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BUSINESS ENVIRONMENT AND SME EXPORTS: THE CASE OF CHILE

TECHNICAL BRIEF NO. 2



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Authored by:

**Jorge Daly and Thibaut Muzart of Management Systems International in
collaboration with Weidemann Associates, Inc.**

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CHILE'S BUSINESS ENVIRONMENT AND SME EXPORTS

Lessons for Developing Countries

The research behind this Technical Brief examined the relationship between the business environment and SME export performance in Chile. This report focuses on issues of firm access and participation in non-traditional export markets and sheds light on which sizes of firms have benefited from Chile's export boom. The business environment for exporters is described and related to the microeconomic and institutional factors underlying Chile's export expansion. Answers are sought to the following questions:

- What are the most important economic and institutional elements of the business environment that influence SME export performance?
- Has there been a surge of exports from SMEs and, if so, how significant has it been?
- How effective have been the roles of public, private and civil society institutions in fostering SME exports, and how important has been the role of public-private dialogue?
- What lessons from the Chilean experience can be useful for project design and implementation in other developing countries?

The research reviewed research papers and articles that try to explain Chile's export performance and in particular the participation of the SME sector. Next, interviews were conducted with specialists in the donor community based in Washington, DC. Third, interviews were conducted by telephone and e-mail with Chilean professionals working in state agencies and with representatives of Chilean exporters and business associations. Research was conducted during the first quarter of 2007.

ECONOMIC POLICIES

Following decades of extensive state-led economic policies, in the late 1980's the country undertook a radical structural adjustment of the macro economy. Measures introduced included reducing monetary subsidies, eliminating price controls, setting non-inflationary monetary targets by a now autonomous Central Bank, restoring fiscal discipline, selling off state-owned companies,



Source: World Bank Development Indicators 2006

fostering more competition in financial markets, opening the economy to foreign investment, and removing tariff and non-tariff barriers to international trade. These pro-market policies drove the economy along a non-inflationary growth path and spurred a vigorous expansion of exports and imports. The government also introduced measures to accelerate private enterprise development including easing business entry, improving the efficiency of goods, factor and financial markets, and simplifying tax administration and procedures for conducting international transactions.

The application of these reforms turned Chile into one of the most open economies of the world, with apparent success. The 2007 Global Competitiveness Report assigned Chile a rank of 27 (1 is best) in the world, by far the best performance in Latin America. The World Bank's Doing Business Report for 2008 ranks Chile 33 of 178 countries in the world (1 is best) in the ease of doing business. Chile ranks 11th out of 157 countries in the Index of Economic Freedom published by the Heritage Foundation.

Table 1: GDP, GDP per capita and inflation

| | 1980 | 1985 | 1990 | 1995 | 2000 | 2005 |
|---|-------|-------|-------|-------|-------|-------|
| GDP (constant 2000 billions of US dollars) | 21.8 | 29.4 | 40.7 | 61.8 | 75.8 | 93.9 |
| GDP per capita (constant 2000 US dollars) | 2,520 | 2,432 | 3,093 | 4,295 | 4,917 | 5,747 |
| Inflation, consumer prices | 35.1 | 29.5 | 26.0 | 8.2 | 3.8 | 3.1 |

Table 1: GDP, GDP per capita and inflation

These positive indicators mask a more complex reality. For one, Chilean exports are still dominated by primary goods, mostly in agriculture and mining.

Expansion of non-traditional exports that are largely lightly processed natural resource-based products such as processed fruits and seafood, wine, wood furniture, and similar items, lag the growth in exports of primary goods. Second, direct exports by SMEs have lagged behind the increase in exports by large firms, resulting in a decline in the share of exports by SMEs.

Earlier policies in Chile attempted to control high inflation by fixed exchange rates, which by 1982 led to a balance of payments crisis, a 14 % decline in the Gross Domestic Product (GDP), and the collapse of the banking system.

