

**International Labour Organisation (ILO)  
SEED**

**The role of government in BDS market  
development**

**The role of government in BDS market development:  
a preliminary review for the International Labour Office (SEED)**

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*The views expressed in this document are those of the consultant alone and do not  
necessarily reflect those of ILO*

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## 1. INTRODUCTION

The Donor Committee for Small Enterprise Development published *Business Development Services for Small Enterprises: Guidelines for Donor Intervention*<sup>1</sup> after a process of extensive scrutiny of development assistance-funded efforts to support small enterprises with non-financial services. As a consequence of this process the small enterprise development (SED) community now has an understanding of 'what not to do' to promote BDS. *Inter alia*:

- Avoid broad or generalised subsidies, particularly at the level of transactions between service consumer and provider;
- Services should not be supply-led by public sector agencies, but determined by the demand of consumers;
- The public sector generally should not get involved in the direct provision of BDS to SMEs.

The view is that publicly-funded development assistance is better used to promote markets for services - markets which ensure that a diversity of appropriate services can be developed and provided to SMEs, driven by their demand and shaped by competition. This new thinking has been labelled by some as the 'market development paradigm'.

Unfortunately any shift in 'paradigm' is usually accompanied by an ill-considered jettisoning of the conventional wisdom in a headlong rush to embrace the new thinking of the future. With respect to the new market development paradigm for BDS, the impression that has arisen is that government has no role to play in BDS. The more realistic view is that government almost certainly will have a role, but that this role may differ considerably from conventional roles.

### 1.1 Objectives

This document is not intended to be definitive in outlining a role for government. Its purpose is to undertake a preliminary review of appropriate roles for government in the development of BDS markets. In doing so it examines the rationale for a government role in BDS markets and the important principles that are likely to influence the kinds of role government might play in Section 2 and then in Section 3 considers examples of specific roles government has played or could play in developing BDS markets. Section 4 concludes with some brief observations and issues for further consideration.

## 2. DEVELOPING A FRAMEWORK FOR GOVERNMENT'S ROLE IN BDS

A recent assessment of government's role in East Asian economic development indicated that government intervention has often been ineffective because:<sup>2</sup>

- It has not been based on a sound analysis of market failures;
- It does not address specific market failures;
- It ignores market signals in trying to achieve objectives;
- It underestimates the information needed for effective interventions;

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<sup>1</sup> Tanburn, J., Trah, G. & Hallberg, K. "*Business Development Services for Small Enterprises: Guidelines for Donor Intervention*" (2000) Committee of Donor Agencies for Small Enterprise Development.

<sup>2</sup> Stiglitz, J. & Yusuf, S. "*Rethinking the East Asian Miracle*" (2001) World Bank.

- It overlooks the limited capacities, competencies and capabilities of the government;
- It overestimates the human and other resources available;
- It disregards efficiency, scale and other considerations.

These historical weaknesses are mirrored more specifically in government interventions in BDS. This experience underlines the importance of developing a clear framework to determine government's role in BDS markets, which is cognisant of both government's capacity and the operation of market mechanisms.

## 2.1 BDS in the wider context of private sector development

### The need for a framework...

For government to make rational, clear decisions about its role in BDS it needs a conceptual or strategic framework. This will inevitably be shaped by wider experience and trends in private sector development and the nature government.

### ... which is influenced by wider private sector and government trends

Key experience or trends that inform our thinking about government's role in BDS include:

(a) ***The private sector as the engine of growth in the economy***

The private sector is widely recognised as a crucial source of innovation, efficiency and growth in all economies. More relevant to BDS, in most advanced economies there has been a dramatic explosion in the service sector in general and the business service sector in particular, driven primarily by the private sector. In the EU business services have grown at around 5.5% per annum in contrast to overall economic growth of approximately 0.4% - driven by outsourcing and demand for new, advanced, knowledge-based and specialised services. The value addition of US business services amounts to 106% of manufacturing value added. This growth has not occurred to the same extent in lower income economies.

(b) ***Considerable privatisation and deregulation of most economies***

Widespread market liberalisation and privatisation of government-owned industries has created space for the private sector, in terms of greater competition and increased opportunities and has seen the stock of private businesses expand considerably. It has also gone hand-in-hand with greater emphasis on private initiative and market mechanisms, more positive attitudes towards business and increased scrutiny of the appropriate role of government; this has influenced moves to streamline government.

(c) ***A continuing and significant role for government***

In spite of a so-called 'rolling back of the state', government's role has not disappeared. In fact in almost all advanced economies government spending as a proportion of GDP has not fallen dramatically, but actually remained constant or risen slightly. Government continues to play a highly influential role, and undertakes a variety of functions that only government can play. No picture of private sector development can be complete without considering the role of government.

(d) ***A different role for Government***

Although the 'size' of government may not have altered radically, the nature or the role of government has changed, often quite fundamentally. At its heart is government which is characterised by less direct intervention in markets, in terms of direct economic roles, and more limited in its scope, focusing on:

- Key public functions, such as health and education, security, legal and judicial systems, security and macroeconomic management - the building blocks for economic and social development;
- Functions and institutions that support markets and market development, such as regulation of standards, consumer protection and enhancing competition.

Ultimately these wider trends have been influenced by experience, particularly the disappointing track record of public economic intervention, in Western economies and the former Soviet-bloc economies, but also in the economies of lower income countries. These disappointments have led to greater awareness of the limitations of government capacity - particularly within a framework of prudent management of the macroeconomy and the public finances - and more singular focus on government's performance in relation to its core functions, notably with respect to market-friendly policy making and regulation.

**BOX 1: KEY PRINCIPLES GUIDING GOVERNMENT'S ROLE IN PRIVATE SECTOR DEVELOPMENT**

- Focus on core competence: areas which only government can deliver
- Appropriate for capacity: prioritise according to resources and hierarchy of importance
- Don't crowd out markets: seek to develop rather than supplant private sector activity
- Improve equity and access: address market failures that limit access of the disadvantaged
- Influence values and culture: policies, education and other government 'signals' to encourage enterprise and competition.

In this context the role of government in relation to the private sector is to develop the frameworks and 'rules of the game' that permit space and opportunity for the private sector to operate: building essential capacity, delivering key public services and promoting standards and competition.

## 2.2 What do these wider trends tell us about government's role in BDS?

### The need for a clear picture

Government needs to have a clear justified picture of its role in BDS reflecting the wider experience and trends described above. Primarily this means:

- Putting **BDS in a market context**; any government role in BDS should be justified in relation to, for example, overcoming market failures, promoting competitiveness or building advanced factors of production and explicitly consider how market-distorting influences are mitigated;
- Establishing **clarity about what BDS actually is**; BDS are private goods - business services. It is critical that such business services are not confused with other functions which may be legitimately regarded as 'public goods'. Business services cannot replace these essential functions - such as education, scientific research, infrastructure - indeed business services are dependent on their availability, just like any other part of the economy;
- Basing any consideration of a government role or intervention on a realistic assessment of government's own competencies and capacities.

The Donor Committee guidelines inform this picture, emphasising that BDS are mainly private goods and should be provided on a commercial basis.

The guidelines envisage Government's role not as a provider of services to SMEs but as a regulator or facilitator of business service markets.

The guidelines make a distinction between 'facilitator' and 'provider'; this distinction is critical and deserves further explanation.

**Box 2: A TYPOLOGY OF BDS**

- Specialised fee-based services, offered to SMEs as distinct products for which they pay a fee
- "Embedded" services, included within a commercial transaction for another good or service eg technical specification and design advice offered by a retail outlet to a supplier manufacturer
- Informally-provided services, such as information, knowledge and advice available to SMEs through other business or social relationships

**Two possible but distinct roles for government: service provision or facilitation?**

**Government as a service provider.** Experience suggests that the most effective providers of business services are organisations or individuals that are 'close' to SMEs; commercially motivated and entrepreneurial, with similar backgrounds, status and structures. This 'closeness' is critical, enabling service providers to understand SMEs and deliver appropriate, viable products on some form of commercial basis.

As reflected in wider experience, government - in terms of its structure, culture, orientation and people - has generally been ill-suited to deliver these kinds of business service directly to SMEs. The broad consensus is that government should not attempt to provide BDS to businesses directly.

**Government as a facilitator.** Facilitation is a temporary intervention which uses public funds to address a specific market failure. Unlike a service provider or other business, a facilitator tries to develop a market to encourage entry and competition, with a view to making the market work more effectively in terms of prices, product diversity or standards. The nature of facilitation will vary according to context, but will usually involve:

- Identification and analysis of constraints as the basis for intervention;
- Developing a clear exit strategy - the facilitating function ceases once a specific service market achieves a defined degree of effectiveness;
- Time-bound and focused use of public funds (subsidies);
- Use of non-cash instruments (eg technical assistance or information), rather than subsidising transactions between service consumers and providers.

