

## 11 The Policy and Institutional Environment Affecting the Rural Nonfarm Economy

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Prevailing policies and institutions condition development of the rural nonfarm economy (RNFE) in a variety of important ways. In most instances, growth of the RNFE is largely self-directed, driven primarily by competitive forces and growth in demand for its outputs rather than by any deliberate public actions. In other cases, tight controls and protection have coddled favored rural enterprise groups, notably certain categories of rural manufacturing, during the early stages of industrial development (see Chapter 13).

This chapter reviews key elements of the policy and institutional environment and how they have affected development of the RNFE. Subsequent discussion, in this and later chapters, examines the kinds of policies and institutional models that are most effective in stimulating poverty-alleviating growth in the RNFE.

### Who Shapes the Environment, and How?

Alongside the multitude of small and medium-sized firms that operate in the rural nonfarm economy, a group of key larger actors makes decisions and takes actions that largely shape the environment and opportunities available in the RNFE. Three particularly influential groups converge in the RNFE, each playing a different but crucial role affecting the structure and dynamics of opportunity for smaller players operating there.

#### *Large Private Firms*

Large modern corporations make decisions and take actions that powerfully shape opportunities in the RNFE throughout much of the developing world. More frequently than governments, in many instances, these private firms initiate sweeping changes in the RNFE. In the wake of worldwide trends toward economic liberalization from the 1990s onward, these agents of change have swept ever more powerfully across the RNFEs of the developing world.

Rural areas have attracted several main categories of large firms. Agribusiness firms locate processing plants and collection facilities in rural areas to

reduce spoilage and transport costs in weight-reducing processing activities and to take advantage of lower wage rates. Tourism promoters export rural services by developing facilities in unsettled regions, along pristine beaches, in interesting ecological niches, or in favorable climates. Resource extraction—of timber or minerals—likewise requires location in rural areas where raw materials are found. More recently, the food retailers (supermarkets, fast food chains, and minimarket chains) that have grown rapidly in large cities of the developing world, starting in the early to mid-1990s, have begun spreading to intermediate cities and larger rural towns across East Asia, Latin America, Southeast Asia, and, more recently, Africa (see Chapter 9). As they spread, many of these retailers develop local contracting arrangements for the supply of perishable and processed agricultural products. Together, these activities—agriculture and the agroprocessing it supports, tourism, extractive industries, and food retailing—provide the economic scaffolding on which much of the supporting RNFE is built. Decisions by large players on where to establish operations largely govern market prospects for ancillary rural service and commercial activities.

In some situations and supply chains, large firms assume what have traditionally been considered public roles. They provide marketing infrastructure and credit and set industry grades and standards (see Chapter 9). Under export subcontracting systems, they may even implicitly set the exchange rate facing rural nonfarm suppliers.

In some instances, the actions of large firms benefit specific categories of smaller rural nonfarm enterprises. They supply key inputs, improved technology, or market outputs for smaller producers (Table 15.1). Urban ceramics plants supply high-quality ceramic liners to village stove producers in rural Kenya (Jeans, Hyman, and O'Donnell 1991). A network of yarn traders in Northeast Thailand links newly specialized household yarn producers with large mills that serve the large and growing export market (Figure 15.2). The tourism industry, from Cancun to Goa and throughout the developing world, generates service sector jobs as well as markets for agricultural products and the marketing services necessary to deliver them to rural hotels.

In addition to marketing both inputs and outputs, some large firms even offer direct assistance to their smaller client firms. For many years Unilever South Africa ran management assistance courses for the many small retailers who distributed its products (Rodolo 1972). It recognized that well-managed, prosperous small vendors would prove more valuable business partners, so it invested in extension support for small firms.

Yet in other cases, large firms threaten to obliterate entire armies of smaller-scale competitors. The recent entry of large dairies and modern chain retailers has decimated smallholder dairying in parts of Chile, Argentina, and Brazil, where thousands of small dairy operations have closed down over the

past decade.<sup>1</sup> Aggressive expansion of factory-brewed sorghum beer during the 1970s and early 1980s threatened the livelihood of over 50,000 home brewers in Botswana (Haggblade 1992). The introduction of mechanized rice mills in Indonesia during the 1980s likewise threatened to put tens of thousands of village women out of business as hand pounders of rice (Timmer 1972).

Changes in market structure induced by large firms frequently require adjustment by small firms if they are to survive in rapidly changing rural nonfarm marketing chains, where some supply channels submerge as newly dominant channels surge. Change arrives swiftly, and small firms must be nimble to effect necessary adjustments. When large food retailers enter regional markets, for example, smallholder farmers and rural processors frequently face difficulties in meeting required volume, consistency, and food safety standards (see Chapter 9). The astonishing power and speed of these moves raise equity concerns and make it increasingly necessary for both small firms and intervention agencies to understand, anticipate, and accommodate changes introduced by these dominant large firms. Recent evidence from the field suggests that today rapidly changing market institutions dominated by large agribusinesses, supermarkets, and export firms represent one of the most powerful forces shaping the business environment and opportunities for that segment of the rural poor with the capacity and resources to respond (see Chapters 9 and 15). For this reason, both equity and growth increasingly demand tools for understanding the structure and dynamics of these rapidly changing supply chains. A growing number of agencies has begun to specialize in working with small firms and small farms on finding ways to facilitate commercial linkages that will enable small rural enterprises to partner with large, often multinational, firms so that the poor may participate more broadly in growing segments of the RNFE.<sup>2</sup>

### *Governments*

Governments powerfully condition opportunities and constraints in the RNFE, though they often do so unintentionally and by default.<sup>3</sup> Many times, national economic policies intended to influence the national economy as a whole generate unintended impacts on individual segments of the RNFE. Less frequently, governments enunciate policies explicitly aimed at influencing the RNFE.