After 1982 Chile pursued a more pragmatic monetary policy by allowing the currency to float in a wide band around a central rate that the authorities tried to hold constant in real terms. More important than controlling inflation was keeping an exchange rate that made exports competitive. In effect since 1983, this "crawling peg" system has been central to the efforts to penetrate foreign markets and is one of the most important factors behind rapid export growth.

Fiscal discipline is now the major tool for controlling inflation.

PRO CHILE

Established in 1974 with the mission of promoting non-traditional exports in foreign countries, this agency is under the aegis of the Ministry of Foreign Affairs. The agency has 12 regional branches throughout Chile and representations in 35 countries across the world. With an annual budget of \$22 million, the agency co-finances market studies, publishes catalogues, provides support to firms that want to open branches abroad, and finances their participation in fairs and missions.

Source: Organization's website, Sepúlveda (Undated); and International Trade Center, 1999

As shown in Table 1, the revised macroeconomic policies have resulted in sustained increases in per capita GDP and a decline in inflation, in particular since the mid 1990s. Unlike the approach of Asian countries like Japan, South Korea and Taiwan in their historical periods of rapid economic growth, the Chileans avoided targeting sectors to spearhead export-led industrial growth. Chilean economic policy has faithfully followed the dictum of comparative advantage, applying policies and support neutrally across regions, industrial sectors and enterprises of all sizes.

Respect for rule of law is a long standing characteristic of the Chilean environment and with the stability shown over the past two decades; domestic and international investors are increasingly convinced that open market policies will continue through succeeding political administrations.

Public and Private Institutions Play an Important Role

Corporation to Promote Production (CORFO)

Established in 1939, CORFO is the economic development agency of the Ministry of the Economy. The agency funds and coordinates programs to increase competitiveness of the Chilean private sector and expand export capacities. Funds and programs are administered by third party operating agents, with CORFO providing supervision and evaluation. In 2007 there were 20 private organizations and 12 financial institutions acting as operating agents for CORFO, administering 50 programs.

There are approximately 32,000 Chilean companies, mainly SME firms, which benefit from CORFO's programs and subsidies. Support programs amount to \$230 million per year, of which 50% is allocated to support export associative arrangements, 30% to improve SME quality assurance and competitiveness, and 20% to provide long-term credit lines.

Source: Organization's website, Sepúlveda (Undated); and International Trade Center, 1999

Within the public sector, the most important agencies supporting services to exporting firms are the Corporation to Promote Production (CORFO), *Pro Chile* and *Banco Estado*. Some of the programs they offer certainly have a positive impact on the competitiveness of SME firms and on their capacity to penetrate foreign markets.

BANCO ESTADO

Established in 1851, Banco Estado is a state-owned bank whose mission is to provide financial services to under-served clienteles, including SME firms. It operates as a typical commercial bank but with financial technologies tailored to the needs of SMEs in urban and rural areas. It is well run and profitable, and does not depend on government largesse.

Banco Estado mobilizes large volumes of savings from large and small depositors alike.

Source: Organization's website, Sepúlveda (Undated); and International Trade Center, 1999

In the private sector chambers of commerce and business associations are common. Some of these associations, like the Confederation of Production and Commerce (CPC) and the Society to Promote Manufacturing (SOFOFA) constructively engage the public sector in the design and implementation of economic and financial policy. The reach and influence of SOFOFA is particularly impressive. This association is divided into 46 sector chapters and eight regional branches with a membership of 2,500 enterprises that represent 80 percent of