The key requirements for facilitation are the capability of undertaking the requisite analysis to identify market constraints and the flexibility to develop interventions to respond to these constraints and engage with a range of possible market players.

These two requirements - capability for analysis and flexibility to respond and engage - are the main challenges for government assuming a facilitation role - of the type envisaged above - in BDS. As Professor Michael Porter notes:

*"an important caveat... is the difficulty of government organisations to conduct the required analysis. Bureaucratic structures and political pressures create a setting ill-suited to objective choices"*<sup>3</sup>

A fundamental question for government therefore is whether it should attempt to develop this capability to facilitate BDS markets or whether it should simply fund specialised facilitators.

This distinction between service provider and market facilitator, albeit simplistic, is useful when thinking about the role government should play in BDS markets. Clearly, it is not possible to be prescriptive about government's role; it will depend on specific contexts and governments. However we need to further elaborate further a picture of a business service market in order understand what possible government roles might look like (see Figure 1).

### **Thinking about the functions needed to make a BDS market work**

Discussions of BDS market development to date have tended to be simplistic (perhaps necessarily), typically focusing on the provision and consumption of specific services. Clearly, like any market, the BDS market has a demand-side - SMEs requiring and consuming services - and a supply-side. However it is vital to look beyond the transactions between service providers and service consumers and consider the functions that need to be in place to allow a market to function effectively. Therefore we need to look at a specific market place and ask the following questions:

- What are the basic functions that need to be performed?
- Who are the key players present in the market?
- What functions do key players perform?
- Who pays for these functions?

**Key functions** might include: delivery of services; product development; capacity development; preparation and dissemination of information; research and development; co-ordination; regulation; the promulgation and enforcement of standards; advocacy.

**Key supply-side players** might include: the private sector, the non-profit or voluntary sector; business membership organisations; government.<sup>4</sup>

**Who does and who pays?** The performance of certain functions may be separated from payment for those functions, for example service providers deliver a service, service consumers pay for it. To illustrate this concept, take a 'developed' market such as the market for accountancy and audit services in Table 1.

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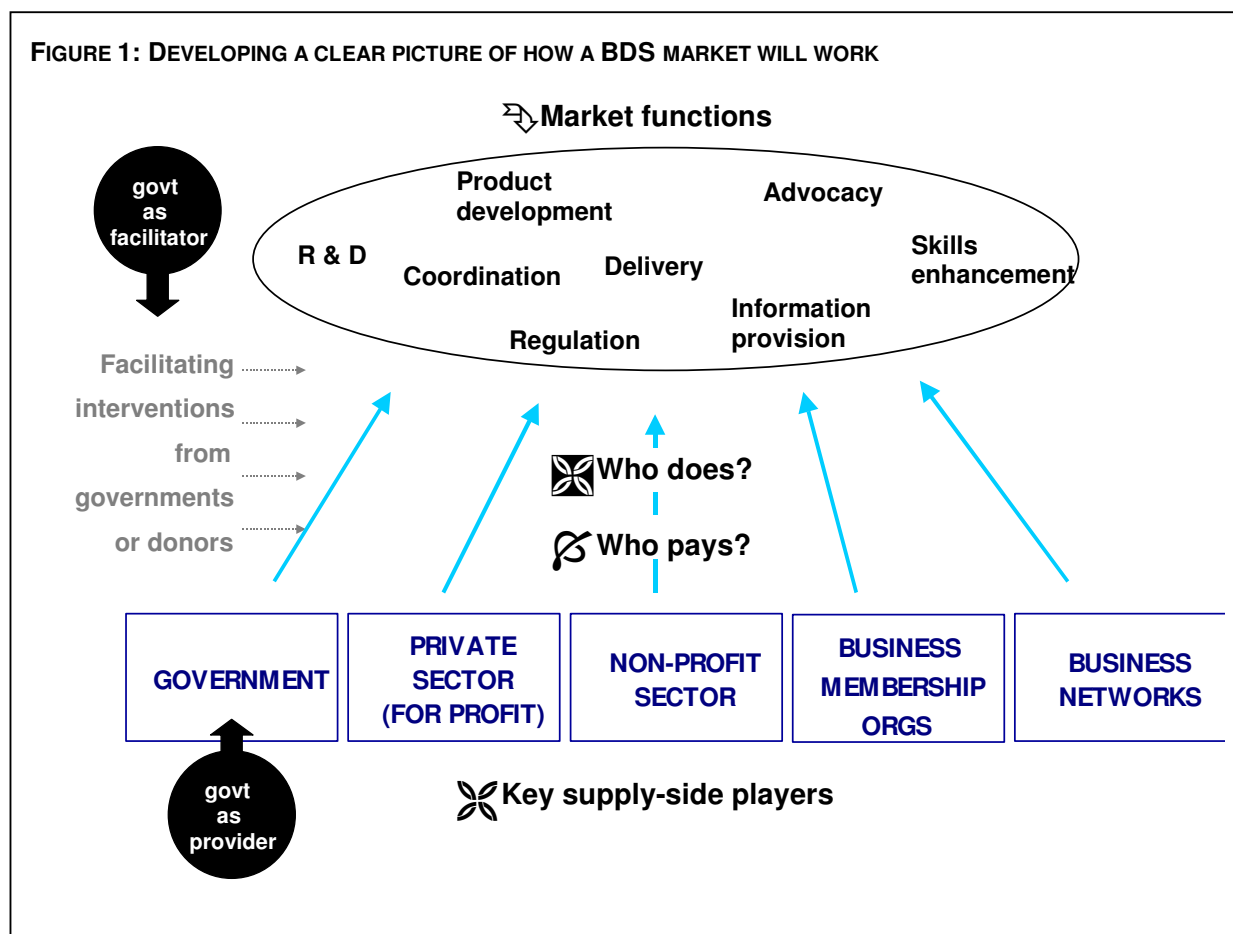
<sup>3</sup> Porter, M. "*The Competitive Advantage of Nations*"(1990) The Free Press.

<sup>4</sup> Note that development assistance - international donors - is seen as temporary intervention and not considered part of the market place: the role of donor agencies is transitory, they should not be regarded as permanent market players.

**TABLE 1: PICTURE OF THE ACCOUNTANCY AND AUDIT MARKET IN THE UK**

Functions	Players	
	Who does?	Who pays?
Delivery	Private sector providers Embedded in networks	Private sector consumers
Product development	Private sector providers	Private sector providers
Skills enhancement	Private sector providers Academia	Private sector providers Individuals (possibly with some government funding)
R & D	Private sector providers Academia	Private sector providers Government
Information	Private sector providers Networks and BMOs (eg Institute of Chartered Accountants) Government (eg tax office)	Private sector providers Government
Regulation	Government	Government
Advocacy	BMOs	Private sector providers Private sector consumers
Co-ordination (including self-regulation)	BMOs and networks Government	Private sector providers Government

*Adapted from BDS Training Programme, Springfield Centre*



*Adapted from BDS Training Programme, Springfield Centre*

### **Making a realistic assessment of government's competencies and capacities**

Governments have a finite level of capacity, in terms of physical, financial and human resources, and potentially infinite calls upon those resources from stakeholders.

Any government is faced therefore with a prioritisation of functions based on available resources, and for all governments this will vary. In principle the more resources government has, potentially, the more government can do (whether or not these functions are appropriate or not is another matter). For lower income economies the need for prioritisation typically is far more pronounced, and the decisions made all that more acute.

This document does not attempt to rank countries' capacity or prioritise specific functions. Country rankings, such as the World Bank's World Development Reports, economic performance and competitiveness indices and benchmarks such as Transparency International's index on 'clean' government are widely available. The ILO has its own guidelines regarding assessment of government capacity.

Making an assessment of a government's capacity is unavoidable when considering its potential role in BDS. A variety of elements of government capacity may affect its ability to play a role in BDS:

- Financial strength eg budget deficit, public sector borrowing requirement or aid dependency
- Effectiveness of public administration eg coverage of basic public services or infrastructure, tax collection rates or integrity of commercial justice system
- Efficiency of public administration eg processing requirements or times for key functions such as business formalisation or bankruptcy proceedings
- Availability of representation and rights of redress eg small claims or administrative courts, ombudsmen etc

The nature of the roles that government can play will reflect to its level of capacity and competence:

- Minimalist roles, relating to developing building blocks for economic development and advanced factors of production;
- Intermediate roles - more 'sophisticated' levels of intervention relating to the regulation and enforcement of standards and competition, for example;
- Activist roles - more interventionist roles, for example promoting greater access and equality and improving efficiency.

There are two final points to recognise when considering government's role in BDS:

- (a) Over time government functions in many countries seem to have shifted from a **regulatory approach** (proscribing or controlling certain activities) to a **promotional approach** (proactive use of incentives and support), and now increasingly to a **service approach**, where government is seen as providing a 'public service' to consumers (ie taxpayers). As a consequence many government functions have become more 'customer-oriented' and arguably have certain service elements.<sup>5</sup>
- (b) A distinction needs to be made between functions that are funded and undertaken by government, those functions that government funds but others deliver, and in some cases functions that government undertakes and others (eg users) pay for directly.

