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# Targeted SME Financing and Employment Effects

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Ruchira Kumar

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**What Do We Know and What Can We Do Differently?**



**WORLD BANK GROUP**

Jobs

# TARGETED FINANCING FOR SME'S AND EMPLOYMENT EFFECTS: WHAT DO WE KNOW AND WHAT COULD BE DONE DIFFERENTLY?

RUCHIRA KUMAR

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# ABSTRACT

SMEs form a dominant share of the private sector in developing countries, and account for more than 50 percent of jobs in their respective economies. Besides their positive employment effects, the growth and vibrancy of these firms is also important for broader economic growth, diversification of economic base and as a source of innovation that is exhibited by some of the start-ups. Women-owned SMEs are emerging as one of the fast growing segments within the SME sector. Youth play an important role in the creation of new firms and start up activities. Given this importance of SMEs for creation of more, better and inclusive jobs, there is significant focus on understanding the constraints to growth of this sector and implementing programs to address them in the World Bank Group and the other development institutions. Among the several constraints that they face, access to finance is usually cited as the most important and there are several instruments that can be applied to address this constraint. However, what is the evidence of impact of these programs on the employment effects? This note brings together the learnings and evidence from access to finance interventions on employment and provides some recommendations for development practitioners who seek to maximize this objective from their access to finance interventions.

# ACKNOWLEDGEMENTS

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# TABLE OF CONTENTS

EXECUTIVE SUMMARY .....	5
I. THE WORLD OF SMES .....	7
A. WHAT DOES THE SME MAP LOOK LIKE? .....	7
B. WHY ARE SMES IMPORTANT? .....	8
C. CONSTRAINTS TO SME GROWTH AND ABILITY TO DO BUSINESS .....	16
II. ACCESS TO FINANCE FOR SMES AND THEIR EMPLOYMENT EFFECTS .....	21
A. DEMAND OF AND SUPPLY FOR SME FINANCING .....	21
B. THEORY OF CHANGE: FROM FINANCING INTERVENTIONS TO SMES TO EMPLOYMENT EFFECTS ..	25
C. EVIDENCE OF EMPLOYMENT EFFECTS OF REMOVING ACCESS TO FINANCE CONSTRAINTS.....	27
III. IMPLICATIONS .....	35
IV. CONCLUSIONS .....	37

# EXECUTIVE SUMMARY

**From the perspective of job creation, Small and Medium Enterprises (SMEs) play an important role.** SMEs, comprising over 90 percent of the private sector among developing countries, create more than 50 percent of jobs in their respective economies. The growth and vibrancy of these firms is also important for broader economic growth, diversification of economic base and as a source of innovation that is exhibited by some of the start-ups. Women-owned SMEs are emerging as one of the fast growing segments within the SME sector. While the employment effects of women-owned SMEs are not necessarily different from their male owned firms, growth of women-owned SMEs is critical for inclusive growth. Youth also play an important role in the SME sector given their significance in starting SMEs.

**Given the important role that SMEs play, there is great focus on programs to address constraints to SME growth within the World Bank Group (WBG) and the other development institutions.** These include both systemic programs designed to improve the broader business and financial environment in which these firms operate, and also targeted interventions aimed at improving firm operations. SME manager opinions collected through the World Bank Enterprise Surveys indicate that among the several obstacles faced by SMEs, access to finance is the most important. And there are several instruments designed and implemented by the international development community to ease this constraint. However, what evidence exists regarding the achievement of the expected results of these programs by way of creation of more, better and inclusive jobs? And does this evidence allow us to help design these interventions better?

**This note brings together evidence from existing literature and analysis on creation of more, better and inclusive jobs through targeted interventions to facilitate access to finance for SMEs.** The objective is to identify solutions for task team leaders that would help them design projects for greater impact on employment. The scope of the analysis covers formal SMEs in non-agricultural sectors and looks specifically at targeted interventions for financing for SMEs. While the more systemic interventions aimed at financial sector deepening are critical for SME growth, these are outside the scope of this particular review.