UNINTENDED POLICY CONSEQUENCES. Policies such as exchange rate regulations, tariffs, and licensing and fiscal statutes typically emerge from a set of complex and ongoing negotiations between government, large domestic urban businesses, and foreign interests. The small and the rural nonfarm enterprises

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1. Gutman (1999), Jank, Farina, and Galan (1999), Dirven (2001).

2. Mead (1994b), LaFleur (2000), ACDI/VOCA (2001), ECI (2001a,b), Hatch (2001), Magistro et al. (2004), Vorley (2004).

3. See Snodgrass and Biggs (1996) for a good discussion of unintentional policy effects.

have little voice in these discussions, most of which proceed with little, if any, thought about their impacts on the RNFE (Liedholm and Mead 1986; Snodgrass and Biggs 1996). In rural areas, agricultural issues rather than the largely invisible RNFE dominate policy discussions. Agricultural research, extension, and infrastructure investment programs, which influence the rate of change in agriculture, simultaneously influence opportunities for agriculturally linked rural nonfarm enterprises (see Chapter 7). Thus, in most situations, the policy environment in which rural nonfarm firms operate emerges by default, out of concerns about other segments of the national economy. As a result, these policies generate unintended impacts on the RNFE, sometimes opening up opportunities and in other instances destroying whole industries.

Macro policies, instituted for a variety of reasons that typically have little to do with the RNFE, affect these firms indirectly via the prices of inputs and outputs that they use. In practice, two common distortions have historically prevailed in many market economies of the developing world. First was a long wave of policies aimed at taxing agriculture in order to transfer resources into industrial investments (see Chapter 2). By penalizing farmers, these policies likewise depressed the markets for rural nonfarm goods and services. For this reason, virtually every major review of rural nonfarm activity has pointed first to the importance of a pro-agricultural policy environment as a fundamental prerequisite for rural nonfarm growth.<sup>4</sup>

Second, a common tendency to subsidize capital and tax labor in large urban firms has tended to discourage labor use in urban areas and conversely to favor labor intensity and limited equipment use among smaller and often rural firms. Interest rate subsidies, foreign exchange rationing, and strong biases in credit allocation in favor of large urban firms have permeated much of the developing world, including South Korea, the Philippines, Brazil, and elsewhere.<sup>5</sup> Similarly, labor laws and minimum wage regulations faced by large urban firms, but largely unenforced in rural areas, induce an economically excessive capital intensity in large and urban firms. Efforts to measure the impact of these distortions suggest that capital costs range from 30 to 65 percent lower in large urban enterprises, while labor costs rise by 20 to 25 percent (Haggblade, Liedholm, and Mead 1986; Snodgrass and Biggs 1996). These disparities suggest that policy environments typically favor labor use and discourage productivity-enhancing investment in machinery and equipment.

A wave of liberalization programs emerging from the structural adjustment efforts of the 1980s and 1990s has also had powerful impacts on the RNFE. Studies suggest that liberalized trade and exchange rate policies generally hurt

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4. See Anderson and Leiserson (1978), Chuta and Liedholm (1979), Liedholm and Mead (1986), Chadha (1993), Tomich, Kilby, and Johnston (1995), Bhatt (1998), and Lanjouw and Lanjouw (2001).

5. See Haggblade, Liedholm, and Mead (1986), Ho (1986a), and Snodgrass and Biggs (1996).

rural firms that compete with imported goods while helping enterprises that serve export markets or use imported equipment and inputs. Sri Lanka's trade liberalization of the late 1970s seriously dampened activity in rural hand-loomed and pottery-making, while rice milling and construction, which use imported equipment and materials, flourished (Osmani 1987). Similarly, liberalization of imported and synthetic fibers in El Salvador placed serious pressure on rural processors of henequen fibers for the manufacture of burlap sacks (Dichter 1986). Because of their low cost and sweeping impact, policies—intentionally or not—often prove to be the most powerful levers by which governments influence incentives in the RNFE.

**EXPLICIT POLICY INTERVENTION.** In some situations, governments explicitly aim to influence opportunities in the RNFE. They provide roads, power, water, and telecommunications in rural areas and rural towns, some targeted specifically to rural nonfarm firms through the creation of rural industrial estates. Some support small business assistance programs providing credit, input subsidies, and training programs (see Chapter 12). Others intervene in labor and product markets, thereby powerfully shaping opportunities in the RNFE.