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<sup>5</sup> Stiglitz & Yusuf (2001) World Bank.

### 3. SPECIFIC ROLES FOR GOVERNMENT IN BDS

The preceding sections suggest that the role government plays in BDS will be shaped by consideration of experience and lessons to date, most notably:

- Don't crowd out markets: government should seek to develop - rather than supplant - private sector activity by addressing failures in BDS markets;
- Be realistic about capacity: prioritise according to government's resources and hierarchy of priorities;
- Focus on core competence: functions which government is best placed to deliver.

The most important conclusion that can be drawn from these principles is that the overarching objective of any government role will be to ensure ***an enabling environment for BDS***. More concretely this translates into three specific objectives:

- (a) ***Develop essential building blocks and advanced factors of production for BDS;***
- (b) ***Promote standards and competition in BDS markets;***
- (c) ***Improve BDS market efficiency and accessibility.***

It is important to note ***that it appears that the development of such an environment may require action which is not always BDS-specific*** but which reflects constraints in the wider economy. For example one of the observations of the recent ADB Technical Assistance to the Government of Indonesia<sup>6</sup> was that many of the constraints to BDS market development actually emanated from outside the BDS market itself.

This focus on an enabling environment for BDS is important because it forces government to be transparent about how it envisages specific BDS markets to work in the long term. This clarity enables government to ***distinguish between permanent market functions*** where it has a legitimate, long term role and ***short term facilitation***, ie transitory interventions where government seeks to address specific market failures.

International experience regarding government facilitation of BDS market development is, as observed earlier, somewhat limited and as a consequence definitive rules to guide government do not exist. It will almost certainly be the case however that the distinction between short term facilitation and more permanent market-supporting functions will vary according to context. The difference between facilitation and more permanent roles will be determined by time scale, government capacity and most significantly a transparent view of how a specific market needs to function in the longer term.

It also appears to be the case that government's role - be it facilitatory or permanent - reflects its core competencies and responsibilities, in particular relating to ***policy-making, regulation, competition and standards regimes, co-ordination, information, science and technology infrastructure and public sector practices***.

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<sup>6</sup> SME Development Technical Assistance to Government of Indonesia, (2001) Asian Development Bank (ADB).

### 3.1 Policy

Government's ability to deliver the building blocks for wider development is vital to the development of BDS markets, and arguably this is a paramount policy objective for government:

*"The expansion of the business services sector has to a large extent been brought about by continuous changes in product development much of which is driven by the improvement in intellectual capital. Education, training and human resources development policies will need to remain in focus permanently as will the need for their rapid modification in the light of competitive changes in product and other market development."*<sup>7</sup>

The role for government here is not to develop specific products or undertake research itself - this is the role of other players - but to **ensure that the building blocks or raw materials for services are in place - for example policies, structures and funding for education or scientific research.**

OECD studies indicate that much of the growth in service employment between the early 1980s and the early 1990s involved high-skilled workers. Most of the growth was in real estate, business and financial services and sanitary services. The OECD distinguishes between two types of new services. One, reengineered services, is heavily affected by globalisation and the development of electronic modes of delivery, which pressure firms to cut costs, differentiate product lines, strengthen innovation and expand markets. The second group, knowledge-intensive services, is associated with the delivery of knowledge to other firms. Both groups demand high skills; the second has a strong focus on scientific and ICT skills.<sup>8</sup>

A 1998 survey of private sector vocational training providers in Zimbabwe found that 88% had completed tertiary education.<sup>9</sup> Similarly in Sweden one out of two people employed in 'strategic' (high-end) business services possessed tertiary qualification. Economies noted for their strong service performance (eg Australia and the UK) have experienced considerable shortages of such skilled and educated workers in recent years, constraining further market growth.<sup>10</sup>

**Human capital** is among the main drivers of service growth and performance, for several reasons<sup>11</sup>:

- Services are labour-intensive and people are the main resource;
- Certain services are highly knowledge-intensive and provide advice and expertise to other firms. They require highly skilled and experienced workers, often with ICT and scientific skills;
- Innovation in services is strongly dependent on the skills, expertise and experience of service workers. Their tacit knowledge and experience with customers are crucial

<sup>7</sup> Commission of European Communities "The Contribution of Business Services to Industrial Performance: A Common Policy Framework" (1998).

<sup>8</sup> Adapted from Pilat, D. "Innovation And Productivity In Services: State Of The Art", (2000) OECD.

<sup>9</sup> Bennell, P., "Vocational Training and Education in Zimbabwe: The Role of Private Sector Provision in the Context of Economic Reform" (1998) University of Sussex.

<sup>10</sup> Murphy, M., Vickery, G., "Strategic business services" (1999), OECD.

<sup>11</sup> *Ibid.*

- to the development of new service products or processes. Many innovation surveys point to a lack of sufficiently skilled personnel as a barrier to innovation;
- Service performance is closely linked to the interaction between the consumer and the service provider. The quality of the service provided depends greatly on service workers' skills, such as creativity, resourcefulness, ability to communicate and strategic thinking;
  - The extensive use of ICT in many services requires workers who are sufficiently skilled to use these technologies effectively.

The importance of policies relating to education, infrastructure and labour market is therefore clear. It is equally apparent unfortunately that the track record of governments in low income countries in these vital areas has not always been optimal; this almost certainly has adverse consequences for BDS market development.

Policies relating to **economic liberalisation** are also critical to BDS market development, manifesting themselves in terms of attitudes towards business and business practices (eg outsourcing<sup>12</sup>), internationalisation (eg FDI and openness to imports), and public sector procurement practices. The World Bank identifies the "...interaction between foreign knowledge and local capability"<sup>13</sup> and the role that trade and broader competition can have on service markets. The above-mentioned ADB TA to Indonesia noted that BDS usage in the furniture industry has risen considerably between 1990-6, as the industry's international trading activity increased, and that BDS now represents the industry's second largest input purchase after timber products. Riddle notes that improvements that liberalisation has brought to the efficiency and affordability of certain infrastructure, particularly telecommunications are also regarded as important for business service market development.<sup>14</sup>

A more specific priority for most governments to stimulate BDS market development is **addressing policy bias**, rather than formulating specific policies for BDS market development. In many countries government policy is biased against the service sector in general. This may take the form of acts of omission, such as an absence of official data on business services or preferential status afforded to manufacturing or agriculture sectors. It may also be explicit, for example by labelling private services as unproductive or undesirable. Observers note that this has been a common and persistent perception in many countries, for example Vietnam (see 3.2 *Regulation*). In Zimbabwe in the 1980s the ministry responsible for vocational training stated that there was "*no role for private sector training institutes*".<sup>15</sup> However, Government can play an influential role in changing attitudes and awareness towards services by **signalling unambiguous and positive support for business services**, for example through public procurement practices or stakeholder involvement. In sharp contrast to the above-cited example, when Zimbabwe began to liberalise its vocational training sector in 1995, a former proprietor of large private sector provider was appointed as Deputy Minister for Higher Education.<sup>16</sup>

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<sup>12</sup> The importance of 'outsourcing culture' to business service market development is demonstrated by the oft-cited 'services gap' between the US and Germany, where services account for 65% and 40% of total value added respectively. The gap is primarily explained by reluctance of German companies to outsource (cited in "Annual Report on the Progress of Research into Services Activities in Europe", *Réseau Européen Services & Espace* (<http://www.reser.net/gb/rapport98.html>)).

<sup>13</sup> Stiglitz & Yusuf (2001).

<sup>14</sup> See Riddle, D. "*Service-led Growth*" (1992) Praeger, also Murphy & Vickery (2000) OECD.

<sup>15</sup> Bennell (1998) University of Sussex.

<sup>16</sup> *Ibid.*

The OECD<sup>17</sup> notes that Government policies in several areas, including technology and innovation policy, have traditionally emphasised high-technology manufacturing industries and focused primarily on large firms. Government's ability to 'pick winners' in traditional sectors is already questioned. However the innovative, rapidly changing nature of business services makes it even more difficult to define specific criteria for selecting firms, sectors or regions for government support, suggesting that **any policy treatment may need to be generic, ie open to all sectors and firms**. This may mean that established policy instruments need to be adjusted and implicit biases removed. For instance, R&D tax credits are more relevant to manufacturing than to services, and, in any case, focus on only one component of total business expenditure on innovation. Manufacturing extension programmes are explicitly designed for technology diffusion in manufacturing. Similar biases may exist in other areas of government policy, such as taxation.