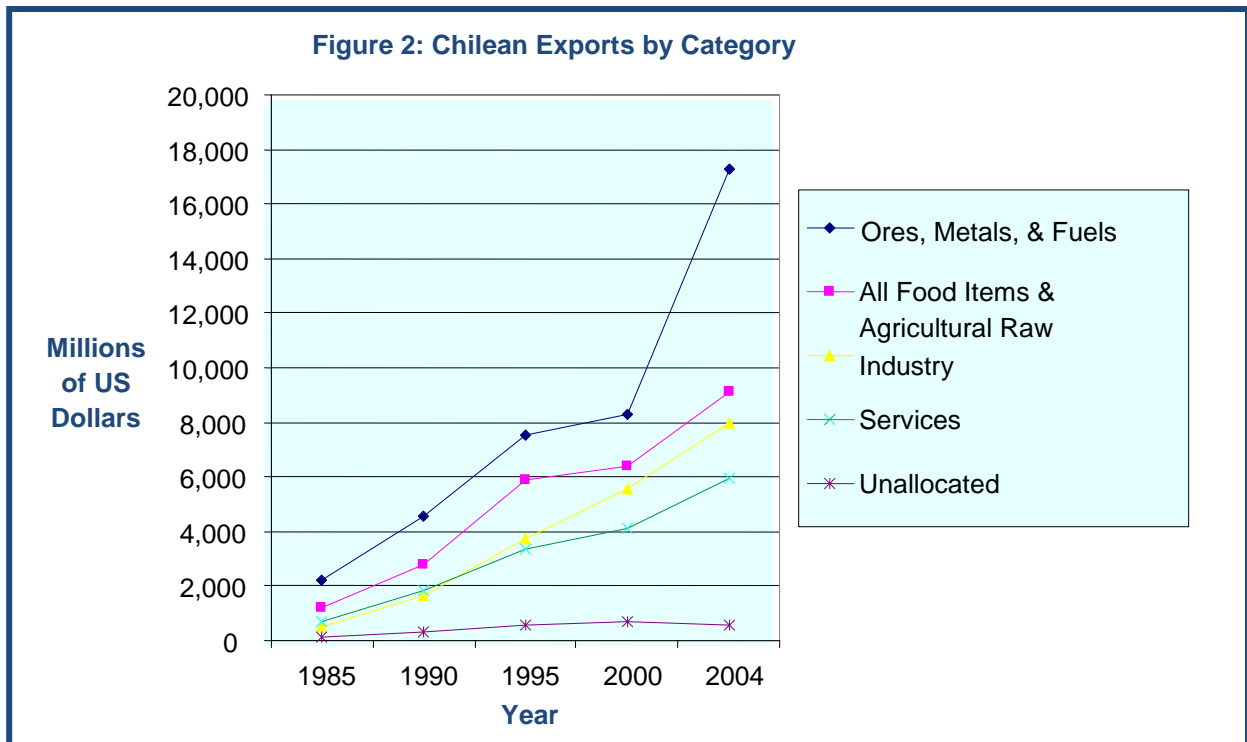
Chile's industrial activity and 45 percent of its exports. SMEs have set up their own associations that provide business services to the membership and advocate for the adoption of policies more friendly to their constituents. The advocacy and representation activities are carried out as individual associations, in alliance with others, or by articulating positions jointly with SOFOFA.

Export Performance

Chile has aggressively pursued export-promoting incentives during the last three decades. The most important are the following:

- Free trade agreements with many countries, including the United States, Canada, Mexico, Central American countries, the European Union, China, South Korea, Singapore and New Zealand,
- Elimination of all bans on specific exports and imports,
- Drawback and simplified tax rebates for export goods,
- Rebates of customs duties, and duty and value added tax waivers for imports used to produce export goods,
- Deferred payment of customs duties on imports of capital goods,
- CORFO lines of credit through commercial banks and Pro Chile support for promotional expenses of SMEs, and Establishment of free trade zones.

Significant increases in exports resulted (Figure 2). In 2006 the number of exporting firms reached 6,880 businesses that placed 5,303 products in 184 countries. (Source: Pro Chile, "Hitos del Comercio Exterior: 30 Años.")



Source: UNCTAD Handbook of Statistics 2005.