In India, the liberalized industrial policy of 1991 ended four decades of heavy protection for specific village industries, exposing them to keen competition and triggering a massive restructuring of rural manufacturing. Similarly, post-war China's collectivized rural nonfarm activity has given way to explicit encouragement of individual private firms and a perceptible spurt in primarily privately owned town and village enterprises. The striking policy reorientation in both China and India clearly demonstrates the potentially overwhelming influence of government policy on rural nonfarm activity (see Chapter 13). Elsewhere in East Asia—in Japan, Taiwan, and South Korea—strong government controls on credit allocation clearly influenced the structure of activity in urban and rural areas (Amsden 1991). The high priority given to public investment in rural infrastructure in both Japan and Taiwan likewise proved a strong stimulus to rural nonfarm activities. In several industries, notably in textiles, direct government investment in model factories played an important role (Saith 1987).

In less directive policy environments elsewhere, governments have concentrated primarily on the creation of physical and social infrastructure and on providing overall economic incentives to nonfarm firms. During the 1950s and 1960s, these incentives favored primarily urban industrialization in Latin America, Asia, and Africa (see Chapter 2). Then in the early 1970s, often with encouragement and financing from Western donors, governments shifted a larger share of their expenditures to the support of rural development. The resulting construction of roads and development of rural health and education facilities laid a foundation for the expansion and modernization of the RNFE.

**PUBLIC INVESTMENT IN PHYSICAL INFRASTRUCTURE.** The voluminous literature on the effect of infrastructure investment suggests that its most significant impact on the RNFE may come indirectly via its influence on agriculture.

A range of cross-country studies has explored these relationships. Antle's (1983) early cross-section study of 47 developing and 19 developed countries measured the impact of an aggregated infrastructural composite (the gross domestic product of transportation and communications per square kilometer of land area) on agricultural output, finding that a 10 percent increase in infrastructural expenditures resulted in a 4 percent increase in agricultural production. A later study by Binswanger, Khandker, and Rosenzweig (1989), which pooled cross-section and time-series data for 58 countries over 10 years (1969–78), found that a 10 percent increase in road density increased agricultural production by 4 percent, while a 10 percent increase in irrigation facilities generated a 9 percent boost in farm output. Project evaluations from a multitude of specific infrastructural investment projects support these findings. A summary of the impact of World Bank–financed infrastructure investments during the 1980s found returns of 29 percent from highways, 19 percent from telecommunications, 13 percent from irrigation and drainage, and 11 percent from electrification (World Bank 1994).

A series of country case studies offers additional evidence on the impact of physical infrastructure on rural economies. Several have considered the implications for agriculture,<sup>6</sup> while some have directly examined the impact on rural nonfarm activity as well.<sup>7</sup> As a group, the agricultural studies document significant increases in both input use and farm output as a result of increases in access to rural infrastructure. They find that a 10 percent increase in rural road density increases agricultural output by 1 to 7 percent depending on the country, region, and time period.<sup>8</sup> Primary education matters as well, with a 10 percent increase leading to a corresponding 5 to 8 percent boost in agricultural output.<sup>9</sup> One study from India has found that a 10 percent increase in the density of rural banks and electrification contributes 3 percent and 2 percent, respectively, to agricultural growth (Binswanger, Khandker, and Rosenzweig 1989).

Infrastructural impact on rural nonfarm activity also emerges as significant. Telecommunications, credit, and electricity all contribute to increased rural nonfarm activity, as measured by either employment or income.<sup>10</sup> Intriguingly,

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6. Barnes and Binswanger (1986), Evenson (1986), Binswanger et al. (1987), Binswanger, Khandker, and Rosenzweig (1989), Ahmed and Donovan (1997), Fan, Hazell, and Thorat (1999), Fan, Zhang, and Zhang (2002).

7. Kamal (1983), Wanmali (1985), Fabella (1987), Haggblade and Hazell (1989), Khandker and Binswanger (1989), Ahmed and Hossain (1990), Hossain (1997), Fan, Hazell, and Thorat (1999), Fan, Zhang, and Zhang (2002).

8. Barnes and Binswanger (1986), Evenson (1986), Binswanger, Khandker, and Rosenzweig (1989), Fan, Hazell, and Thorat (1999), Fan, Zhang, and Zhang (2002).

9. Binswanger, Khandker, and Rosenzweig (1989), Fan, Hazell, and Thorat (1999), Fan, Zhang, and Zhang (2002).

10. See Kamal (1983), Barnes and Binswanger (1986), Khandker and Binswanger (1989), and Lanjouw (2001).

for the often-neglected rural service sector, Kamal (1983) finds that rural services enjoyed over half of the nonfarm benefits from telephone expansion in rural Egypt. Two recent studies from China and India suggest that a 10 percent increase in rural education and literacy rates will increase nonfarm output and employment shares by 5 to 6 percent, while a 10 percent increase in rural road density boosts nonfarm output and employment shares by about 2 percent (Fan, Hazell, and Thorat 1999; Fan, Zhang, and Zhang 2002). An array of regression studies confirms that road improvements and decreased distance to markets increase rural nonfarm participation and earnings.<sup>11</sup> Using a composite index of infrastructural development for rural Bangladesh, Ahmed and Hossain (1990) find a 21 percent increase in rural nonfarm income in infrastructurally more advanced villages. Moreover, wage rates rise by 12 percent as labor demand increases, particularly in nonfarm activity.