Such bias has resulted in the invisibility of the business service sector, in most developed and developing economies, characterised by a paucity of official data on business services in terms of their nature, economic contributions and trends. **Overcoming information deficits would improve wider awareness and attitudes towards business services and result in more informed policy setting and implementation**. The invisibility of the business service sector can also lead to the 'fragmentation' of government infrastructure which deals with such services. For example,

*"the main economic ministry in Ireland, the Department of Enterprise, Trade and Employment, has responsibility for a wide range of locally and internationally traded services. However, another ministry is responsible for tourism, another is responsible for arts and culture and another again is responsible for construction. Responsibility for a wide range of energy, transport and communication related services lies with yet another ministry."*<sup>18</sup>

Such a fragmented picture is commonplace and clearly has implications for the effectiveness of co-ordination of government involvement in business services (see 3.4 *Co-ordination*).

In summary, it is interesting to note that a considerable number of the constraints and policy prescriptions identified here are not dissimilar to those routinely identified in relation to small enterprise development and private sector development in general. This is perhaps not surprising in view of the fact that in almost all countries business services are overwhelmingly provided by small firms. They face the same constraints as other SMEs, in terms of, for example, policy bias, burdensome restrictions on start up and operations and constraints to market access and capital (see 3.2 *Regulation*) and that arguments for developing a level-playing field for SMEs applies equally to development of BDS markets.

More specifically, policy requirements for business services<sup>19</sup> might include:

- Regulatory reform to ease access and reduce costs of service-relevant ICT, eg high-capacity broadband communications, and attention to ICT skills and the development of ICT-related business services. Regulatory frameworks and standards for the development of electronic commerce are also essential;

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<sup>17</sup> Pilat (2000) OECD.

<sup>18</sup> Martin, T., *"Innovation in Services and the Knowledge Economy: the interface between policy makers and enterprises—a business perspective"*, (2000) Irish Coalition of Service Industries.

<sup>19</sup> Pilat (2000) OECD.

- Further reform of regulatory structures to promote competition and innovation and to reduce barriers and administrative rules for new entrants and start-ups;
- Reduction of trade and foreign investment barriers in services to strengthen competition and promote the diffusion of innovative ideas and concepts across countries;
- Redesign of some instruments of government policy, such as the scope of R&D support and technology diffusion programmes, to remove implicit policy biases against services.
- Greater attention to service-related skills in education and training policies, since people and their knowledge, client and communication skills are drivers of service performance;
- Promotion of an innovation culture in services through stronger competition, improved access to finance and risk capital and removal of barriers to entrepreneurship and risk-taking;
- Attention to intellectual property in services exposed to high levels of international competition to ensure that business continues to innovate;
- Promotion of innovative behaviour in areas where government is an important provider or purchaser of services;
- Closer co-operation with business to improve policy design and delivery;
- Better and more comprehensive data collection.

### 3.2 Regulation, other statutory instruments and interventions

Policy bias and inconsistency can translate into the introduction of regulatory or other statutory instruments which inhibit BDS market development. These include restrictions on private sector training, curtailed access of private sector firms to government service procurement and other key inputs (such as labour or finance) and lack of competition. Improved regulation of certain key areas is thought to be beneficial to business service market development.

**Labour, telecommunication media market flexibility** as noted above is important to business services market development. Regulatory restrictions can limit flexibility, stifle innovation and increase prices. For example, the Dutch government has attempted to balance improved labour market flexibility with concerns about employment quality and security through an Act on Flexibility and Security, addressing issues concerning temporary work contracts and non-standard working hours. Whilst this regulation applies across all sectors, it impacts in particular on sectors with more flexible working practices, such as the business services sector. Certain parts of this legislation are seen to constitute threats to the activities of some service providers, for example those that use, or 'broker' temporary workers, such as recruitment or employment agencies.<sup>20</sup>

Action to **address taxation inconsistencies** may also be warranted, because business services are often subject to different **taxation** treatment than other sectors. In Vietnam for example effective rates for services are higher than for manufacturing, and the treatment of tax deductible expenses is similarly unfavourable.<sup>21</sup> In Indonesia, certain kinds of tax treatment,

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<sup>20</sup> Murphy & Vickery (1999) OECD

<sup>21</sup> Riddle, D., "Business Services in Vietnam", (1998) Mekong Project Development Facility (MPDF), IFC.

such as mandatory income tax withholding or a local tax on advertising have acted as disincentives for using or supplying services.<sup>22</sup>

**Financial sector liberalisation** appears to have a positive impact on BDS market development, in two ways. Firstly by **improving access to finance** for private business service firms, who typically experience restricted in comparison to manufacturing firms, largely as a result of rigid financial sector lending requirements (ranging from collateral requirements to interest rate ceilings and directed lending stipulations), many of which have statutory sources. In a study of 14 African and Asian developing or transitional economies, A 2000 study<sup>23</sup> found that private service providers could not acquire an overdraft or line of credit against accounts receivable. Similar findings in Indonesia confirm this constraint.<sup>24</sup> Secondly, increased sophistication of the financial services sector has **stimulatory effects on business service demand**, both from firms seeking financial services and finance organisations themselves.

Government also needs to **consider the consequences of public sector involvement or influence**. In certain business service markets government actions can crowd out private sector involvement or distort competition unfairly. The fact that public sector service provision in Vietnam accounts for approximately 70% of total service provision, whereas in most countries the norm would be about 25%, clearly constrains the development of service markets.<sup>25</sup> (See also boxes 4 and 5.)

The impact of regulation and other government intervention also needs to be considered in order to **minimise barriers to entry and operations** for potential market entrants and existing service businesses, which in many markets can constrain the viability of private sector service businesses.<sup>26</sup> In Vietnam the role of the private sector in training is legally restricted to a narrow range of fields, such as computer-related training. Public administration and state-owned firms are also discouraged from purchasing services from private sector firms, including business service providers. Zimbabwe's overly-stringent registration and accreditation requirements for private sector training organisations in the vocational training sector have been mentioned previously, but some observers note that the government even established a public sector education college explicitly to force private organisations out of business. However more positively, once entry barriers were made less onerous (and partly as a result of favourable demand side conditions, such as technology, foreign exchange, international courses wider as a result of economic liberalisation) rapid growth in private registrations occurred during 1990s (by over 300% between 1989-1996). This simply serves to illustrate the deleterious effects of excessive government control on the training market place.

Burdensome regulation of service markets is not solely a developing economy phenomenon: the OECD observes that in Germany many services face high levels of regulations such as entry barriers, price and quality controls<sup>27</sup> and that technical service providers cite long administrative and authorisation procedures as an obstacle to innovation. In Italy, legislation,

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<sup>22</sup> SME Development Technical Assistance to Government of Indonesia, "Mid-Term Action Plan for SME Development (MTAP): Strategy and Recommendations (2002 draft), Asian Development Bank (ADB).

<sup>23</sup> Riddle, D. "What do we know about BDS markets?" (2000), Mekong Project Development Facility (MPDF), IFC.

<sup>24</sup> SME Development Technical Assistance to Government of Indonesia (2002), ADB

<sup>25</sup> Riddle (1998), IFC.

<sup>26</sup> The accreditation system of the South Africa government's enterprise agency, Ntsika, has also been identified as commercially unrealistic (see Hitchins, R., "Developing Markets for Business Services", Issue Paper No. 5 (2000), SDC).

<sup>27</sup> Murphy & Vickery (1999), OECD.

norms, regulations and standards emerged as the fourth most important constraint on innovation for service firms.<sup>28</sup>

However it is important to note that liberalisation does not necessarily mean 'zero regulation': in Zimbabwe this appears to have been the case. Inadequate government oversight and enforcement of training practices, coupled with corruption and politicisation of registration procedures, has damaged the credibility of the market in general.

Policy and regulatory implications are significant because they also impinge directly on other, more focused government functions below. Ensuring more appropriate and effective regulation is a role which only government's can play, by:

- Ensuring that there is a transparent and justified rationale for regulation, balancing the need for public protection on the one hand with objectives for improved access and choice and greater competition on the other;
- Regularly reviewing the appropriateness of service-related regulation (important given the rapid pace of change in the service sector), and the consistency of regulation across all sectors;<sup>29</sup>
- Consciously monitoring regulatory impact.

#### **Box 3 : LIBERALISATION STILL LEAVES IMPORTANT ROLES FOR GOVERNMENT**

Recognising the limitations of the public sector system, during the 1990s Zimbabwe took steps to liberalise its previously restrictively regulated vocational training system. Liberalisation saw marked increases in private sector provision. However the market continued to operate inefficiently, characterised by distorted competition, corruption and politicisation and ineffective government administration of registration and oversight functions. Key improvements needed include:

- Less onerous registration requirements and streamlined administration processes
- More effective, independent oversight and enforcement
- Improved quality and availability of information about training costs and performance (eg examination results) of training providers
- Better co-ordination/communication between government and private training providers

Chile made a similar shift to encourage more private sector provision of vocational training. Critical elements in implementing this shift were (i) statutory change to permit private delivery of vocational training, (ii) promotion and oversight of competition and, (iii) financial incentives. However the subsidies introduced into the system have often been 'captured' by larger firms and caused distortions in demand and supply side behaviour. Observers note these problems arose from inefficacies in government policy and control.

