

## Private Sector Development Synthesis Note

### Current Debates on Small Enterprise Development

*last updated: November 2018*

#### Key take-aways:

- Small enterprises provide a large share of employment in low-income countries. However, their contribution to job growth is driven by a few fast-growing businesses. Considering the lower survival rates of small enterprises, job growth for large and small enterprises is broadly similar.
- Combining finance with management training has had some success in increasing incomes of small business owners; yet, long-term effects on productive growth may require support to small but high-growth entrepreneurs, and improving the market systems in which they operate.
- A study in more developed countries found that the establishment of an SME promotion agency, which channels all government support to the sector, was more efficient than spreading resources over various support organisations.

At least [US\\$24.5 billion of development aid](#) has been targeted at Small and Medium Sized Enterprises (SMEs) and donors have maintained a strong focus on SMEs for many years; yet the targeting of small enterprises is controversial. Advocates maintain that smaller enterprises are the place where most poor people find employment and economic opportunity; targeting them with assistance makes more sense than helping larger companies (which may not need as much help anyway). Opponents, however, argue that much employment is also lost through ‘churning’, as small enterprises come and go. Besides, they note, it is important to look at the entire private sector, since small enterprises often depend on larger ones for inputs and markets. This Note explores the debates in more detail, links to further reading.

#### >> 1. What is a small enterprise?

**Definitions of small enterprises vary widely.** Most commonly, they are defined by employee number. The World Bank Enterprise Survey (WBES) classifies enterprises with 5-19 employees as small and those with 20-99 as medium. The World Bank Group definition considers enterprises with 10-49 employees as small, 0-10 as micro-enterprises and 50-299 as medium-sized. Small enterprises can also be a shorthand for SMEs, Micro and Small Sized Enterprises (MSEs) and Micro, Small and Medium Sized Enterprises (MSMEs). More sophisticated definitions have also been proposed ([Kushnir, 2010](#)).

**Critics highlight that certain groups tend to be excluded from such classification systems and subsequent studies.** WBES only interview formal businesses with five or more employees, and exclude micro and informal enterprises. Even more so, studies tend to focus on the non-agricultural private sector and exclude family farming or wage agriculture. Some also argue that firm size categories are arbitrary and note that enterprise characteristics are better described by classifications such as ownership, degree of formality/informality and technological sophistication (e.g. [Biggs, 2002](#)). This Note does not follow one definition, but instead highlights relevant research and opinions across definitions.

#### >> 2. Do they drive job employment and creation?

**Donor support to small enterprises is often justified by their significant employment share.** Reviewing WBES data from 104 countries, [Ayyagari et al. \(2014\)](#) found that nearly a fifth of jobs are with small enterprises (5-19 employees), and nearly half are with SMEs (5-99), with both shares rising in low income countries (see Figure 1).

This still downplays the contribution of small enterprises, as informal and micro-enterprises are excluded. Using household surveys in 13 Sub-Saharan African countries, [Fox and Sohnesen \(2012\)](#) found that formal enterprises, small and large, account for just 9% of employment, informal household and micro enterprises 15%, and that most people (70%) were employed in family farming.

**More often, however, the key justification for supporting small enterprises is that they are especially effective at creating new jobs.** [Ayyagari et al. \(2014\)](#)

also found that in countries where jobs increased, small firms accounted for nearly a half of new jobs and SMEs accounted for three quarters of new jobs in low income countries (see Figure 1).

