to their character and content – not to be utilised repeatedly, especially in the case of SME. A small company may contract a consultancy for the purpose of re-engineering its production process. Once this is accomplished, there will probably be no need for a second re-engineering for quite a long time. This may be very different in the case of large branch firms that may restructure their processes subsequently, thus capitalising the experiences of foregoing consultancies when contracting 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 of “market creation through the generation of positive experiences” may find its limits in the low demand of repeated service provision.¹⁷

3.5 OBS and SBS: a gradual difference rather than a clear-cut distinction

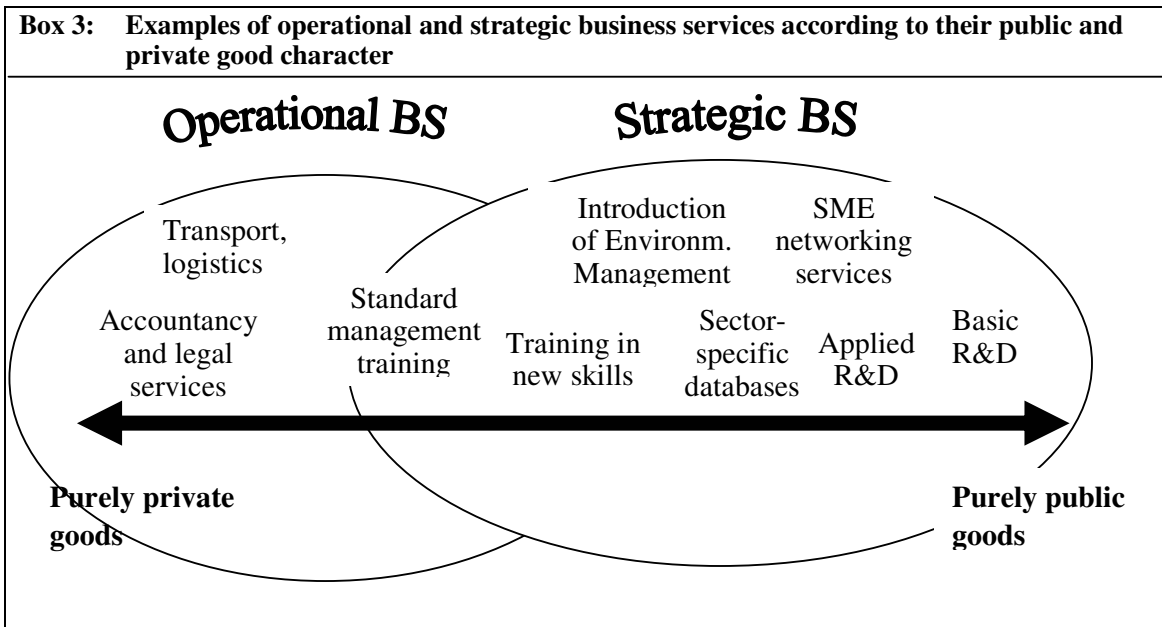
The distinction between different types of OBS and SBS makes it easier to discuss the private or public goods character of each and every one of the services and thus the possibility that they may be provided on a merely commercial basis and the necessity and possible ways of donor interventions. Nevertheless, 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 to associate special services with one of the mentioned groups:

- How would we e.g. classify the advisory service that prepares an enterprise to be certified by the norms of ISO 9000ff? On the one hand, the process clearly enhances the long-term internal capacities of the company, thus suggesting a 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 demarcation between BOS and AOS will not remain unaltered with time. Many services like grid electricity or the access to a telephone that may today be considered as basic at least for formal enterprises of a given minimum size might have been seen 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 probably a basic business tool in only a few years.

17 A non-traditional approach in the same direction is at present implemented by the GTZ “Small Enterprise Development Project” in the Palestinian territories. Here SME are provided for free a comprehensive business diagnosis, with the expectation that this may raise the awareness of the needs to contract specialised consultancy.