### **3.3 Competition and standards**

Promotion of competition and standards in general places firms under competitive pressure (see Porter<sup>30</sup>) and this stimulates the need to upgrade and outsource certain functions. In both cases government has an important role to play in reinforcing competitive pressures and ensuring that regulation does not introduce barriers to competition and flexible practices. This can be an important demand-side stimulus to BDS market development. In the EU and OECD

<sup>28</sup> Pilat (2000) OECD.

<sup>29</sup> The government of the Netherlands' Functioning of Markets, Deregulation and Quality of the Regulatory Environment Programme initiated in 1994 has been noted to have had a beneficial impact on business services such as accountancy and legal services (cited in Murphy & Vickery (1999) OECD).

<sup>30</sup> Porter (1990).

***promotion of competition*** is thought to be an essential to the development of more successful service markets in a number of countries:

*"The ease of entry in many services, linked to the absence of economies of scale, suggests a high degree of competition. However, entry conditions are only one element of competition, and other factors, such as the degree of regulation in many sectors and the lack of international competition, suggest that competition in services may be more limited than in manufacturing."<sup>31</sup>*

***Appropriate standards*** setting and enforcement regimes can have similar effects to competition, increasing transparency and competition between products and firms, and as a result stimulating incentives for upgrading or innovation. Government's role (and the efficacy of that role) in such regimes varies from country to country, and may include legislation (eg for consumer protection or emissions levels), establishing specific standards, issuing standards-related guidelines and information, certification, enforcement and even technical assistance to firms. The nature of the standards regime and the role that government assumes within it can influence business services market development.

The South African Bureau of Standards (SAB), a government agency, with assistance from a donor-funded project, has worked with service providers seeking to broker linkages between small firms and public sector buyers, like the South African National Defence Force. SAB works with service providers to assist SMEs to comply with government procurement standards.

Kenya and Argentina both have adopted models which link public sector standards and quality agencies, with sectoral associations and private sector service providers to serve industry and promote standards in the export sector. This has required government consciously delegating, contracting out or co-ordinating certain functions, such as certification or training, which in many other countries remains in the public domain.<sup>32</sup>

Conversely in Indonesia, the certification of *halal* food products for Muslim consumers is handled by a central government agency. The absence of provincial-level certification and related services are seen as key constraint to the development of food processing and distribution businesses. Decentralised service provision would be beneficial. Similarly the recent slump in fish exports in Uganda, as a result of inappropriate fishing methods, such as the use of poisons, may well have been addressed more rapidly if better links had been established between government regulation and enforcement, public agriculture and fisheries research organisations and industry.

In the above examples government has consciously shifted away from a direct provision role. By co-ordinating and signalling, it has ***facilitated the entry of private sector service providers into the market for standards and quality-related services***. Government continues to establish and enforce guidelines for standards (eg health and safety, hygiene, handling of dangerous substances, use of weights and measures) ensuring that any public welfare objectives are met.

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<sup>31</sup> Pilat (2000), OECD.

<sup>32</sup> Giovannucci, D., Reardon, T., "Understanding Grades and Standards", World Bank. (Date unknown)

**BOX 4: POTENTIAL TO DEVELOP THE MARKET FOR STANDARDS & QUALITY MANAGEMENT SERVICES IN VIETNAM**

The Directorate for Standards and Quality in Vietnam is the government agency responsible for the field of standards and quality certification. Aside from its statutory regulatory role, STAMEQ has a number of functions: promotion of awareness about standards and quality issues; provision of basic information, such as international compliance standards and sector specific standards; accreditation and certification; technical assistance, training to firms seeking certification.

The field quality and standards management in Vietnam has grown rapidly following economic reforms and in response to increased FDI, trans-national joint ventures and exports. Approximately 600 Vietnamese firms have some form of formal quality certification (eg ISO). STAMEQ, by its own estimates accounts for approximately 50% of the market for consulting and training services in the field, employs several hundred technically skilled and experienced staff in service provision roles and generates revenues of approximately US\$5m.

Observers note that the pervasive role that STAMEQ plays in the field inhibits the development of a market for standards and quality management services in two ways:

- By failing to adequately separate accreditation and certification functions from service provision functions, it does not conform to international requirements for national certification bodies, therefore the national system lacks credibility, often encouraging firms seeking certification to go 'offshore'.
- STAMEQ competes unfairly (in terms of access to information, government funds and status) with the private sector and captures resources that the private sector needs, eg skilled labour.

STAMEQ's mixed role stems from a lack of clarity about the role government should play in relation to the market for standards and quality services. It fails to distinguish between roles that are legitimate areas for public sector involvement and funding - accreditation, certification, enforcement and information, and services which are private, like consulting and training. The result of this opacity is that core public functions essential for the market to operate effectively are not funded adequately. Instead inadequate state funding forces STAMEQ to finance its statutory roles by engaging in service provision, crowding out the private sector.

Faced with similar dilemmas, governments need to adopt a more transparent approach:

- Identify functions that are clearly within the remit of the state - information, certification and enforcement - and ensure that they are adequately funded from budgets or using delivery-based contracts or specified user fees (or some combination).
- Avoid provision of private services such as consulting and training where there is little long term justification for government direct involvement.
- If short term involvement is warranted initially (for example before there is a critical mass of service consumption, which is often the case when standards and quality regimes are first introduced), from the outset it should be entirely separated from core functions.
- The foundations for future private sector provision and competition should be established from the outset, for example, by ensuring that any short term service provision role is based on appropriate legal structure, permitting charging at accepted market rates and employment of staff according to commercial norms.
- Government should endeavour to provide appropriate information and signals to potential private sector service providers encouraging their entry into the market - for example, by developing the capacity of private service providers, using them to deliver services to firms or other public sector agencies - where ever possible

These examples suggest that certain government functions benefit from being 'close' to businesses, suggesting a stronger role for 'deconcentrated' agencies or local authorities, if they have sufficient capacity and autonomy.

In other countries government plays a more direct service provision role, for example by providing laboratory testing and quality control facilities. The arguments for providing these services are that the cost of such facilities is prohibitive, or that there is little rationale for duplication and competition. If access to such facilities is open, including to private sector service providers, then there is no reason why they should not contribute to service market effectiveness.

However government's ability to deliver such services is often weak in most low income countries (eg Morocco<sup>33</sup>) and is further compounded by lack of co-ordination between government agencies and fragmented controls and enforcement in the standards and quality field in general. There is evidence to suggest however that such ineffective or inappropriate government involvement can inhibit service market development and indeed the integrity of national systems for standards and quality (see Box 4). It is vitally important therefore that government has a clear picture of how such a market should operate in the long term and what its role within that market should be.<sup>34</sup> In particular, international experience suggests that accreditation, certification and service provision functions should be separated.

In summary, while systems for standards and quality - and government's role in their establishment and operation - clearly carry risks arising from excessive regulation and distortions to competition, operated appropriately they can influence business service market development in two ways:

- (a) As a **source of incentives or pressure to upgrade, outsource and specialise**, creating opportunities for new business service development (eg the standardisation and regulation of Japanese rice markets, permitted the emergence of several specialised business service inputs such as warehousing, inspection, grading and re-packaging<sup>35</sup>).
- (b) As a **system for ensuring high standards within business services themselves** (eg France has extended some of its certification and accreditation schemes to services, including the *Offices Professionnels de Qualification*, for example to consultancy services. It has also broadened an annual award scheme which recognises specific quality improvements to services as well as industry.<sup>36</sup>)

### 3.4 Co-ordination

Market information is frequently imperfect or asymmetrical. Simply providing information to address these deficits may not always be sufficient, justifying more pro-active co-ordination to bring market actors together. This is a role that government may be well suited to play in BDS markets, both in terms of short term facilitation and longer term roles.

**Involving other stakeholders to develop public-private partnerships.** In Chile government has attempted to develop a more market-oriented vocational training system, introducing private sector providers to compete in the provision of services to firms and individuals. It has done this through a combination of financial stimuli (tax rebates and direct subsidies) and non-financial activities aimed at responding to market skills requirements and decentralising service provision to more appropriate actors. (It should be noted that there are some concerns about the additionality and qualitative impacts of government subsidies.)<sup>37</sup> Zimbabwe's efforts to liberalise its vocational training sector also required government co-ordination.<sup>38</sup>

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<sup>33</sup> *Ibid.*

<sup>34</sup> See for example Nexus Associates, "Evaluation of Industry Institutes in Thailand" (2000) Royal Thai Government/ World Bank.

<sup>35</sup> World Bank "World Development Report" (2002).

<sup>36</sup> Murphy & Vickery (1999), OECD.