Figure 1 – Employment and job creation by firm size (adapted from Ayyagari et al, 2011)

	Small enterprises	SMEs
Employment across countries	16%	46%
Job creation across countries	45%	75%
Employment in low income countries	23%	51%
Job creation in low income countries	58%	89%

**However, these results only count firms which survive;** given that the failure rate of small start-ups is high, the bias in favour of survivors is likely to give an overly positive impression. Furthermore, the sample was very heterogeneous, with a small number of ‘transformational entrepreneurs’ being responsible for the bulk of job creation. [Page and Söderbom \(2015\)](#) conclude in Ethiopia that small and large firms create similar numbers of net jobs. [Liedholm and Mead \(1999\)](#) classify micro and small sized-enterprises (MSEs) into new-starts, non-growing enterprises, small growers and graduates. Non-growing enterprises, carrying out survival activities, are most common. However graduate enterprises, starting small but growing to 10+ staff, account for only 1% of MSEs but a quarter of new jobs created by existing MSEs; it is especially young and growing small enterprises that make disproportionately high contributions to employment ([ILO, 2015](#)).

**This suggests that it is the small and growing enterprises, especially the graduates, that growth-focused development agencies should support.** The [Aspen Network of Development Entrepreneurs](#) champions this approach.

### >> 3. How productive are they?

**A common criticism of small enterprises is that they have lower levels of productivity.** For instance, Page and Söderbom (2012) found that firms with 30 employees have twice as much value-added per worker as firms with 5 employees (for firms with 100 employees, it is three times as much), largely linked to the lower levels of capital stock per worker, in smaller enterprises. Small firms are also less likely to engage in innovative activities, such as adding new product lines or incorporating new technologies ([World Bank, 2013](#)). Others highlight that some small enterprises are very productive and innovative. For instance, [De Mel, McKenzie and Woodruff \(2009\)](#) found that over a quarter of micro-enterprises in Sri Lanka engage in innovation, particularly marketing and product innovation.

**A debate also exists over the extent to which they contribute to national productivity and competitiveness.** Competitive advantages, such as flexibility and closeness to customers, can allow them to innovate and complement large firms; higher turnover rates can also accelerate market development. Altenburg and Eckhardt (2006) argue this is less pronounced in developing than in developed countries, though, as most small enterprises focus on a few activities characterized by low entry barriers. Thus, small enterprises tend not to be innovative, or to spur structural change.

### >> 4. Are they more pro-poor than other firms?

**Small enterprises also receive significant support because they are seen as providing more opportunities for poorer people.** This is in part because there are not enough economic opportunities directly available in larger firms. Over the last decade in Sub-Saharan Africa, the employment share of household and micro-enterprises increased more than that of formal enterprises, as the labour force

increased more rapidly than the formal sector could create jobs (Fox and Sohnesen, 2012). Smaller firms also tend to have lower entry requirements, in terms of skills, education and qualifications. Small enterprises are also important employers of marginalised groups who have difficulties finding employment in larger firms. As such, many smaller businesses are survival enterprises, operating out of necessity rather than with intent to grow (CAFOD, 2014). Liedholm and Mead (1999) suggest that development agencies with a focus on poverty reduction should focus support on such survival enterprises. Altenburg and Eckhardt (2006) also suggest that SMEs play an important role in providing products and services to the poor, although comparisons to larger enterprises are missing.

**A counter-view is that in the longer term, the competitiveness of the overall economy, as driven by larger enterprises, will have a significant impact on the poor, for instance through increasing the tax revenues available for social services and indirect employment impacts.** The [Market Systems](#) (or M4P) approach, that donors such as DFID, Sida and SDC support, emphasises that all enterprises are part of wider market systems, and that large-scale poverty reduction requires these systems, rather than only individual enterprises, to work more effectively. Further, critics also highlight that job quality is often worse at small enterprises, with lower incomes and less job security due to the lower enterprise survival rates. Smaller firms generally have worse working conditions (Biggs, 2002). Informal firms, in particular, generally offer no benefits, nor dependable severance pay (IFC, 2013).