- Transport may be considered a BOS for all goods producing enterprises, but may as well contain strong elements of an AOS, when 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 expressed in box 3. Secondly, because the categorization – and thus the inherent degree of public good as well as the marketability of a given business service – depends on many specific circumstances, e.g. the general development level and locational factors. Nevertheless, it provides elements which help us to differentiate where market-led BDS provision is likely to work.



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 product differentiation, shorter product cycles and the development of new markets possible. Innovation is a cumulative and interactive process. As economic structures become more differentiated, and intangible assets (such as knowledge, experience, brand image) more important, the innovation process becomes much 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; companies form strategic alliances to perform joint research or marketing; linkages between the private sector and public research centres, regulatory bodies and other institutions become much denser; and the “turbulence”¹⁸ in enterprise structures increases, what becomes evident when we look at the number of mergers, acquisitions and spin-offs. Under these dynamic conditions network coordination – e.g. knowledge flows, harmonization of interests, management of logistical interfaces – becomes crucial. This calls for differenti-

18 Audretsch (2001), p. 11ff.

ated and efficient BDS which are 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 developed in most countries of the south. Developing countries typically lack competitive firms, and the degree of interfirm and institutional specialization is low. This brings about a vicious circle, where 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.

From this perspective, a minimalist approach towards government action to support BDS may not be adequate. Considering the long periods required for interactive productive systems to develop and 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 setting of national standards, enforcement of laws and regulations, organization of consumers 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 tries to create the preconditions for a new service market in a situation where both supply and demand are still negligible.

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 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 being 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 specialized service providers are hardly available in Thailand.

At the firm level, GTZ currently works with 12 “pilot companies” only. 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. All in all, the introduction of EMS does not conform with the Guiding Principles of BDS.

Nevertheless, it 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 to improve 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; establishment of a complaint centre where citizens can denounce environmental offences, thus generating pressure for companies to adopt cleaner technologies. If this approach succeeds (which mainly depends on the political will to pass and enforce stricter environmental laws) it will create demand for, among others: laboratory services, auditing and certification services; engineering services, emission control, monitoring, and management training. Already at this early stage GTZ tries to train and work with private local service providers wherever possible.

Source: Interviews with GTZ program staff

Many public service providers in Thailand (including GTZ projects) justify their intervention on the grounds of deepening and upgrading the productive structure. The necessary specific services for these new and more demanding activities are not yet locally available. In these cases, providers argue that their services – although being 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 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 confront this trade-off.

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 try to avoid this effect. For example, the Senior Expert Service and CIM claim to second experts only if the respective expertise is not available locally. Yet in practice it is impossible to scrutinize 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 compete in the Thai market, trying to place experts from their respective home countries. This situation does not favour due diligence. Companies may even turn to different agencies to receive several successive consultancies almost for free. Still, program 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 partially be provided by local service providers. The net effect of the primary intervention would then be market-creating.

GTZ projects in Thailand seem 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 who lack a business-oriented attitude. In some cases, though, projects make 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. Finally, most GTZ managers try to convince their counterparts of a more market-oriented approach and establish Good Practices in line with the principles of the International Donor Committee.

Source: Interviews with staff of the relevant institutions

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 guarantee adequate employment and living conditions in peripheral regions and avoid rural-urban migration.

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 in order to enhance 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 the 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 privatizing BDS markets and 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 their 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 with a liberal discourse.