<sup>37</sup> Espinoza, EM., "Vocational Training In Chile: A decentralised and market oriented system" (1994) ILO.

<sup>38</sup> Bennell (1998) University of Sussex.

Government's co-ordination role in other markets may also influence business services. For example in the labour market it is common for governments to provide services relating to **vacancy or skills gap matching**, where employers seeking new staff are matched to suitably qualified unemployed individuals who have registered with a government employment agency. From government's perspective services are geared towards political objectives - reducing unemployment counts and benefit claims. How do these public services influence private sector business services? Employment and human resource management-related business services are one of the fastest growing areas of business services in OECD countries. It is not clear whether government-provided services of this nature adversely affect these services, or stimulate them, by for example making vacancy information available for use by private service providers or through the purchase of specialist services, such as labour market surveys or advertising.

In principle, government's attempts at co-ordinating the labour market may have an unintended but potentially positive business service market development effect. Government-commissioned labour market and skills services often identify 'skills gaps' between employers' requirements and labour market skills. Actively disseminating such information may be useful in sending signals to private sector training providers, encouraging them to improve products or focus on new market segments.

Establishing mechanisms which substitute for personal knowledge and trust allows businesses to reach beyond their conventional networks into potentially more diversified and value-adding relationships. In Europe and US the **enforceability of contracts and the ability to mediate and arbitrate disputes** efficiently, has played a significant role in broadening business networks and the expansion of sub-contracting and joint ventures for example. As noted earlier these trends have played a critical role business service development.

Government may play a role in mediation and arbitration functions, such as conflict and dispute resolution, and obviously in small claims and administrative courts - arguably a form of 'public' business service - where government is seen as legitimate, neutral intermediary. In Brazil's Sinos Valley shoe manufacturing cluster, the absence of such a public business service appears to have been a critical constraint. In order to perform such a function effectively Schmidt<sup>39</sup> notes that government requires specific capacity, in terms of:

- Sector-specific knowledge;
- Techniques of conflict resolution;
- Expedient and even-handed administration.

Government may need to curb its natural tendency to be the 'co-ordinator or overseer of first resort' when it comes to the field of business services. **Self-regulation** is often common in many business services, and in most cases is quite effective. However self-regulation still may require external stimulus, both to respond to changing conditions and to reflect the interests of other stakeholders, for example in accountancy and audit services. In lower income countries the existence of self-regulation (and bodies for self-regulation) may be more rare, possibly justifying a more pro-active government role. The challenge for government is to recognise the existence and value of self-regulation mechanisms, utilising or strengthening them where appropriate and intervening when they do not fulfil their self-regulatory functions. In the example of the UK accounting and audit sector in the UK, government has worked closely with professional bodies, for example on the promulgation of and adherence to standard

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<sup>39</sup> Schmitz, H., "Responding To Global Pressure: The Role Of Private Partnership And Public Agencies In The Sinos Valley, Brazil" (1999) University of Sussex.

accounting practices and procedures or interpretation of changes to taxation. Equally however it has censured self-regulators or introduced new statutory regulation in when self-regulation has failed.

**Co-ordination across government** with respect to services may also be important. As noted earlier responsibility for service-related policy and regulation is often fragmented between agencies. Moreover the approach of government towards liberalisation of markets for procurement of services by public enterprises and public administration needs to be consistent across agencies, in terms of requirements for public tendering or recognition of professional qualifications.<sup>40</sup>

The availability of **land, property and related infrastructure** is critical for most businesses. A physical commodity like property is not a business service in its own right however, and not the focus of this document. However many observers identify a significant role for the public sector in co-ordinating or even providing property-related services to SMEs, most notably packages of 'work space + services', such as incubators or science parks.

The efficacy and rationale for such services is the subject of considerable debate and conflicting evidence. Their contribution to business service market development is not clear. Property space, industrial estates and even incubators across the globe are provided efficiently and affordably by the private sector, usually at far higher occupancy rates. In Germany reviews of the network of business incubators have found that they have supported new firms in first phase of expansion, but there has been little start up activity or additional job creation, whilst survival rates barely exceed the national norm.<sup>41</sup> In Germany only about 11% of incubators are exclusively government run and funded. In 2001, the government of North West Province, S Africa managed to let about 10% of floor space in its industrial park near Rosslyn, despite lease rates far below market rates and offering free support services. In contrast the commercial space 2km away was fully let and occupied by many SMEs.

Evaluations of UK science parks have found that the 'service input' as originally envisaged has not occurred to a demonstrable level, and that these parks have been most successful as good quality real estate at affordable prices (and profitable for government). Some observers note that this has been the role of the government in the development of the successful Emilia-Romagna region of Italy. (This however remains the subject of some debate, with some observers crediting government with a more influential role, whilst others suggesting that government's role has been at best marginal.) However there is some evidence that government co-ordination can link different players to promote collaboration and clustering. For example in the electronic sector in southern Scotland, government appears to have played an influential role in bringing research institutions, investors and businesses together (see 3.6 *Science*).

Overall the rationale for a direct role for government in the property market is not clear and arguably a focus on more deep-seated property market inefficiencies - relating to property rights, land tenure and contract enforcement - would be more beneficial. Indeed property-related services are usually one of the more effective business services - commercial leasing and property management, estate agency/realtors - in most countries.

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<sup>40</sup> Daniels, P., "Service Sector Development in Integrated Super-National Markets: The EU Case" (1995) Working Paper on Producer Services No. 30, University of Birmingham.

<sup>41</sup> Meyer-Stamer, J., Wältring "Behind the Myth of the Mittelstand Economy", (2000) Project Meso NRW.

### 3.5 Information

As noted by earlier, almost all OECD countries suffer from pronounced information deficits about business services; information weaknesses in developing economies are generally even more pronounced. Developing a broad information pool for BDS market development is arguably a conventional public good, a long term process and least likely to be undertaken by the private sector. To date BDS-specific interventions in this area are few and far between, but there are some lessons to be learnt from other areas of economic and social development where government seems to have been effective:

- Awareness building and promotion of entrepreneurial culture: this has been effective in North Rhine-Westphalia in Germany, now with one of the highest business start up rates in Germany, increasing dramatically from a traditionally low base
- Social marketing campaigns: have been highly successful, eg in the HIV/AIDs field in Thailand. Some observers note that such campaigns could be utilised to promote general business awareness about services, by linking entrepreneurial success with better managerial practices and use of external services.
- Developing a pool of transparency and information: government can play a significant role in compiling, or funding the compilation of, a range of broad business-related information - basic statistics and data, studies of economic and sectoral trends, business confidence surveys, foreign currency and trade reports. This basic information can be utilised by private sector service providers for developing products and serving clients. It is worth noting however that private sector firms, research organisations and the media are increasingly undertaking the compilation of even basic statistics and data, which would have been conventionally regarded as a government role in many countries.

#### **BOX 5: GOVERNMENT INFORMATION PROVISION: SERVICE MARKET DEVELOPMENT AND DISTORTION**

All UK companies are legally obliged to file reports and accounts to Companies House, a government agency, which currently holds information on approximately 4m businesses. Access to basic information is openly available for a small statutory fee. Companies wishing to use raw data for commercial purposes have to pay higher fees (one company, ICC pays GBP240,000 per annum).

Such companies, often commercial service providers, utilise Companies House data to develop specialised services, such as databases and credit rating systems. Recently however Companies House has begun to provide similar specialised services, such as a web-based surveillance service. However this triggered investigation by UK competition authorities, on the grounds of unfair competition: Companies Houses gets company information for free and therefore can cross-subsidise these more sophisticated, non-statutory services, providing them more cheaply than commercial service providers. This is a clear illustration of the central role that government can play in developing business service markets, but equally how lack of clarity about roles (and a funding imperative) can lead to market distortion.

Studies by the Economic and Social Research Council of Cambridge University, UK<sup>42</sup> suggest that government can play an important role by providing **gateways or signposts**, providing SMEs with information or links to specialist service providers, bridging information and awareness gaps between the supply and demand sides of the business service market. This finding reflects the experience of using vouchers to stimulate training services markets, most notably in Latin America. The information or referral functions that accompany voucher

<sup>42</sup> Bennett, R., Robson, P., Bratton, W. "Government Advice Networks for SMEs" (2000) University of Cambridge; Bennett, R., Robson, P. "Intensity of Interaction in Supply of Business Advice and Client Impact" (1999) University of Cambridge.

schemes have been found to be critical, suggesting pervasive market information, awareness and trust 'gaps'.<sup>43</sup>

Provision of information to improve **the efficiency of the public-private interface** created by government regulation, is both a vital government role, but also can contribute to service market development. For example government agencies in the UK responsible for tax or bankruptcy administration, have established tax, payroll and bankruptcy service 'windows' or 'hotlines'. These dedicated units issue guidelines and advice on technical issues and can be used by firms directly or by professional business service firms, such as lawyers, accountants and advisers who then provide more specific, tailored services to clients. Government 'one-stop-shops' can provide similar gateway services, whilst improving the efficacy of regulatory functions. For example in Bali, Indonesia firm registration levels have improved considerably as a result of a pilot one-stop-shop scheme. In Nepal, GTZ found that the provision of VAT information and guidelines to business management training firms has enabled them to develop moribund bookkeeping products into more successful training products by including a VAT compliance module.