**The analysis finds that while there is a large amount of empirical evidence on the effects of SME growth on jobs, there is limited evidence of SME financing interventions at the sector or firm level on job creation.** Evidence is usually collected for identifying impact on SME growth but there is a lack of rigorous data from program level evaluations on the creation of more and better jobs. SME interventions, including those for addressing financing constraints, cover a spectrum of objectives from SME income stabilization, growth, economic diversification and employment. Data suggests that based on objectives, there is a need for greater targeting of types of SMEs within the broader SME sector. There are some segments of SMEs which create more jobs than others- the transformational high growth SMEs. Identifying these SMEs using big data and innovative methods such as psychometric testing is important. From the perspective of financing interventions, this also means a deeper understanding of not only the SME sector but also the differing financing needs of different segments of SMEs. This, along with a well-established monitoring and evaluation program will help to better outline a theory of change and the suite of effective solutions.

The note is organized as follows. In Section I, the note presents a summary of relevant SME statistics, the role SMEs play and the constraints they face. Section II delves into access to finance constraints for SMEs,

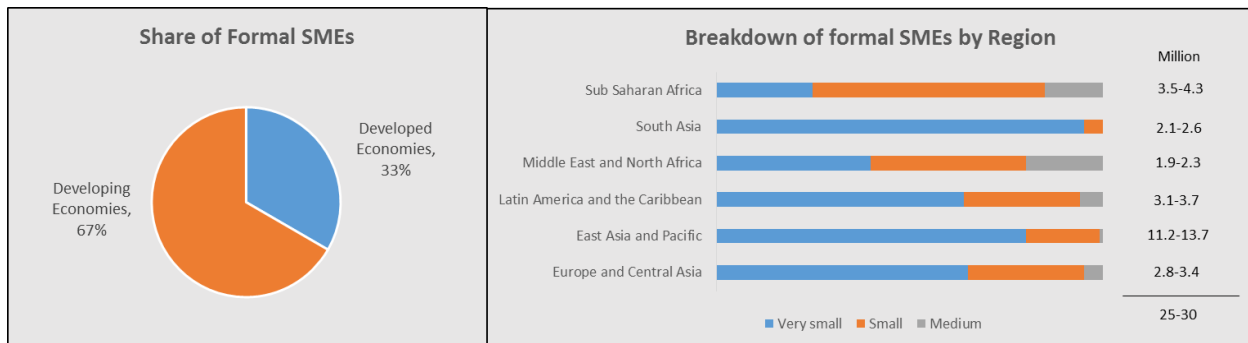
discusses the different financing instruments used to target SMEs and summarizes the evidence of employment effects of these access to finance programs. It also looks specifically at particular segments of SMEs- startups, high growth SMEs and women-owned SMEs to determine what is known about the effects of targeting their financing constraints. Section III ends with recommendations for future designs of programs and concludes.

# I. THE WORLD OF SMES

## A. WHAT DOES THE SME MAP LOOK LIKE?

There are approximately 35-45 million formal non-agricultural SMEs globally, comprising about 10 percent of the universe of both formal and informal micro SMEs (MSMEs) of 400-500 million.<sup>1</sup> Figure 1 shows that of these, approximately 67 percent, or 25-30 million operate in developing countries, with the largest share in East Asia and Pacific.

**FIGURE 1: SHARE OF FORMAL NON AGRICULTURAL SMES; BY REGION**



Source: IFC Enterprise Finance Gap Database, 2011<sup>2</sup>

The split of the firms by size by region also highlights the existence of the ‘missing middle’ in developing countries, or the very small share of medium sized firms (having 50-99 employees).<sup>3</sup> For example, as Figure 1 shows, this segment of SMEs is 20 percent of the total in Middle East & North Africa (MENA) and close to nonexistent in South Asia. There are several reasons for this problem of the missing middle, including severe constraints that small and potentially productive firms face in growth. Access to finance is a key one, with these firms being too large for micro finance institutions and too small for corporate banking.<sup>4</sup> Evidence suggests that if their access to finance constraints were alleviated, they would be able to generate positive and significant returns to capital. As these firms would grow, there would be a positive impact on generation of more and better jobs.

**The SME sector is also heterogeneous.** A large percentage of the SME sector is small, comprising tiny workshops, service providers and craftsman enterprises. These small enterprises are essentially reluctant entrepreneurs who do not have access to wage income and are in survival mode. Only a small fraction of

<sup>1</sup> IFC Enterprise Finance Gap Database 2011

<sup>2</sup> By definition, very small comprises firms with 5-9 employees, small comprises firms with 10 to 49 employees and medium comprises firms with 50 to 99 employees.

<sup>3</sup> The missing middle refers to the shape of the distribution of firms by size in an economy wherein a large number of firms are either very small and informal, or large and formal. There is a gap of existence of formal medium sized firms, which is a constraint to the country’s economic growth and employment.