SMEs IN CHILE

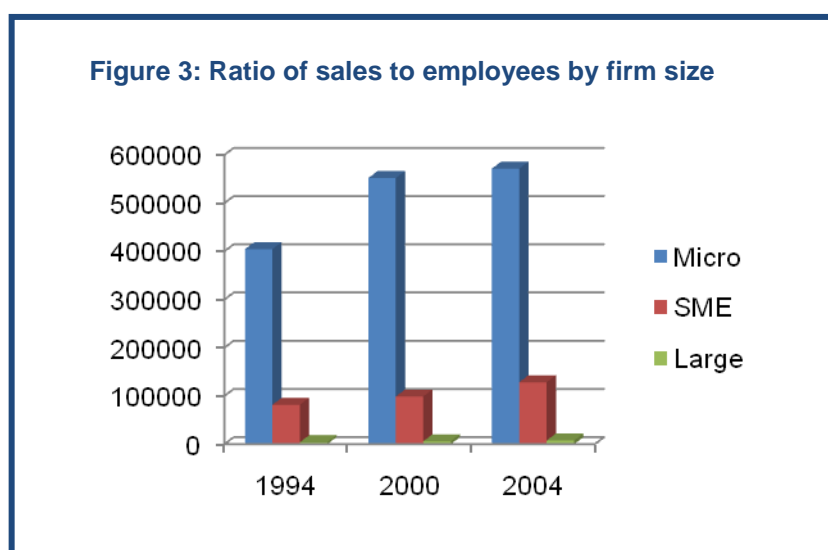
Firms in Chile are classified by size according to two criteria. One criterion, annual sales, is adopted by the Ministry of Economy (MINECON), which uses data from the Internal Tax Service. The other, the number of persons employed, is adopted by the Ministry of Planning and Cooperation (MIDEPLAN), using data from the National Socio-economic Survey.

Micro firms accounted for 81 percent of the number of firms in 2004, SMEs for 18 percent, and large firms 1 percent (Figure 3). Of the approximately 128,000 SMEs in 2005, 36 percent engaged in commerce, 16 percent each in services and transportation, 13 percent in industry and manufacturing, 12 percent in agriculture and 6 percent in other sectors.

Sales

Firms of all sizes increased sales for the period 1994 – 2003. The growth of sales by SMEs of 49 percent pales in comparison with the growth in sales of large enterprises of 140 percent. During that period large enterprises increased their share of sales from 69 to 78 percent, with both micro and SM enterprises giving up share. The amount of sales per enterprise was nearly flat for micro and small/medium enterprises, but increased significantly for large firms.

The amount of sales per employee increased 22 percent between 1990 and 1996 for microenterprises (from 2.25 to 2.74), 38 percent for small/medium enterprises (from 8.75 to 12.05), but 84 percent for large enterprises (from 93.00 to 171.11) (Figure 3).



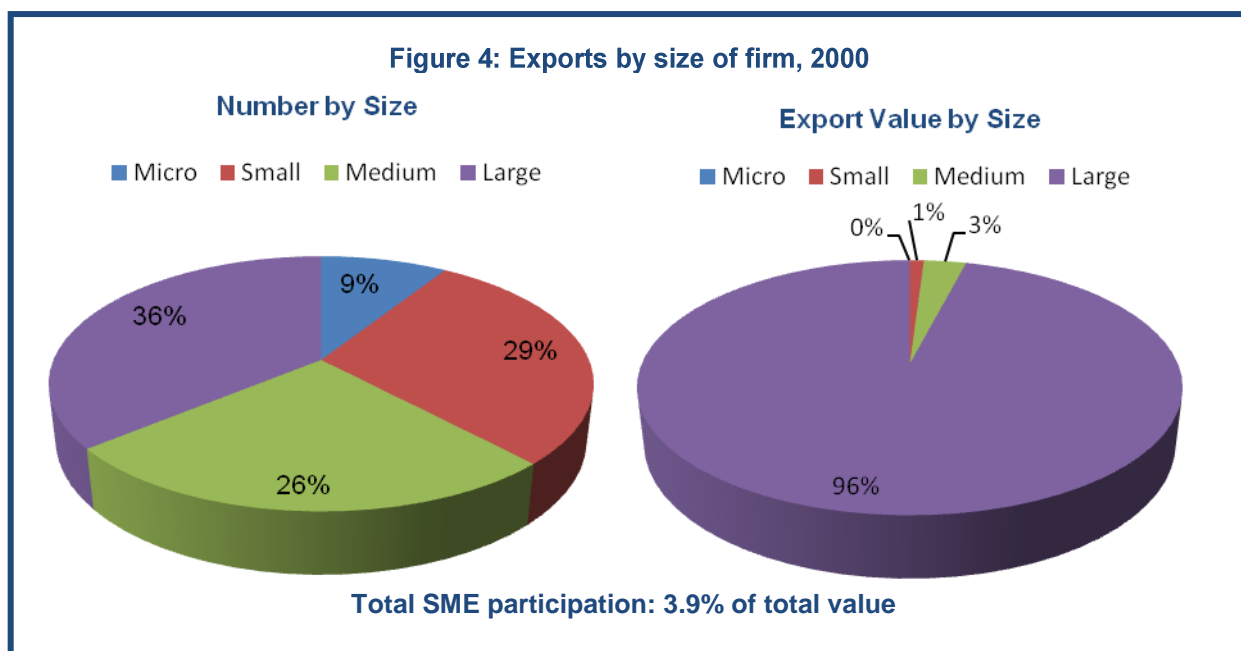
Source: Authors' computations based on CORFO, in Dini & Stumpo 2002, and Chile Emprende, 2005