## >> 5. What is holding back small enterprises?

Figure 2- Top three reported constraints by firm size (IFC, 2013)

	Small	Medium	Large
Access to finance	1	1	3
Electricity	2	2	1
Informality	3	3	
Tax rate			
Skills			2

**Small enterprises report more business obstacles than larger enterprises.** However, there is debate about what the key obstacles are, and this has significant implications for policy responses. Access to finance is often viewed as the most significant obstacle, see Figure 2 (IFC, 2013). This is in part because banks consider it more risky and expensive to serve small enterprises as higher risk and more expensive. Women-owned businesses are particularly constrained as they have fewer

securitisable assets and weaker property rights (Klapper and Parker, 2011). This view is challenged, for example, by Aterido, Hallward-Driemeier and Pagés (2011), who found that increased access to finance is more beneficial for larger firms.

**Small enterprises also face significant obstacles in other aspects of the business environment** – such as taxes and regulation, inflation, corruption and street crime (Schiffer and Weder, 2001). Liedholm and Mead (1999) argue that a conducive business environment is more important for existing businesses that are growing, than for new, small businesses. Aterido et al (2011) note that a weak business environment can displace activity from larger firms towards micro-enterprises.

**Factors internal to smaller enterprises have been studied less.** On the one hand, certain skills and competencies may be relatively poorly developed among SMEs, where education levels are often lower. Yet inadequate workforce skills are prioritised more as a problem by larger firms, according to Table 2, above. The [World Bank \(2013\)](#) notes that productivity is particularly affected by management practices, and that management skills among small enterprise owners in Sub-Saharan Africa vary widely.

## >> 6. How can development agencies most effectively support small enterprises?

Development agencies use a number of approaches, with the aim of enabling small enterprises to grow faster and to employ more people, to pay higher wages and to better serve the poor.

[ILO \(2015\)](#) notes that 'access to finance and entrepreneurship training can contribute to income generation and the creation of more and better jobs, especially when they are provided as a package'. More evidence on the impacts of business management training is available [here](#). ANDE (2012) and de Kok, Deijl and Essen (2013) also review wider SME development programme evaluations.

[ANDE \(2012\)](#) advocates in particular for support to **Small and Growing Businesses (SGBs)**: growth-oriented firms employing 5-250 people, and seeking \$20,000 - \$2 million in investment capital. Similarly, [Michael, Peter and Jann \(2012\)](#) call for support for 'constrained gazelles', which have similar characteristics to top performers but are not as successful, and operate with substantially lower levels of capital. According to [Grimm, Knorringa and Lay \(2012\)](#), constrained gazelles typically don't require the traditional business management training often provided to small enterprises. They often have advanced managerial ability, higher levels of education (at least completed primary school), have been in business for more than a year, and operate in a non-traditional sector. Their primary support needs are access to capital, insurance, and infrastructure (e.g. reliable electricity supply).

[White \(2004\)](#) and [2018](#) highlight support to national governments to improve the business environment for small enterprises; some evaluations of this work are online [here](#). [De Kok, Deijl and Essen \(2013\)](#) highlight how regulatory reforms can stimulate access to finance, although this might not help survival enterprises. [Berner, Gomez and Knorringa \(2012\)](#) argue that it is not institutional hurdles that hold survival entrepreneurs back, since they are anyway not seeking to grow, but only to spread their risks. [Naude \(2011\)](#) argues that such measures need to be complemented by more pro-active support, such as education and training. **Development agencies also use programme approaches which increasingly aim to build up markets sustainably** – such as [value chain development](#), [local economic development](#) and [Market Systems Approaches \(or M4P\)](#).

[ILO \(2016\)](#) reviews experience with government-led SME Promotion Agencies in six countries (USA, Chile, Brazil, South Korea, South Africa and Spain). It concludes that 'the setup of an SME promotion agency, through which all government support to the sector is channelled, proves more efficient than spreading resources over various support organizations.'

*Click on this link for the DCED's Small Enterprise Knowledge Page, with a range of useful resources on the theme: [www.enterprise-development.org/implementing-psd/small-enterprise-development](http://www.enterprise-development.org/implementing-psd/small-enterprise-development)*