The EU<sup>44</sup> has identified a number of possible information-based functions relating to business services that could be the focus of government in most countries. These include:

- Improving data collection, research and analyses on the demand and supply of business services;
- Analysing the contribution of business services to economic output;
- Examining the dynamics of business services and particularly the role of small firms in business service delivery and consumption;
- Evaluating requirements for appropriate quality assessment and regulation for business services;
- Dissemination of information.

### 3.6 Science and technology

The promotion of science and technology which can be used to develop more sophisticated industrial development has been a key policy priority area in almost all countries. In particular Germany, Japan, Taiwan and Korea are widely cited as role models in terms of the quality of their industry-oriented science and technology and its influence on business. This reputation is founded on the priority (and funding) afforded firstly to general and tertiary education and secondly to scientific and applied research. The importance of a sound educational, scientific and technological knowledge base to the development of specialised business services has already been noted above.

It is important to note however that government support for science and technology does not necessarily translate into a flow of knowledge (or services) between science and business. In Germany, where there is a strong practical orientation in academia, such as the universities of applied science (*Fachhochschulen* - FHS) and a high level of government involvement in research institutes (approximately 225 receiving some form of government funding), it has been found that a high proportion of SMEs do not interact with research organisations. Interestingly a public law foundation, the Steinbus Foundation, has acted as a successful intermediary for technology transfer between government and universities and industry,

<sup>43</sup> Goldmark, L., Addis Botelho, C., "Paraguay Vouchers Revisited: Strategies for the Development of Training Markets" (2002), DAI/MBP; Goldmark, L., Fitzgerald, L., "Vouchers: From Practice to Principles" (2001), DAI/MBP.

<sup>44</sup> Commission of European Communities (1998).

providing 'match making' services between firms seeking technological inputs and universities and other research organisation. The foundation is now 90% self-financing, charging clients an average fee of approximately \$3000-5000.<sup>45</sup> It appears that a demand exists for technology matching and adaptation services and that potential exists for additional commercial service providers to enter this market.

Quite what the role of government should be in such a specialised, highly fluid area is uncertain. Certainly the capacity and effectiveness of government to play a direct role, particularly in very low income economies, should be scrutinised. Even in high income economies, it is important to note that a government role in the development and dissemination of technology is not always essential, nor always successful;

*"Where infrastructure exists, but fails to support industry, government is frequently the problem."<sup>46</sup>*

Technology and technical expertise is expensive, often beyond the resources of government in most low income economies. For example, in Pakistan's North West Frontier Province government technical training centres (established with international donor assistance) have often received insufficient funding to cover overheads, leading to deteriorating facilities and problems with staff retention, constraining service development and revenue generation.

Problems commonly relate to the rigidity and adequacy of funding, a lack of strategic vision about the role of technology and research in building industrial competitiveness and government R&D conducted in isolation rather than 'customer-oriented'. The ability of government to remain 'one step ahead of the market' is rare. Indeed, some observers argue however that the highly formalised German system (and that of Japan) despite historic success, has struggled to adapt and develop, particularly in the service sector due to their formal structures and emphasis on traditional areas like manufacturing, when compared with the US or UK.<sup>47</sup>

An illustration of the potentially stifling nature of government involvement in this area is Taiwan's Industrial Technology Research Institute. This was transformed to become more practically and commercially oriented by inserting independent management with industry experience, increasing the level of client financing and shifting government funding from budgetary disbursements to contract basis, in effect making it less like a government agency and more like a business. By the early 1990s only 5% of ITRI's funding came in the form of untied government disbursements, 50% came from the private sector and the remainder from government contracts. Other Taiwanese agencies appear to have benefited from independent, commercially oriented management structures, whereas bureaucracy and politicisation has hindered the efficacy of similar agencies in other East Asian countries.<sup>48</sup>

Given the limits of government resources and responsiveness therefore, a more effective role for government may be the **facilitation of linkages between centres of academic, scientific and technological research and the private sector**. In the UK government has actively tried to encourage 'spin-offs' from academia to the private sector. In particular it has facilitated links between academia and venture capitalists, who in addition to funding, provide a range of

<sup>45</sup> Meyer-Stamer & Wältring (2000).

<sup>46</sup> *Ibid.*

<sup>47</sup> For example Meyer-Stamer & Waltring (2000) suggest that Germany's failure to adapt to changing market conditions (eg in media and IT-related services) stems from a system shaped by established and conservative stakeholders, eg trades unions and business membership organisations.

<sup>48</sup> Stiglitz & Yusuf (2001) World Bank.

support services<sup>49</sup>. The modality for such schemes varies, but usually based on some kind of agreement where the venture capitalist agrees to provide a certain amount of funding and support to spin-offs in return for exclusive access to specified university research units. The implication for BDS market development here is two-fold (i) the academia-venture capital linkage contains 'embedded business services', but also generates opportunities for external service providers, and (ii) spin-offs from university often include specialised business service firms offering eg design and consultancy services.

Findings<sup>50</sup> suggest that there are several critical roles that government may play in promoting science and technology which is relevant to the business sector, and which also are likely to contribute to the development of specialised business service markets:

- Most important is an **appropriate policy and competitive framework** (trade and industry and FDI policy, protection of intellectual property rights), which ensures that there is competitive pressure on firms which forces them to upgrade and which enables investment in technological development;
- Also significant is government **funding, development of the essential infrastructure** for science and technology ( eg facilities and standards for testing and quality control) and **public procurement**;
- Finally, **promoting linkages** between research institutions and industry.

### 3.7 Procurement, outsourcing and linkages

Facilitating the access of small firms to large firm and public sector procurement opportunities has been argued by some as an important role for government and has been a feature of many East Asian economies. This has often taken the form of local content and 'set aside' legislation, requiring large firms, inward investors and public sector agencies to work with SMEs in some manner and assistance schemes for SMEs to facilitate their dealings with the corporate and public sectors. The efficacy of such measures is variable and debated. Taiwan's model is regarded as successful, Indonesia's 'fostering' scheme, less so.

In the UK, a network of Regional Supply Offices has been established to do this, linking large and small firms, providing search, diagnostic, compliance and technical assistance services to large and small. An evaluation of the RSO network have indicated that there is no rationale for public sector involvement in such activities on a widespread basis, and that the impact of such involvement have been subject to significant displacement and additionality effects.<sup>51</sup> However the evaluation did identify the following areas for more focused government involvement:

- **Areas of rapid market or technological change** where short term buyer-supplier mismatch occurs;
- **Inward investment** where international buyers and local suppliers face information constraints;
- **Monopsony situations.**

Given the scale of public expenditure in all countries (typically equivalent to around 50% of GDP) public procurement can be a significant source of commercial opportunities and also can serve to 'signal' important trends to the private sector, for example, with respect to standards

<sup>49</sup> Financial Times "From ivory tower to market", (20 Dec 2001), "The Forward Group brings together research and management", (24 May 2001).

<sup>50</sup> World Bank, *Technology Institutions and Policies: Their Role in Developing Technological Capability in Industry* (1997).

<sup>51</sup> RSO evaluation

and quality certification. However as noted above outsourcing of public procurement remains limited or highly restricted in many countries. Government therefore has a legitimate role in **improving access to public sector procurement**, which can contribute to BDS market development:

- Simplifying or streamlining public tender requirements - particularly for lower value contracts - increases the possibility of SMEs bidding for government contracts, but in order to do so they often require additional inputs from service providers;
- Providing transparent information on public tender opportunities and guidelines; as noted above several projects in South Africa are working to develop brokers (service providers) who utilise such information to develop products for their SME clients;
- Improving the efficiency of public administration eg by outsourcing; government is often an important consumer of business services itself, assisting business service markets to reach a critical mass of consumption.

### 3.8 Explicit business service market facilitation

Given the relatively limited experience of BDS market development, examples of government attempts to explicitly develop service markets are scarce. Indeed, one of the most striking observations that can be made when assessing the plethora of public SME support schemes around the world is that there is little cognisance of the existence of private sector markets for such support, nor any clear rationale for government intervention to develop business service markets - most justifications do not go any further than 'assisting SMEs', with little consideration of long term access, choice or efficacy.

An argument is sometimes made however (often retrospectively) that government development and provision of such business services has a **market creation effect**. In the purported absence of private sector services, public business services create an awareness of services and a market leader or brand, upon which the private sector can enter and develop. There is little evidence to support such arguments. In the UK, a country that has been at the forefront of such public SME support structures, after several decades and billions of dollars of government funds, there is no conclusive evidence that such schemes have contributed to private business service market development. In fact it may have simply created a parallel system characterised by heavy subsidy, limited outreach and low SME satisfaction.