Exports

In 2000 SMEs accounted for almost 55 percent of the total number of enterprises that exported; large enterprises accounted for 36 percent. On average SMEs exported goods and services worth \$240,000 (see Figure 4).

Large enterprises accounted for 96 percent of the value of exports, with SMEs accounting for less than 4 percent.

Between 1997 and 2000 SMEs increased exports by 3.9 percent, while large enterprise increased their exports by 96 percent. Available data suggest that while SME firms are



Source: Comité de Fomento de la MyPE, 2003

increasing their export dollar values, their relative contribution to total exports is small and has declined.

However, there are two important qualifications to this view. First, official statistics only report direct exports from individual firms and do not capture indirect participation in exports from SMEs through associative arrangements.¹ Thus exports by SMEs that are part of a cluster or value chain are not attributed to the SMEs. An example is the salmon industry which clusters more than 150 firms that employ 29,000 people and generate other 12,000 jobs. Almost 97 percent of their output is destined for export, which doubled between 1996 and 2000, yet is not attributed to SMEs in the official statistics.

A second point is that the Chilean definition of an SME uses a low value of annual sales, between \$US 600 thousand and \$US 2.4 million depending on the sector. This is much lower than the limits set by countries such as Argentina (between \$US 1.8 and 10.8 million), El Salvador (up to \$US 4.6 million) and the Dominican Republic (up to \$US 5 million).

Hence many firms that are defined as large in Chile would be regarded as small or medium firms in other countries. The implication is that both the actual number of SME firms that export and the low contribution of SME firms to total exports that is reported by the official statistics may will be understated when compared to other exporting countries.

¹ Associative associations may be vertical or horizontal. In vertical associations SMEs link themselves with larger exporters, thereby becoming indirect exporters. The SME benefits by avoiding the expense of critical services for exporting, such as market analysis, identification and design of products, brand development and direct relationships with foreign buyers. Disadvantages are concentration of sales to a single buyer, limited bargaining power with their partner, and limited acquisition of market information that blunts future plans to export directly. Horizontal associations group like producers to pool their resources to place their products in foreign markets. Benefits include doing business among equals, it is easier to develop their own brands, discounts on input supplies may be possible, and bargaining power is increased with foreign buyers. A disadvantage is that horizontal associations are not easy to implement and maintain.

SME Exports and the Business Environment

According to interviewed SME representatives, the key components of macroeconomic policy that relate directly to the ability of their firms to compete internationally are:

1. The exchange rate and tax incentives,
2. Free trade agreements,
3. Improvement in the economic infrastructure, and
4. Ease of access to financial markets.

A Successful SME Exporter

Viñas Montes was founded in 1987 by partners who shared the vision of making Chilean wines internationally known and recognized. By 2006 the company exported 600,000 cases to 75 countries in five continents. This former SME now ranks as the fifth largest wine exporter.