The importance of rural roads, electricity, and telecommunications in fostering rural nonfarm growth consistently emerges from anecdotal evidence as well. East Asian comparisons among Japan, Taiwan, and South Korea inevitably highlight the importance of rural infrastructure in the rapid growth of rural industries in Japan and Taiwan.<sup>12</sup> Studies done elsewhere highlight the importance of roads (Fabella 1987; Ranis 1989) and of electricity and telecommunications (Oshima 1986b; Lanjouw 1999) in the growth of specific rural industries. Other studies underscore the importance of roads in shifting the composition of rural nonfarm activity. While activities that depend on export markets or imported inputs benefit from rural road construction, those that compete with urban manufactures often suffer. Thus the frequently observed demise of the village tortilla, basket, and pot makers in the face of improved rural road access (Ancey 1974; Rello 1996).

**PUBLIC INVESTMENT IN EDUCATION.** The weight of available evidence suggests that basic education generally increases the productivity and wages of rural nonfarm workers.<sup>13</sup> Higher education likewise proves helpful in the start-up of modern subcontracting businesses as well as in adjusting to the new technologies and contracting arrangements required in modern agroindustrial supply chains.<sup>14</sup> Prospects for growth appear to expand significantly for entrepreneurs with secondary education and beyond, and education seems to help

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11. Barrett et al. (2001), Block and Webb (2001), Canagarajah et al. (2001), Smith et al. (2001).

12. Saith (1987), Ranis and Stewart (1993), Kawagoe (1998), Lane (1998), Lee and Suh (1998).

13. Bigsten (1984), Collier and Lal (1986), Ho (1986b), Vijverberg (1988), Mook, Musgrove, and Stelcner (1990), Islam (1997), Abdulai and Delgado (1998), Jolliffe (1998), Estudillo and Otsuka (1999), Lanjouw (1999), Trung (2000), Ruben and Van Den Berg (2001), Fan, Zhang, and Zhang (2002), Lanjouw and Shariff (2004).

14. See Bigsten (1984), Collier and Lal (1986), Fabella (1987), Steel and Webster (1991), Francis and Hoddinott (1993), Birks et al. (1994), Simler (1994b), Parker, Riopelle, and Steel (1995), Jolliffe (1998), and Ohno and Kikuchi (1998).

small firms adjust to new opportunities and new dangers.<sup>15</sup> Yet the impact almost certainly varies by activity and operating environment.<sup>16</sup> It is generally larger in urban areas and among larger firms. A major review of studies estimating the returns to education suggests social rates of return of about 25 percent for primary schooling and about 15 percent for secondary schooling, with some regional variations across the developing world (Psacharopoulos 1985). Like investments in basic physical infrastructure, public investments in rural education appear to increase the productivity and incomes of the rural poor who work in nonfarm activities.

### *Private Nonprofits*

A plethora of private, civil society, and public agencies promote rural nonfarm activity on equity and environmental grounds, mostly on a not-for-profit basis. These agencies see large numbers of poor households engaged in small businesses that provide an important supplement to their meager household earnings. They see the need for increased rural nonfarm earnings in areas where widespread landlessness and diminishing farm sizes limit farming for large segments of the rural population. They note that low capital requirements for labor-intensive rural nonfarm activities ensure easy access to these activities by poor households.<sup>17</sup>

Equity-oriented groups—such as nongovernmental organizations, religious groups, donors, and selected government departments—implement an array of direct interventions on behalf of the poor (see Chapter 12). In recent decades, these efforts have been dominated by the provision of financial services.<sup>18</sup>

INVESTING IN RURAL FINANCIAL INSTITUTIONS. A variety of institutional structures has emerged to deliver savings and credit services to the rural and urban poor.<sup>19</sup> Some, like the Unit Desa, or Village Bank, of Bank Rakyat in Indonesia (BRI-UD), offer market-oriented savings and lending services to individuals through their dense network of rural commercial bank branches. Others, such as several rural credit programs in Bangladesh, have grown to serve millions of poor people by offering loans through joint liability groups. In contrast to the branch banking model, some organizations focus on the establishment of small independent member-owned village banks or credit unions.

Outreach has proven impressive, particularly in rural Asia, where high population densities permit large-scale, low-cost administrative systems serving vast populations. In the year 2000, Indonesia's BRI-UD had \$800 million

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15. Parker (1995), Parker, Riopelle, and Steel (1995), McPherson (1996), Daniels and Mead (1998).

16. Fabella (1987), Vijverberg (1988), Moock, Musgrove, and Stelcner (1990).

17. The voluminous record on credit impact at the household level is examined in Chapter 12. In general, evaluations report some increase in income for the majority of assisted households and firms, with the greatest impact on those who are less poor. See Chapter 12 for details.