<p>Box 6: Political “pet projects” in Thailand</p> <p>In Thailand, politicians have designed some BDS programs which have obviously been designed to gain political support rather than achieving maximum efficiency. Some programs 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 in order to increase the efficiency of service delivery, higher levels of government often interfere with politically motivated ad-hoc decisions, leaving questions about policy coherence and long-term commitment for once decided programs.</p> <p>After the recession following the 1997 financial crisis, the government launched a deficit spending-strategy to stabilize internal demand, partly supported by donor contributions like the Miyazawa Initiative. A considerable portion of this money was channeled through SME programs and initiatives for local economic development, thus “flooding” the market for SME services, crowding out market-based service delivery and frustrating efforts increase the degree of cost-recovery and financial sustainability. What’s more, government funds were mainly allocated to ministries and “tambons” (= districts) loyal to the ruling Thai-Rak-Thai party.</p> <p>One such political “pet project” is the “One Tambon – One Product” OTOP initiative, with an annual budget of nearly 20 million US\$. OTOP is a top-down support program for local handicraft which encouraged production without giving due attention to marketing and completely neglecting aspects of financial and organizational sustainability. OTOP thus repeats errors of many donor-financed programs of past decades. The OTOP budget was only allocated for two years, and it is completely unclear whether the program will receive a renewed government input or not. Other “pet projects” include the support for five sectoral clusters, and the ITB program. The latter supports university professors to provide consultancies for SME (see above). Some observers stated that the programs main effect is to increase the personal income of these academics, thus contributing to politically co-opt this potentially critical group.</p> <p>Sources: Altenburg et al. (2003)</p>

Besides the politicians, **bureaucrats** working at the level of implementing agencies may act as rational and selfish agents who are mainly interested in maximizing the budget of their bureaux and secure 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 but also try to maximize political gains or particular

benefits for their institution. As a result, bureaucrats may produce the services in more than a socially optimal quantity.¹⁹

Especially in federal political systems, where different administrative levels offer support for SME, this often results in the 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 of pursuit of self-interests.

Finally, **beneficiaries** gain from subsidized services. Especially in a policy environment where they have long accustomed themselves to receiving services for free it will be difficult to switch towards a system of market-based service provision. To withdraw public subsidies from government schemes may face strong opposition and come at a high political cost.

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

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 unaffected. In Thailand for instance, the Department of Technical Cooperation (DTEC) is reluctant to accept international donors to establish BDS cooperation with private sector entities.