What accounts for this success story? First is the experience and resilience of the firm's owners and managers. The vision of placing their fortunes in the penetration of the high-quality segment of the market drove them to develop the Montes Alpha Cabernet Sauvignon, reputed in the US market as a high-quality wine. Good knowledge of the market was an instrumental factor.

Second, the support from Pro Chile facilitated promotion by renting big spaces in international fairs, making contact with potential buyers, distributing samples, getting discounts for trips and so forth. Viñas Montes decided to reimburse Pro Chile all the expenditures made on its behalf.

Source: Viñas Montes and Pandol websites and phone interviews with company's representatives.

In the country at large, the widespread consensus among public officials, development practitioners and private businesses is that the government's commitment to keep a **competitive real exchange rate** was a fundamental factor accounting for export growth. Private businessmen including representatives of SME associations found this commitment credible and; consequently; made long-term investments.

Tax incentives that played a decisive role to bolster exports are:

1. Reimbursement of customs duties applied to imports of raw materials and intermediate inputs that are used in the production of exported goods,
2. Anticipated reimbursement of the value added tax, and
3. Reimbursement of 3 percent of all taxes on inputs purchased by exporting firms.

With the numerous free **trade agreements** that the government negotiated, SMEs could access a wider variety of imported inputs at cheaper prices, which reduced production costs. Interestingly, free trade agreements were negotiated bilaterally with developed and developing countries alike. Preparing for and negotiating bilateral trade negotiations requires the presence of superbly trained trade negotiators who are technically assisted by a cadre of highly skilled professionals, as well as effective coordination among state ministries and effective dialogue between the government and representatives of the private sector. Fortunately, these critical skills were present in Chile.

Bilateral trade agreements meant breaking away from the Andean block and joining the largest South American economies – Brazil and Argentina – as an associate member that enabled the country to keep a lower and uniform external tariff and retain some duties to protect its agricultural sector. As a consequence, Chilean goods freely enter most of the countries with

large consumer markets such as the United States, Canada, Mexico, the European Union, Thailand, and China.

An ambitious program of modernization and expansion of the **economic infrastructure** was launched in the 1980's, which included items such as new highways to connect small towns located in rich agricultural areas with urban centers, renovation of airport terminals and seaports, improvements in communications and others. All groups of respondents concurred that the infrastructure improvements have been an important factor for the competitiveness of their firms and that each successive government has "done their job" with respect to continued improvements.

A principal vehicle to finance and implement the numerous projects has been **public-private partnerships**. This vehicle has proven effective and confirms the need for technically skilled civil servants who can enlist the participation of the private sector for the public good.

Access to finance for SMEs is not a rosy picture in Chile, with only 17 percent of SMEs obtaining credit from commercial banks. Supplier credit is plentiful, but typically covers only a portion of the needs and is relatively expensive. Several government backed programs exist to encourage lending to SMEs though their penetration to date is limited. A usury law that mandates interest rate ceilings, relatively high bank capital requirements, and a focus on collateral-based lending combine to limit finance offerings to SMEs.

Regulatory Impact

In Chile several key attributes to successful business development are:

1. **Transparency:** Since the demise of the military government in the late 1980s, laws and regulations are increasingly designed in consultation with key stakeholders in the private sector, including business associations that represent SME firms.
2. **Accountability:** The ability for regulators to make arbitrary decisions has been reduced significantly; although much remains to be done to match accountability that exists in most developed countries.
3. **Targeting and Proportionality:** Some SME representatives believe proportionality is lacking; that existing programs will not significantly reduce the disparities between large and small firms. Because of lingering memories of state activism, Chilean authorities are reluctant to act, rejecting pro-SME interventions if they are anticipated to cause market distortions.
4. **Consistency:** Since the mid 1980s laws and regulations have become increasingly stable, reducing uncertainty and building confidence that encourages decisions for new investments.
5. **Efficiency.** Interviewed SME representatives point out that SMEs often are constrained by over regulation, a zeal for over vigilance, mainly expressed in too numerous visits by inspectors of state agencies – health, environment, agriculture, tax



inspectors and so forth. They point to three areas that negatively impact the capacity of SMEs to compete in domestic and foreign markets:

- Local governments enact numerous regulations affecting business operations that are unnecessarily complex, unclear and costly to comply,
- Labor legislation is restrictive, primarily related to hiring and firing, and
- Environmental regulations that are required by trade agreements with developed countries require costly investments that many SME firms find difficult to comply with.