18. See, for example, Otero and Rhyne (1994), Morduch (1999a), and Daley-Harris (2005).

19. Lapenu and Zeller (2001), Meyer (2002), Hirschland (2005), Nagarajan and Meyer (2005).

in loans outstanding to 2.7 million rural borrowers, and it reported over 25 million savers. Bangladesh's multitude of large-scale rural credit programs serves about 40 percent of the households in the country, with \$390 million in loans outstanding. Thailand's Bank for Agriculture and Agricultural Cooperatives reaches over 4 million clients, lending to about three-fourths of farm households each year (Meyer 2002). In Latin America and Africa, however, rural outreach has proven far more difficult because of lower population densities and higher contact and administrative costs. Consequently, credit programs in those regions have remained concentrated in high-density urban settings, while rural outreach has proven more modest.

Increasingly, major players in poverty lending have focused on attaining financial sustainability as well. The largest of these, Indonesia's BRI-UD, became financially self-sufficient in 1989 after five years of government and donor subsidies and remains highly profitable today (Robinson 2002). Yet other star credit programs, such as that of Bangladesh's Grameen Bank, remained dependent on regular subsidy inflows for over 20 years.<sup>20</sup> Over 100 of the largest microfinance institutions (MFIs) now voluntarily provide their accounts for analysis, though numbers reporting vary from year to year. In 2001, 60 percent of the 148 reporting institutions required ongoing subsidies of about 10 percent of their full operating and financial costs (Meyer 2002). As of 2003, slightly under 50 percent of the 124 reporting MFIs required subsidies, although that proportion rose to over 60 percent among the 49 institutions that focused on poorer clients (Barres 2005). Of the many thousands that fail to report—including several hundred in Bangladesh alone—most continue to rely on ongoing subsidizes.

In spite of accounting and reporting improvements, performance data on microfinance institutions remain spotty. Worldwide, some microfinance specialists believe that only 1 percent of all microenterprise lending programs are financially self-sufficient and that only 5 percent ever will be (Morduch 1999a; Development Finance Forum 2004). Despite widespread ambitions to attain financial self-sustainability, most microfinance institutions continue to rely on regular inflows of government subsidies (Schreiner and Yaron 2001; Armandariz de Aghion and Morduch 2005). Like roads, education, infrastructure, and business development service programs, the credit programs rely on regular infusions of public funds.

Given that the inevitable start-up subsidies necessary to launch these financial institutions compete with other worthwhile public investments—in rural infrastructure, education, and agricultural research—efficient allocation of public resources requires a comparison of the benefits and costs of these alternative investments. Yet the cost of building rural credit institutions remains unknown, or at least unreported in most of the latest generation of impact

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20. Boomgard and Angell (1994), Yaron, McDonald, and Piprek (1997), Morduch (1999b), Schreiner (2003).

studies.<sup>21</sup> A recent review of the economics of microfinance found “just two serious cost-benefit analyses of microfinance programs” (Armendariz de Aghion and Morduch 2005, 233). Indeed some proponents argue that because credit programs aim to create self-sustaining financial institutions, they should be exempted from the rigors of cost-benefit comparisons. If microfinance interventions succeed in building self-sustaining savings and credit institutions, they argue, there is no public cost, only public gain. The difficulty with this argument is that currently most microcredit institutions are not yet fully cost-covering, and many probably never will be. A recent study from Latin America summarizes the available evidence as follows: “Is public support for microcredit wasted or worthwhile? No one knows. . . . The question is whether microfinance is better than some other development project for the poor” (Navajas et al. 2000, 334). Given the paucity of evidence comparing benefits and costs of microfinance institutions (Schreiner and Yaron 2001; Armendariz de Aghion and Morduch 2005), the bottom line today is that we simply do not know how investment in rural financial institutions stacks up against other alternative uses of public funds.

### **The Case for Intervention**

In an ideal world, government interventions would be justified on the basis of sound economic or social concerns. On efficiency grounds, governments play a potentially key role in ensuring an enabling business environment, supplying necessary public goods and correcting for market failures. On equity grounds, they often intervene to assist the poor in navigating difficult economic circumstances and transitions. Correcting for market failures, pollution, and other externalities may lead to intervention on environmental grounds.

#### *Creating an Enabling Business Environment*

**POLICY.** The overall business environment in which nonfarm firms operate proves central to their competitive health and to their prospects for growth. Trade, tariff, and exchange rate policies all affect the prices of imported inputs used by rural nonfarm traders, services, and producers—inputs such as fuel, specialized machinery, and cloth. They likewise govern the prices of competitive imports from abroad. Rules on access to foreign exchange, repatriation of profits, and foreign direct investment influence incentives facing foreign investors. For this reason, the wave of economic liberalization washing over the developing world since the 1990s has unleashed a flood of foreign direct investment in agribusinesses, leading to an unprecedented concentration of export

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21. See Townsend and Yaron (2001), Khandker (2003), and Schreiner (2003) for welcome exceptions to this rule.

and domestic food processing and marketing (see Chapter 9). The prices of factor inputs, credit, and labor govern the profitability of alternative production technologies, while transport and communication costs influence the spatial distribution of rural nonfarm activity (Chapter 8). The stability of prices and of the policy environment itself affects investment incentives and risk premiums. Agricultural policies likewise feature prominently in most discussions of policy incentives affecting rural nonfarm growth.<sup>22</sup>

Policy discussions have likewise focused on the legal and regulatory environment. Zoning and licensing laws, enforcement of fiscal legislation, and labor and social welfare regulations all influence business incentives. Many complain of zoning restrictions that hamper small and rural nonfarm enterprises.<sup>23</sup> Licensing and zoning laws often limit or regulate the operating locations available for specific activities.