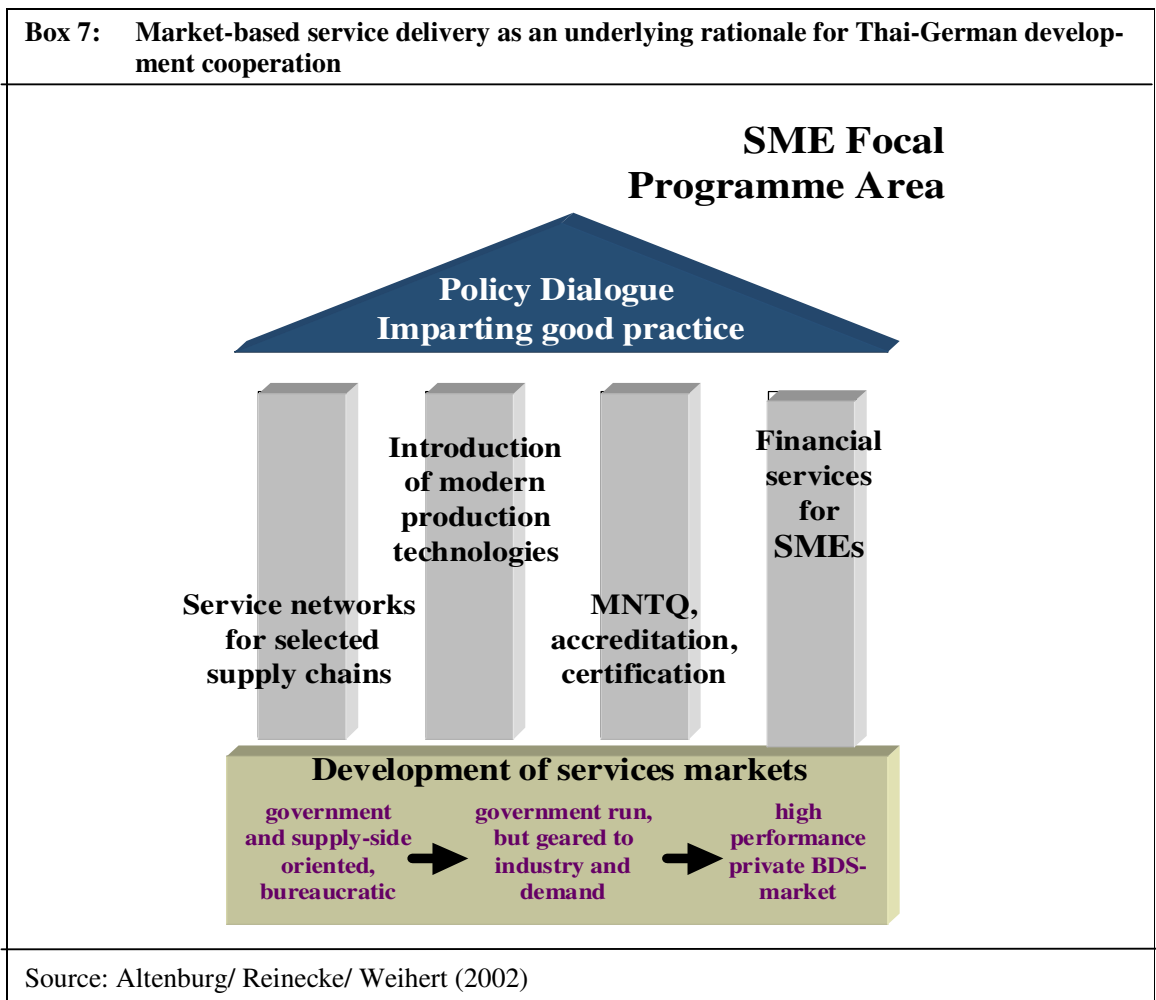
In such conditions, any effort to develop undistorted BDS markets faces serious constraints. Government agencies will eye new entrants to the service market distrustfully rather than supporting them; these entrants will have to compete against heavily subsidized schemes; and customers will not easily 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 implement a number of necessary changes. In many countries, this commitment cannot be taken for granted, and contrarian interests of bureaucracies benefiting from the status quo are well-organized. Yet under certain circumstances windows of opportunity do exist. In Thailand, the Prime Minister himself put administrative reform high on the political agenda. Some BDS

¹⁹ Chang (1996), pp. 22 ff.

institutions are required to become financially self-sustainable, most public institutions are obliged to define key performance indicators and monitoring systems, and the government announced that future budget allocation 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 of BDS delivery, promote a public-private dialogue, both at the level of general policy-making and of individual institutions, aimed at defining principles of subsidiarity and division of tasks, and advise on issues of organizational development, e.g. how to establish systems of M&E and change incentive systems. Thai-German development cooperation therefore identified moving from public sector-led to market-based service delivery as a general principle, cutting across its different services schemes for SME and eco-efficient industries (Box 7).



For BDS practitioners this raises a number of questions, e.g. 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 phasing out of temporary market interventions may be handled, etc. In most developing countries, the reality is characterized by highly distorted markets as well as politicians and bureaucrats pursuing selfish interests. Therefore it is a matter of managing a gradual transition from bureaucratic, supply-driven and subsidized to business-like

modes of service delivery rather than trying to implement policies for undistorted markets. The next chapter presents some practical conclusions for such a gradual transformation.

7 Practical conclusions for Thai-German development co-operation

In order to maximize the impact of Thai-German development cooperation, all service providers involved should have a common understanding of BDS delivery. This is not yet the case. The Thai government demands some institutions to become financially self-sustainable, while other institutions continue to deliver similar services free of charge. In the same vein, some of the joint Thai-German projects clearly aim at creating private markets, while others are less careful about market-distorting subsidies. What's needed is a consensus to move towards 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 agree on the terms of BDS delivery (e.g. criteria for public support, rates of subsidy, sequencing for out-phasing), a policy dialogue needs to take place

- among German (GTZ, the CIM Integrated Experts Program, the Senior Expert Service, the InWent training programs, etc.) and international development agencies (e.g. The Kenan Institute, UNIDO, DANIDA);
- between German agencies and their direct counterparts as far as they provide BDS;
- with ministerial and supra-ministerial bodies, e.g. the Prime Ministers Office, the Budget Bureau, The National Economic and Social Development Board, and the Office of SME Promotion.