<sup>4</sup> In the case of Sub Saharan Africa, the percentage of very small firms is also tiny. Access to any sort of finance, including micro financing, is scarcer, due to several issues including lack of capacity of the banking system to measure and manage risks, as well as being geared more towards the business of deposits than lending. (<http://www.economist.com/news/middle-east-and-africa/21701484-africa-has-enterprising-people-too-few-businesses-opportunities-galore>)



SMEs, about 5 to 10 percent, have the potential to grow larger and more productive if their constraints are eased.<sup>5</sup> However, these ‘high growth’ SMEs or ‘transformational’ SMEs or gazelles account for a significant percentage of job creation, as much as 25 percent of SME employment, and 40-45 percent of new employment (ILO 2015).

**Of the total number of SMEs in developing countries, women-owned SMEs account for 30 to 37 percent, or about 8 to 10 million SMEs** Within size class, women own smaller enterprises, and about 20 percent of medium-sized enterprises. Further, a majority of women-owned SMEs are in the retail and wholesale sector (about 40 percent).

**Given the difference in types of SMEs, either by age, size, ownership or the countries in which they operate, they face different constraints.** For instance, small, women-owned SMEs, SMEs in certain sectors such as agriculture, SMEs in fragile states are all more likely to face severe constraints to growth and survival. More details on the difference in the nature of these constraints are provided in the next section. The implication is that a clear understanding of the context in which SMEs operate, the segmentation of the SME sector and the prioritization of their needs is an important prerequisite before SME programs are successfully implemented.

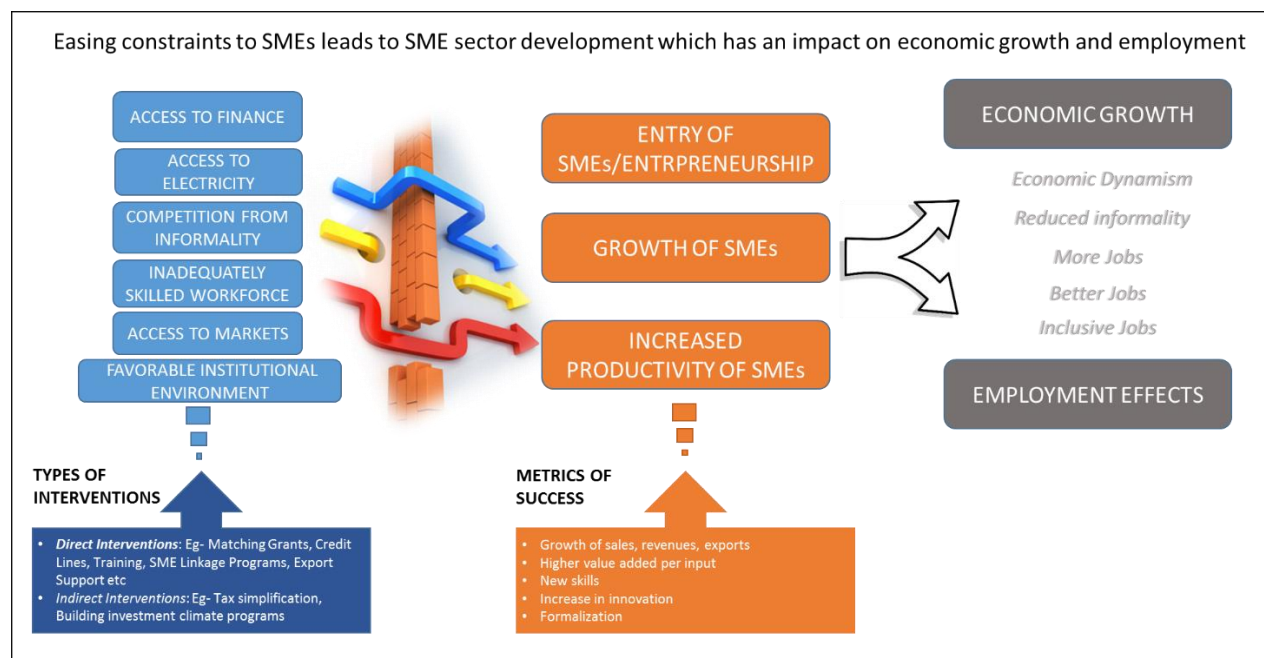
## **B. WHY ARE SMES IMPORTANT?**

**There is a large body of literature that outlines the important role SMEs play in economies including supporting economic growth, innovation, employment and reducing informality.** Figure 2 describes a simple causal chain of the outcome of easing barriers to the SME sector and the follow on impact on the larger economy via economic growth and employment. The figure below also lists the types of interventions that are used to help facilitate these vectors of SME growth and specific variables that reflect SME sector development. Evidence of the impact of SME development on two key variables- growth and employment, is discussed thereafter.