**INFRASTRUCTURE.** Public infrastructure provides lubrication essential for the smooth functioning of the RNFE. Transport infrastructure, electricity, telecommunications, and banks enable the information, commodity, and financial flows essential for rural nonfarm activity.<sup>24</sup> Investments in rural education, health, and skills development likewise provide essential building blocks for prosperous, high-productivity rural jobs.

As nonfarm development becomes increasingly dependent on external markets, newer types of infrastructure and institutions become critical: port facilities, container shipping facilities, air shipment facilities, quality-certifying institutions, and testing laboratories. Growth in the RNFE requires a set of public goods that the private sector, left to itself, will typically not provide in sufficient quantity.

**MARKET INSTITUTIONS.** An evolving collection of rules, practices, and norms governs transactions among the large and small enterprises that populate the RNFE. Spot markets often prevail in open-air or communal marketplaces. Ongoing relationships build social capital among networks of rural nonfarm traders, assemblers, and processors, often cemented by reciprocal financial and product flows. Large firms serve as clients and customers of smaller entities. They develop systems of exchange involving implicit contracts, formal sub-contracts, and supplier credits.

Grades and standards help regulate and moderate exchanges among large and small firms. Historically, public agencies have established grades and

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22. Johnston and Kilby (1975), Anderson and Leiserson (1978), Chuta and Liedholm (1979), Chadha (1993), Tomich, Kilby, and Johnston (1995), Bhatt (1998), Lanjouw and Lanjouw (2001).

23. De Soto (1989), Mead (1994a), Morrisson et al. (1994), Mead and Morrisson (1996).

24. Fluitman (1983), Saunders, Warford, and Wellenius (1983), Binswanger, Khandker, and Rosenzweig (1989), Ahmed and Hossain (1990), Ahmed and Donovan (1992, 1997), World Bank (1994), ESCAP (2004).

standards as well as the certification systems that enforce them. In recent decades, however, the large supermarkets and exporters that increasingly dominate food and agribusiness marketing chains in the developing world have introduced private grading systems and procedures that have become de facto standards to which smaller players must adjust (see Chapter 9).

### *Equity Concerns*

Because the RNFE plays a key role in the livelihood strategies of the rural poor, changes that adversely affect small rural nonfarm firms and employment require special vigilance by government. Market and trade liberalization, which unleash new forces of competition in rural economies, heighten these concerns. As large firms increasingly penetrate rural areas of the developing world, the legions of small firms exposed as a result to new competition and market concentration may face serious dislocation without some sort of temporary assistance in making the transition to newly ascendant market niches or alternative occupations. Governments across the developing world encounter opportunities and pressures to assist rural producers in navigating these rapid transitions.

Equity considerations also motivate most of the nonprofit agencies that currently intervene in the RNFE. They aim explicitly to open up opportunities for the rural poor to participate more fully in globalizing markets and to diversify their income earnings through nonfarm pursuits.

### *Environmental Concerns*

Some types of rural nonfarm activity pose significant environmental problems in rural areas and rural towns. Tanneries, small-scale chemical plants, textile mills, and even food processing firms pollute waterways in many Asian countries. Some types of large manufacturing firms emit significant volumes of airborne pollutants.<sup>25</sup> For example, in China during the mid-1980s, township and village enterprises produced one-sixth of the water pollution and solid wastes in the country (Kirkby, Bradbury, and Shen 2000). In instances such as these, government has an important regulatory role to play, sometimes by simply imposing in rural settings the same environmental standards and enforcement already practiced in larger urban centers.

Over the past five decades, many governments have intervened inadvertently in the RNFE as policies and decisions made for other reasons have spilled over into the RNFE. Others have elected to intervene explicitly in the RNFE for both economic and political reasons. These interventions have taken a variety of institutional forms.

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25. See Kirkby, Bradbury, and Shen (2000), Thanh (2002), and Tacoli and Satterthwaite (2003).

## **Alternative Institutional Models**

### *Institutional Gaps*

In spite of its size and economic importance, the RNFE frequently falls through gaping holes in the fabric of existing promotional and support institutions (Gordon and Craig 2001). Ministries of agriculture, which dominate the rural landscape, typically find themselves preoccupied with issues of farm production, research, and extension. Only rarely do they establish marketing divisions to monitor and support rural nonfarm assembly, marketing, and agroprocessing activities (Abbott 1986).

Ministries of commerce and industry concentrate most frequently on large urban centers and on international trade rather than on dispersed, itinerant rural firms. Even notable exceptions such as India's Village and Khadi Industries Commission and China's priority rural industries program concentrated exclusively on rural manufacturing to the exclusion of the often larger and faster-growing rural services and commerce (SGRNFS 1995). Consequently, large segments of the RNFE fall through the cracks.