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

1. Market assessment and careful justification of any public intervention. As we have argued before, 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. Therefore, intervention rather than non-intervention in BS/BDS-markets has to be legitimated by clear analysis of the given situation. Donors should only support service provision schemes if partners provide convincing arguments for market intervention, and they should ask for 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 for 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 and 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 organisation that manages and administrates the funds and the service provider are identical. Without a rather 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 time, disregarding aspects of a careful direction of the measures and the best possible cost-benefit-ratio. In some way moral hazard is an immanent feature of this kind of “closed shop” service providers. Thus, the separation of both functions is important to raise effectiveness. Moreover, the separation of functions between funding and delivery reduces the risk of crowding out private service suppliers. This is especially the case when private service companies can apply for public funding. Such competition increases the transparency of service markets, thus providing additional information whether there still is a case for public intervention.

Problems may arise when service 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, advocacy and SME networking) with commercially viable services. The latter may be important to gain the necessary recognition of the clientele and update technical expertise about sector-specific needs, which in turn are preconditions for efficient advocacy. Some GTZ managers in Thailand 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 considered as inevitable advertising costs for the development of new service markets. It is therefore difficult in practice to trace the “transferred funds” and exclude unfair competition in commercial services. To handle this problem without creating a complex and expensive monitoring system, an appealing body where cases of unfair competition can be denounced may be established, 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 for the service provider himself because important resources may be dedicated for services that are not really relevant for the target group. It may also be detrimental for other (private) service providers, because a lack of accountability may lead to an 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 between 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 partly tend to pursue self-interest, 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 with regard to 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.

Paralleling the conceptual debate on BDS provision systems, there have been intense discussions about what “good performance” means for BDS and how it can be measured. Although

substantial progress was achieved with the Performance Measurement Framework proposed by McVay,²⁰ serious methodological problems remain unresolved, e.g. with obtaining the necessary data, and especially with the measurement of service impact on SME,²¹ given that it is difficult to prove clear causal relations 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 challenge remains to design a performance measurement framework that is both reliable and manageable, thus not requiring too extensive data sets.

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 if they could be reached simultaneously and independently, so the 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 and define priorities.

1. Financial sustainability vs. impact: As we have shown when we discussed different forms of market failure (chapter 3), there is a trade-off between the marketability and thus financial sustainability of services and their “strategic character” that in some way is the basis of its impact on the 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 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, increasingly focus 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 the SME is limited to the resolution of day-to-day problems and easily perceived needs. Thus they cannot contribute to the “great leap” often necessary to be able to compete and survive under rapidly changing market conditions.

2. Outreach vs. financial sustainability: When 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, as used in BS/BDS related documents has other connotations as well and when 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, while being far from the “break even point” in rural areas, where solvent customers are scarce and transaction costs high. In some markets, this problems may be resolved by concessionary models that oblige service providers to cross-subsidize from the commercially attractive areas to the areas that shall be covered e.g. for social reasons. Outreach can also be defined with regard to special target groups. Empirical evidence shows that service providers when pursuing a sustainability strategy tend to target higher income clients “leaving a typical market gap in serving the poor”.²²