The two most common instruments to (not necessarily explicitly) develop service markets utilised by governments and donors in low income countries have been matching grants and vouchers. These two instruments have already received exhaustive (and sometimes controversial) coverage in the SED literature, and the purpose of this document is not to review this again, but to consider their efficacy from a government perspective.

**Vouchers** have been regarded by many as the potential market development instrument of choice, particularly for training markets (admittedly in the absence of many alternatives!). In Latin America, where they have been used most extensively, their market creation effects remain debatable. In Paraguay and Brazil Goldmark et al<sup>52</sup> note that national or local government have been willing to adopt voucher schemes, and that they show a marked reluctance to 'turn off' the subsidies in the face of powerful political constituencies. In effect vouchers become a permanent form of subsidy, albeit with a different form of delivery. The persistence of voucher schemes is therefore seen as a potential source of distortion in the training market. They do however note that in the case of Paraguay that voucher schemes

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<sup>52</sup> Goldmark et al (2000, 2001).

may have provided the impetus for the privatisation of the national government-owned training agency, and that public sector trainers were able to leave the national training agency to establish their own training businesses.

One of the lessons of voucher schemes - and salient to a consideration of government's role - has been that the administration of voucher schemes has generally been most effective when in the hands of independent organisations, isolated from government control and political manipulation.

The information provision element of voucher schemes, as noted above, appears a more promising avenue for government involvement. There is no consensus on the form such information provision should take. However the concerns about the commercial viability of information provision are probably warranted, and this would appear to be an argument for some form of public role, such as information gateways, frameworks for standards etc (see sections 3.3 *Competition and standards*, 3.4 *Co-ordination* and 3.5 *Information*). However it should be noted that some agencies (most notably ILO/FIT<sup>53</sup>) are experimenting with approaches to develop such business service information provision as products or content packages for the commercial media.

The efficacy of **matching grants** has been the subject of scrutiny and controversy, most notably within the World Bank, which championed this particular instrument for a number of years.<sup>54</sup> Matching grants certainly appear to be costly to deliver, their outreach necessarily limited, whilst the additionality of their impact (in terms of service market stimulation and development) is not clear. For example the World Bank's Business Uganda Development Scheme (BUDS) has provided considerable number of 'repeat' grants to enterprises (including nine to a single microfinance provider), which somewhat undermines the 'inducing trial' justification for such interventions. Efficacy notwithstanding, on cost grounds alone it is difficult to imagine how such schemes could be taken up at any scale by low income country governments without considerable on-going donor support. As with vouchers, the discretionary power of grant allocation in the hands of (usually low paid) civil servants carries with it considerable risks of corruption and collusion.

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<sup>53</sup> <http://oracle02.ilo.org/dyn/empent/empent.portal>

<sup>54</sup> Biggs, T., "A Microeconomic Evaluation of the Mauritius Technology Diffusion Scheme" (1999), RPED Discussion Paper, World Bank.

## 4. OBSERVATIONS AND FUTURE FOCI

The purpose of this document was to provide an initial review of the role that government plays or might play in BDS market development. It was not intended to be comprehensive in its coverage nor definitive in its conclusions. It is hoped that it will stimulate much needed further discussion and examination in what is a relatively youthful and complex field. At this juncture it is possible to make a number of general observations about the role of government in the development of BDS markets, some more specific action and, inevitably, some unresolved questions.

### Some general observations...

**Many constraints to BDS markets lie outside the BDS market itself.** An enabling environment for BDS is essentially the same as the enabling environment for the rest of the private sector. In fact, given the significant role that SMEs play in providing business services, the need for a level playing field for all enterprises is especially valid for the business service sector. From government's perspective addressing many BDS market constraints will often relate to core government roles and responsibilities in areas such as education and basic skills development, the legal framework, vital infrastructure and market structures and competition.

**'Special case' treatment of the BDS market is probably not justified.** Given the historical bias or invisibility of BDS, there is a case for scrutiny of and revisions to existing policy, regulatory and promotional frameworks. The emphasis here may be on making them more inclusive, improving the collection and dissemination of information on the business services sector and altering public sector attitudes towards privately provided business services (considered below). However in the longer term there does not appear to be a case for radically different treatment of BDS markets from that other markets - as far as possible, policy and regulatory treatment which is generic or neutral, ie open to and equitable for all sectors and firms - is desirable.

**BDS market development may be disproportionately affected by the efficacy of policies which shape the nature of human capital,** such as education, science and technology and labour markets. This is an area in which government traditionally plays (and should continue to play) a significant role in the development of human capital, through the education system, funding and infrastructure for science and regulation of the labour market.

There appear to be **links between BDS market development and economic and social liberalisation.** A policy and regulatory regime which encourages trade, foreign investment, economic diversification (including privatisation and liberalised public procurement) and competition can stimulate both service use and service opportunities. Similarly liberalisation of communications and the media is vital to improve access to information and improve the flow of business-related knowledge.

### ... Some BDS-specific actions...

The comprehensiveness, quality and availability of business-related information in general is inadequate in many low income economies, and particularly for the service sector. There is a need for **greater recognition of business services and collection of business service-related information in government economic and business data.** This is a vital first step in improving policy and regulatory frameworks for BDS as well as more specific remedial measures, and is important in increasing the visibility and credibility of the sector.

**More appropriate and contemporary regulation** to reflect increasingly service-based economies. As a result of policy bias and inadequate information, regulation has generally not been cognisant of business services, and is generally grounded in an agricultural and manufacturing based economy. More frequent regulatory reviews and impact assessments which are cognisant of business services, together with greater attention to coherence and co-ordination across government departments responsible for business service-related areas is therefore essential. Equally regulatory and quality standards frameworks which focus on enhancing competition can influence firms to upgrade skills, processes and performance in general, can also stimulate business service use.

Just as regulatory frameworks need to reflect contemporary trends, so too does educational policy and content. Recognising and **incorporating service-related skills within educational curricula** is an important element in improving the human resource base for service market development.

In parallel with an improved information base for BDS, government may need to take specific actions to **improve public sector attitudes** towards business services. It may do this in a variety of ways, such as signalling positive support for business services through key appointments within the civil service or through **improved public sector procurement practices**. The liberalisation of the latter, by introducing greater flexibility in procurement practices and consciously increasing the range of functions that are open to private sector provision, can greatly enlarge the private sector's (and especially SMEs') access to procurement opportunities, and serve as an important stimulus to BDS market development. As a potentially significant consumer of business services, government can send influential signals to business service providers, for example by adherence to recognised quality standards in its procurement requirements.

Similarly government needs to **ensure that access to government** generated information (eg economic statistics and trends, regulatory guidelines, standards compliance requirements etc) and government facilities **is more equitable across sectors**, particularly to often-excluded private sector service providers. Government should actively encourage linkages between higher education institutes and research facilities and the private sector where possible.

#### .... And two tricky questions

**Can government facilitate BDS markets?** The nature of business service markets is that they are often fluid and intangible. To facilitate BDS market development requires good analytical capacity, up-to-date information and flexibility, qualities which are not always synonymous with government agencies anywhere, let alone in resource constrained low income countries. A significant question remains as to whether government can develop this capacity or whether it will need to rely on non-government specialist organisations.

A further challenge is that facilitation is by definition time-bound. However governments have often proved unwilling or unable to intervene on a temporary basis. In the face of political pressure and a variety of vested interests, it can be extremely difficult to dismantle the funding, organisational structures and staffing of supposedly short term initiatives, which inevitably acquire a permanency and self-perpetuating momentum of their own.

**How relevant is the facilitator concept for government?** The Donor Committee guidelines introduced a useful distinction between service provision and market facilitation. In concluding that, in general, governments should avoid direct service provision, the inference is that the role of government should therefore be as a facilitator. The conclusion of this line of logic is

that any government role should therefore be short term and transitory. However this is neither accurate nor realistic. Preceding discussions have shown that BDS markets are not simply about transactions between service consumers and service providers. BDS markets, like any other market, require a range of other **supporting functions** - policy, regulation, information, research and development etc - that cannot simply be viewed as short term inputs. Many of these functions are the natural roles of government.

The concept of BDS facilitation is therefore challenged or at least made more complex by including government in a broader, more realistic picture of markets. This picture includes a greater variety of market functions and market players than is perhaps conventionally envisaged. Within this picture government does not emerge as a provider of BDS to firms, although many of the functions that government undertakes arguably may have discernible service elements or characteristics. Similarly government does not appear to emerge as a natural BDS market facilitator as currently understood; the functions that government is best suited to perform are the basis for an enabling environment for BDS market development, and in most cases should be regarded as integral to the market.