Private services, even though they predominate in many rural nonfarm economies, find little support from their respective ministries of health, education, and transport. Instead these line ministries typically focus on the delivery of public rather than private services. Yet private schools, private clinics, private transport, and private media and entertainment frequently grow quickly in buoyant rural economies. Similarly, responsibility for siting, financing, and maintaining rural infrastructure remains splintered across line ministries of post, telecommunications, energy, and roads. Meanwhile, secondary roads and maintenance typically fall within the purview of local government authorities. The result is a highly fragmented institutional network from which to deliver public support for rural nonfarm activities.

### *Integrated Responses*

To bridge the sectoral divide that fractures most institutional support networks, governments have responded in a variety of ways. Considerable institutional experimentation took place in the 1970s, during the first great wave of public interest in broad-based rural development.<sup>26</sup> In the course of that and subsequent experimentation, at least seven different institutional models emerged. Four are integrated models that recognize the mutual interdependence between agriculture, nonfarm activity, infrastructure, education, and social services, then try to find institutional models that can coordinate the delivery of these

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26. See Ruttan (1975, 1984), Rondinelli and Evans (1983), Holdcroft (1984), and Donaldson (1993).

interconnected ingredients. The remaining three models take a sectoral approach to rural nonfarm promotion.

**MINISTRIES OF RURAL DEVELOPMENT.** A common response during the 1970s, new ministries of rural development typically assumed a broad cross-sectoral mandate for the provision of agricultural support, social services, non-farm business assistance, and infrastructure. Yet these new omnibus ministries quickly encountered stiff resistance from the old line ministries of agriculture, commerce, roads, post, and telecommunications, which vigorously resisted the erosion of their prerogatives and the resources they controlled. In most settings, the resulting institutional skirmishes and infighting quickly dissipated the influence of the new ministries of rural development. So most governments have abandoned this model as unworkable. The short-lived ministries of rural development have mostly disappeared, their functions subsumed within the line ministries whose mandates they usurped (Holdcroft 1984).

**HIGH-LEVEL, SUPRAMINISTERIAL COORDINATING UNITS.** An alternate model called for the establishment of a rural development czar or council, often located in the president's or prime minister's office, to coordinate the rural activities of the line ministries. One example of this approach comes from Botswana, where a rural development coordinator sat in the Ministry of Finance and Development Planning but reported directly to the vice president, who chaired a newly established Rural Development Council (RDC). Because of the high-level political commitment of the Botswana government, the effectiveness of the RDC, and the tight link between RDC priorities, rural development planning, and central government financial budgeting, this system ensured synchronized priorities and activities across central government ministries and their rural counterparts in the local and district governments. Consequently, the system yielded generally impressive results. The small size of the country, its highly professional and effective civil service, and its strong political commitment all contributed to the smooth functioning of this model. However, in other settings these ingredients are not always present.

**SPECIAL REGIONAL OR PROJECT AUTHORITIES.** The rural development fervor of the 1970s gave rise to a generation of integrated rural development projects. Funding agencies persuaded host governments to sanction the creation of special regional or project authorities to manage these complex, multisectoral interventions. Heavily subsidized and largely reliant on donor funding, these special project authorities naturally withered as donor enthusiasm faded and the great tide of rural development funding ebbed, leaving the remains of rusted institutional carcasses littered across the rural landscape. Domestic financial stringencies imposed by structural adjustment programs in the late 1980s amplified the contraction in funding available for rural development efforts. Some rural development programs continued to function, nonetheless, notably the large regional development programs of Northeast Brazil (Tendler 1993). The vast majority, however, remain defunct and largely discredited as overly ambi-

tious, excessively expensive, and too difficult to manage (Ruttan 1975, 1984; Holdcroft 1984).

DECENTRALIZATION AND DELEGATION TO LOCAL GOVERNMENTS. Early in the twenty-first century, as during the 1970s, decentralization and local economic development have emerged as popular strategies for spurring rural development.<sup>27</sup> Some groups refer to these new-generation efforts as territorial development.<sup>28</sup> Given the frequent necessity of local collective action as well as infrastructure and public service provision, efforts to strengthen local decisionmaking and resource mobilization remain central to effective local area development efforts. Recent examples from China of highly dynamic RNFE growth spurred by local government initiative have fueled institutional emulation in India and elsewhere (see Chapter 12). In other settings, however, local governments remain bereft of fiscal resources and decisionmaking authority, both of which financially beleaguered central governments prove reluctant to devolve.<sup>29</sup> Ultimately, for decentralization to work well, central governments must retain a high level of commitment and willingness to concede financial and political control. Yet this commitment requires a level of selflessness that many central government political leaders find difficult to muster. A review from Latin America notes that “Latin America has experienced numerous waves of decentralization since the countries of the region first gained their independence. Each has finally ended with a recentralizing of authority at the national level” (Peterson 1997, 31). While many countries have made progress in decentralizing control, in others the transfer of real authority and resources to local-level decisionmakers remains an ongoing challenge.<sup>30</sup>

