



## Creating Better Business Environments for Micro and Small Enterprises

Simon White

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**Background:** This brief summarises the DCED's Business Environment working group technical report [Creating Better Business Environments for Micro and Small Enterprises](#). The DCED Business Environment

Working Group produces Policy Briefs to provide short, relevant guidance on specific topics related to donor and development agency support for BER in developing economies.

### Key Messages for Donors and Development Agencies

- **Give priority to levelling the playing field:** ensure firms are not disadvantaged in the business environment based on their size or the sex of their owner (and recognise that while a law, regulation or procedure may appear neutral, it can have very different effects on firms of different sizes).
- **Simplify, reduce costs and improve transparency:** simplify the legal and regulatory regime, reduce the costs of compliance and improve the transparency of regulatory and administrative decisions for all firms.
- **Invest in an objective assessment of the business environment:** place more effort on proper diagnostics, improving the quality of data to guide policy making, including an assessment of how the business environment affects MSEs.
- **Identify the causes and not just the symptoms:** carefully analyse national circumstances and contexts and identify the root causes to poor MSE performance.
- **Think small, aim for growth:** understand how government policies, laws and regulations affect the MSE sector and its potential for growth.
- **Avoid single, isolated reform measures:** understand how change in one part of the system may affect other parts.
- **Go beyond business environment reform:** recognise how the business environment relates to other factors affecting MSE competitiveness and growth.
- **Ensure integrated solutions:** use technical and financial cooperation to create suitable conditions and public-private dialogue, while improving legislation and regulation, administrative provisions and bureaucratic procedures.

- **Improve representation and voice:** promote dialogue between the private and the public sector and ensure the MSE sector can participate in these processes.
- **Improve policy coordination and coherence:** ensure the specific needs and opportunities of the MSE sector are addressed by government, whether through specialised MSE development agencies or inter-ministerial mechanisms.
- **Apply a gender lens to reform:** ensure the sex of a business owner is not a determinant of success.
- **Monitor and evaluate to stay on track:** apply regular reviews and establish robust feedback mechanisms.
- **Invest in further research:** fill the gaps in the knowledge on MSE development and the contribution of business environment reforms to improving MSE competitiveness and growth.

## Introduction

Poor business environments create a disproportionately negative effect on micro and small enterprises (MSEs) and hinder their development. In response, many donor and development agencies support reforms that focus on these enterprises. This Policy Brief presents the high-level findings of an examination into the impact business environment reforms have on MSEs in developing economies and describes a series of good practices for donor and development agencies.

MSEs are defined as private enterprises at the smaller end of the size spectrum. Definitions of firm size vary by country and organisation.<sup>1</sup> MSEs demand attention by reformers for two reasons.

First, they are major contributors to national development. In most countries, microenterprises and SMEs account for the highest number of firms. This number increases as the size of the firm decreases. Similarly, microenterprises and SMEs are important contributors to national employment, value-addition and gross domestic product.

Second, MSEs are more vulnerable to a poor business environment than larger enterprises. Smaller firms pay a proportionally higher cost for doing business than do large firms. Moreover, the external threats

created by poor business environment place MSEs in a more vulnerable position.

Many agencies embed MSE concerns in their business environment reform-support programmes, ensuring reforms are designed to benefit all firms regardless of their size. They endeavour to ensure MSE perspectives are captured in business environment assessments and programme monitoring. However, because MSEs typically have specific reform needs that go beyond general business environment issues, a more differentiated approach to reforms based on enterprise size class is often proposed.

While the ‘one size fits all’ theory that underpins the need for a level playing field is generally agreed on, the need for a case-by-case differentiation can be worth considering. However, a market or systems-based approach argues against this and seeks to benefit all enterprises regardless of their size.

## The purpose of reforms

MSE-oriented business environment reforms **boost economic growth and transformation**. They maximise the opportunities for economic growth and transformation through an assessment and identification of the factors that inhibit the growth of MSEs. This includes reforms that focus on **women's economic empowerment** by removing the legal and

<sup>1</sup> Unless otherwise defined in this document, micro-enterprises are private firms with fewer than five employees, small enterprises have between five and 19 employees, medium-sized enterprises between 20 and 99 employees, and large enterprises with 100 or more employees.

regulatory barriers affecting a disproportionately high number of women-owned and managed enterprises found in the MSE sector.