Government officials indicate they are trying to make the regulatory framework more efficient and responsive.

Many SME associations exist, but not all are self-sustaining with competent staff who can engage in policy dialogs with the government. There is another problem: because only 5 percent of SMEs belong to associations, the government adopts a cautious approach when discussing policy issues for the sector through the associations.

Public support for SME exports is centralized in CORFO, Banco Estado and Pro Chile. CORFO plays the most prominent role. The Program of Suppliers (PDP) subsidizes 50 percent of the cost incurred by a large firm that is transferring technical and administrative technology to prospective SME partners. The program has been active for more than a decade and is popular with both large enterprises and SMEs. The Promotion of Association Projects (PROFO) encourages SMEs to join in horizontal associations to improve management, production and marketing systems.

While the Chilean experience offers useful lessons that can be applied in other settings, one must remember that Chile's political economy exhibits particular features and attributes that may not be present in other developing countries. Features worth highlighting are:

- The wide gap between rich and poor has been significantly reduced and today a large and engaged middle class exists.
- A tradition of respect for the rule of law underlies a public expectation for transparent implementation of economic policies and regulatory norms.
- Key state agencies enjoy a significant degree of autonomy and officials exhibit technical competence and are mostly paid adequately.
- Corruption in the form of state capture by powerful bureaucrats, whether or not acting in cooperation with powerful economic elites, has significantly diminished since the demise of the military dictatorship in 1989.
- A constructive dialog between the public and private sector helps to enact regulatory norms that facilitate wealth creation by private firms.

Lessons Learned

High economic growth and good export performance, primarily by large corporations, have distinguished Chile for the last twenty years. A friendly business environment underpins the expansion of private enterprises and a steady increase in jobs and incomes.

The most important lessons learned are:

First, **macroeconomic fundamentals** matter. This means sound conduct of fiscal, monetary and exchange rate policies, open trade policies, and an economic infrastructure that facilitates efficient business operations.

Second, the **administrative and institutional qualities of state agencies** matter. While a country can pass business-friendly regulatory norms, they will come to naught if the administrative capacity does not exist to implement them, or if authorities give in to pressures from rent-seeking enterprises to set norms that maximize private benefits.

Upgrading the administrative capacities of state agencies is not a sufficient condition for effective administration of public policies. Also necessary is installation of an institutional framework that builds transparency, trust and consultation between the public and private sectors. Examples include operational autonomy for the Central Bank and the bank supervision agency.

Third, a **policy dialogue that enhances social and economic inclusion** matters. Public-private dialogue requires the engagement of financially independent, competently staffed, well-run private sector organizations that are representative of their constituents. In Chile the large majority of SME firms have yet to find or set up bodies that can properly represent them. The government is aware of this problem and has instituted programs to strengthen SME associations.

The Chilean model of public-private dialogue cannot be easily replicated in countries where the relationship between the public sector and the private sector is fundamentally antagonistic. Neither is it likely to yield good results when the goals and interests of large enterprises and SME firms diverge dramatically.

Fourth, **finance** matters. The Chilean experience vividly demonstrates that far-reaching reforms in the business environment will have a limited impact on SME exports when firms do not have adequate access to financial services. In fact, permanent and sporadic SME exporting firms believe that the finance problem represents a more severe obstacle than the more typical restrictions of licensing, labor legislation and environmental requirements. Unsurprisingly, the majority of SME firms also share this view.

Fifth, the **overall managerial capacities of SME firms** matter. Many SME firms in Chile are outmatched by competitors in domestic and international markets, not so much because of “glitches” in the regulatory framework or difficulties in accessing commercial bank loans at reasonable terms as by the reluctance or inability of owners to introduce modern management techniques.