### *Sectoral Institutions*

EXPANSION OF RESPONSIBILITIES IN MINISTRIES OF AGRICULTURE. Because of their extensive presence, ministries of agriculture typically staff the most effective extension network functioning in rural areas. Therefore, they become natural candidates for extending central government mandates in rural areas. In practice, this all too often involves nothing more than the addition of a marketing division or agroprocessing unit within the ministry (Abbott 1986). Historically, these units have fared poorly in ministerial resource allocation decisions because their marketing mandate is viewed as peripheral to the core ministry functions of boosting farm production. In response to greater competition in domestic agricultural markets, as a result of trade liberalization, this

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27. Rondinelli (1981), Cheema and Rondinelli (1983), Nel (1996), Peterson (1997), Key-fors (1998), Manor (1999), Helmsing (2001), World Bank (2001), Tacoli and Satterthwaite (2003).

28. Farrell and Thirion (2001), Stohr (2001).

29. Bahl, Miner, and Schroeder (1984), Bahl and Linn (1992), Tacoli (1998).

30. Chapter 13 describes the striking contrast between decentralization efforts in China and those in India.

view is now changing in some settings, particularly as countries face greater opportunities to capture more value added from agriculture through agroprocessing and the production of higher-value products. Chile and Brazil, for example, have invested heavily in the past decade to modernize small-scale farming and accelerate agricultural growth by promoting agroprocessing and improved marketing, including stronger links with urban markets (Berdegú 2001).

**RURAL INDUSTRY PROGRAMS.** Eschewing the cross-sectoral approach embodied in the integrated models, some countries have instead focused on one portion of the RNFE—rural manufacturing. Both China and India adopted this strategy early on, India with its village and *khadi* industries programs and China with its five small industries policy. Though the industries selected for assistance differed, both countries translated high-level policy commitment for rural industry promotion into a complex system of subsidized inputs, policy protection, quotas, and promotional institutions. Both favored rural manufacturing and largely neglected rural commerce and services. During the 1990s, both governments abandoned these heavily subsidized systems, deprotected the previously favored rural manufacturers, and liberalized incentives to a considerable extent (see Chapter 13). In doing so, they have both ushered in an era of major transition—the large-scale disappearance of many highly protected but uncompetitive rural industries and the rapid growth of other activities, such as export subcontracting and local services.

**DEVOLUTION TO THE PRIVATE SECTOR.** Sector- and commodity-specific promotional efforts increasingly rely on private sector service delivery to promote nonfarm business growth. Drawing on early private sector experience (Rodolo 1972), a wave of projects and agencies have experimented with developing business linkages between large and small firms in order to facilitate the commercial provision of marketing and other business development services.<sup>31</sup> In these efforts, promotional agencies play a facilitating role in developing business linkages, branding, grades and standards, and contracting procedures necessary for large numbers of small firms to effectively supply the quality and volume required by large agribusiness firms.<sup>32</sup>

### *Institutional Tendencies*

In spite of increasing concern about rural poverty and the potentially important role the RNFE can play in redynamizing rural economies, large gaps remain in public policies and promotion programs. Though decentralization to local governments and devolution to the private sector have gained momentum in recent years, no clear institutional delivery system currently dominates rural nonfarm

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31. Barton (1997), Grierson, Mead, and Moyo (1997), Lusby and Panliburton (2002).

32. Edesess and Polak (1993), ACDI/VOCA (2001), Vorley (2001, 2004), Bear, Gibson and Hitchins (2003), Magistro et al. (2004).

promotion efforts. Thus institutional diversity and gaping holes promise to characterize the promotional landscape for the foreseeable future.

### **From Platitudes to Prescriptions**

Platitudes prove difficult to dislodge. And so we are forced to conclude, like a long parade of past observers, that growth in the RNFE will require favorable public policies, adequate infrastructure, human skills, and well-functioning market and credit institutions. Unlike past observers, however, we note that dominant private sector firms increasingly rival public institutions in shaping the policy and institutional environment in which small rural nonfarm firms of the developing world operate.

Moving beyond the standard platitudes will require diagnostic tools that enable interveners to determine which elements of the policy and institutional environment will prove most crucial to rural nonfarm growth in specific instances. Which policies constrain opportunities in a given situation? Which roads will generate the greatest impact? Where can improved marketing, credit, or educational institutions enhance growth prospects for small rural nonfarm firms?

Generic assessment tools will prove appropriate in some circumstances. General overviews of the policy environment may prove useful, particularly in transition economies of Eastern Europe and other similar settings where egregious shortcomings in systems for securing property rights, land tenure, contract enforcement, foreign exchange, and access to credit constrain business activity across all segments of the nonfarm economy (Davis and Pearce 2000).

Frequently, however, growth-enhancing policy, infrastructural, and institutional investments prove commodity- and site-specific. So in many practical cases, situation-specific assessments will prove more illuminating than the generic. After review of a broad spectrum of specific rural nonfarm programs, policies, and settings, in the remaining chapters of Part III, Chapter 17 will propose an operational strategy for building institutional and policy environments that aims to facilitate equitable growth of the RNFE across the many diverse landscapes of the developing world.