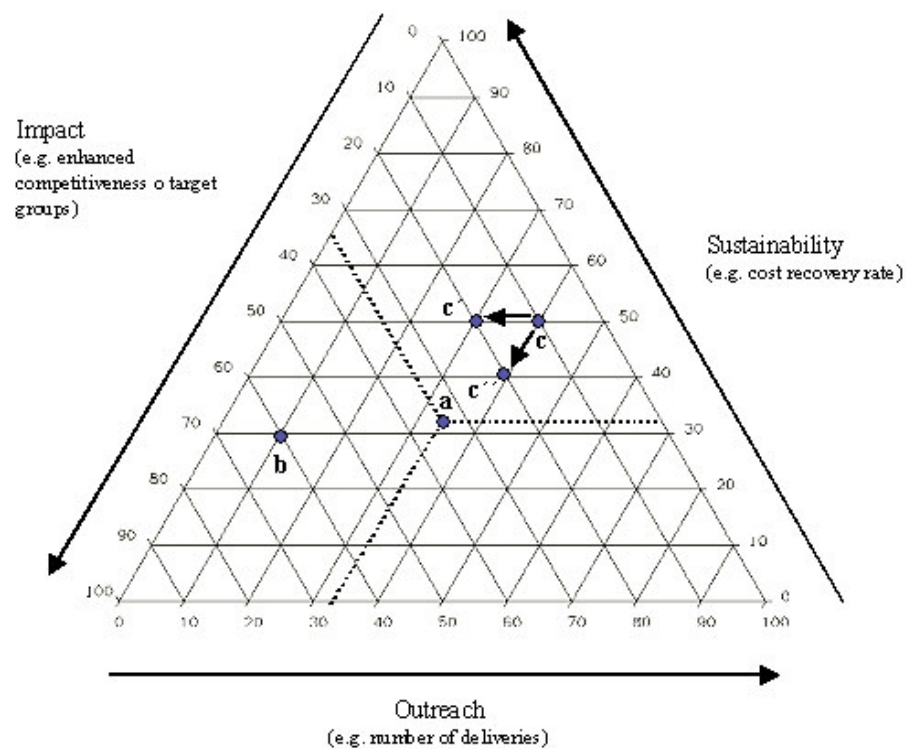
20 See McVay (1999) and McVay (2000).

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

22 McVay /Miehlbradt (2000), p. 25; see also Tomesen/Gibson (1999).

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, 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 spill-overs for the national economy.

Prior to any intervention in the local service market objectives and performance indicators should be clearly defined. It should be considered 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 will be a *weighted combination* of the three dimensions. We propose the “Performance Triangle” as a useful tool for visualizing priorities and establishing performance criteria in BS/BDS-development. It helps to structure discussions and reach a common understanding of the priorities given to the three dimensions of performance.



How to read the diagram:
 The “objective triangle” permits to visualise 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 visualised 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).

5. Establishing a direct link between performance and resource allocation. Monitoring and evaluation are not an objective in itself, but should be used for continuously improving the system. The most effective way to guarantee the responsiveness of the system 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 financially reward good performers. In the case of the Fraunhofer-Society (FhG) in Germany, those FhG research institutes that

successfully link with private companies receive additional public funding.²³ We propose that the two sub-systems 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 the funds in a certain period but that their remuneration should be partially based 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, such as relating the amount of funds controlled by teams or individuals of the organization to past performance. This kind of outcome-based incentives would induce managers and decision-makers to select the most promising service provider in those areas where competition exists and to always 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 the providers. There is no reason why service providers – even public or semi-public organizations – should not compete against each other for funding.²⁴ Depending on the kinds of services to be provided different forms of competition may be implemented. To avoid moral hazard there 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 upon previous performance and/or the 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 be the natural reaction of the service providers.

5. **Compulsory co-financing.** To ensure ownership of the receiving SME 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 the 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 a higher proportion of transferred funds will be necessary. Also the external framework conditions are relevant: Where the SME may act under conditions of economic growth or at least stability, a higher proportion of private financing should be expected. Where on the other hand the macroeconomic conditions are changing quickly and competition becomes live-threatening to many companies, governments or other funding organizations may opt for a higher proportion of subsidies, stressing short term impact and outreach, while postponing aspects of financial sustainability.

23 See www.fhg.de.

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

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