Reforms are also used to **encourage formalisation**. Business environment reforms contribute to the formalisation of firms by creating the conditions in which informal firms find that formalisation offers more benefits than cost, along with the use of better enforcement mechanisms. Similarly, improved labour and labour-related legal and regulatory regimes are used to address the **job quality** challenges faced by many of MSE workers.

National entrepreneurship policies and programmes are designed and implemented to **promote entrepreneurship**. These include support for entrepreneurship education, finance, innovation, and culture, and are mostly focused on entrepreneurial start-ups.

MSE-oriented business environment reforms are used to address the problem found in **disadvantaged regions**, where poor people are more prevalent and MSEs more common (e.g., rural economies). Similarly, these reforms often focus on **industries** in which poor people are more highly represented (e.g., agriculture).

Agencies support regular **public-private dialogue** in which MSEs are better represented and more involved.

## Special treatment and legal and regulatory exclusions

Business environment reforms that target MSEs often create exclusions or exemptions for MSEs from the demands of full legal and regulatory compliance. In such cases, reform programmes should clearly identify which kinds of enterprise require attention and why.

Donor and development agencies, and their partners, should develop a better understanding of how

business environment reforms affect MSE growth and competitiveness. More awareness and evidence on MSE growth factors is needed to guide policy and legislation reforms.

One example of the special treatment assigned to MSEs is the European Union's Small Business Act (SBA). This is regional framework aims to support entrepreneurship across Europe, simplify the regulatory and policy environment for small businesses, and remove the barriers to small business development. The European Commission (EC) conducts a regular Performance Review to monitor and assess progress in implementing the SBA. This includes consultations with the European Parliament and EU Member States' governments, as well as the network of SME Envoys. The Commission also tests the impact of EU legislation and programmes on SMEs.

Using an MSE lens to assess the business environment and adopting a Think Small First approach to policy, legal and regulatory reform can improve the business environment for most businesses and not just a selected few.

## Reform challenges

Donor and development agencies have many challenges when considering reforms for MSEs.

They must find ways to **avoid inhibiting growth and transformation**. Rather than focussing exclusively on MSEs, donors can support business environment reforms that contribute to enhancing the dynamics of the broader private sector as the engine of economic growth.

Reforms should determine how best to **provide the right incentives to encourage formalisation**. The motivations for formalisation are not well understood and the right incentives for the transition to the formal sector are often lacking. Thus, it is important for donors to understand the growth motivations and aspirations of informal firms and

respond to these with the relevant incentives. Similarly, it can be difficult to identify and fully understand the **drivers and dynamics of informality**. It is risky to overemphasise support to formalise informal firms and often better to understand the economic drivers and dynamics of informality. Design reforms that are tailored to address these issues based on clear evidence.



## Acknowledgements

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The BEWG serves as a platform to share information and knowledge on donor-supported business environment reform in developing countries and to identify and support good practices and new approaches in this field. For more publications by the BEWG, visit <http://www.enterprise-development.org/implementing-psd/business-environment-reform>

Feedback is welcome and should be sent to the DCED at [admin@Enterprise-Development.org](mailto:admin@Enterprise-Development.org)

Agencies should **take care not to support overly simplistic, isolated reforms**. Reforms should not be treated in isolation. Instead, donor and development agencies must understand how reforms in one part of the system affect the whole system.

Reforms are often hindered by the limited capacity of developing-country government ministries, departments and agencies. Thus, donor and development agencies need to **recognise the limitations in government capacity** and ensure their programmes and ambitions are customised to these constraints.

The **lack of data** inhibits an evidence-based approach to policy making and reform. More investment into relevant and accurate data is required, in the design phase and whilst monitoring reform effects.

The power imbalances between MSEs and larger enterprises and government authorities make it difficult to establish the political will for reforms that benefit the MSE sector. Donor and development agencies need to find ways to identify and respond to **political economic drivers**.

While important, business environment reforms are often not enough to **support the integration of MSEs into national and global supply chains** (e.g., value chain interventions, public procurement, local content). Donor and development agencies need to complement these reforms other supply-side interventions.

It can be very difficult to quantitatively assess the constraints and priorities for MSEs and **measure the impact of reforms**. Thus, agencies must find ways to monitor progress and adapt their programmes where required. This also requires effective coordination, policy coherence and effective information sharing and programme alignment between ministries, departments and agencies, and collaboration and dialogue with the private sector.

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