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<sup>5</sup> There are several benchmarks to define these high-growth SMEs including growth rates, employment sizes. (For example, Coad et al discuss two types of definitions- one is the share of firms in a population that see the highest growth during a particular period. The other defines such firms as growing at or above a particular pace, measured either annualized or between start and end year). Global Entrepreneurship Monitor, 5-year study of 800,000 entrepreneurs found that while high growth was 4%, they generated 38% of all jobs. Research on 925 Colombian companies from Enterprise Surveys found that high growth was 8% but represented 45% of new job creation. NESTA paper showed 6% of UK firms were high growth.

**FIGURE 2: CAUSAL CHAIN OF EASING CONSTRAINTS TO SME SECTOR**



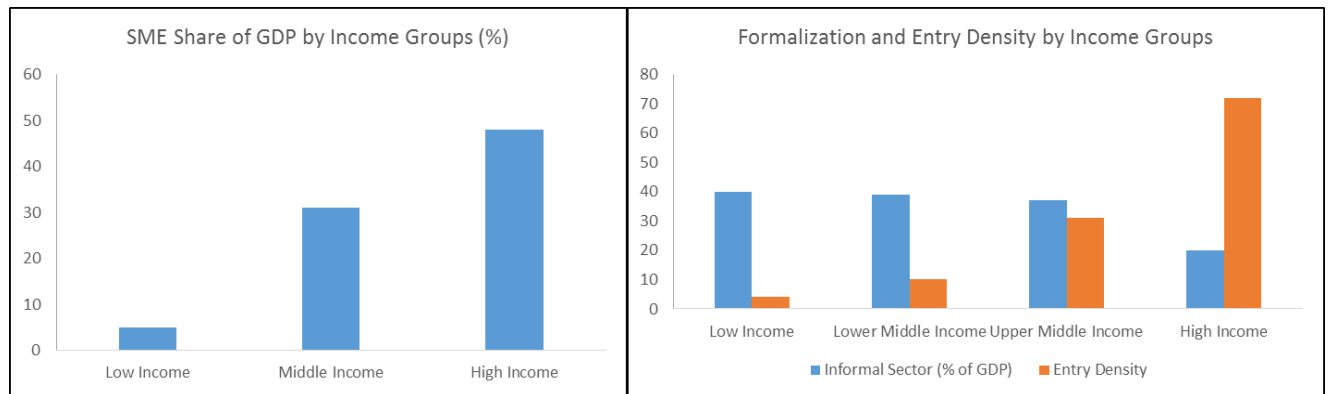
A vibrant SME sector has a significant role to play in the economy.

**1. Growth:**

**A vibrant and growing SME sector is a key ingredient in contribution to growth in both developed and developing countries.** Evidence indicates that SME sector size and economic growth are positively related though the causal impact on long run growth is not clear (Beck 2005). Figure 3 shows evidence from an empirical study in the manufacturing sector (Ayaggari 2007) of growing SME sector contribution to GDP with increasing levels of income. While its contribution to GDP is less than 10 percent in low income countries, the share increases to close to 50 percent or higher in high income countries.

**As countries grow richer, the constraints to SME growth ease up (examples being easier firm entry and exit, access to finance, electricity, credit information sharing) leading to greater opportunity for formalization, economic dynamism and innovation among SMEs.** If the conditions are provided for SMEs to thrive, there is a greater churn that allows the most efficient firms to survive and grow in efficiency, allowing the economy to push toward the productivity frontier. High income countries are characterized by high rates of entry and turnover of small firms rather than a large SME sector. Increased opportunities and incentives for formalization also result in a contraction of the informal sector, which is less productive than the formal sector. Therefore, there is a reallocation of resources towards more productive uses.

**FIGURE 3: RELATIONSHIP BETWEEN SME GROWTH AND GDP, FORMALIZATION AND ENTRY DENSITY**



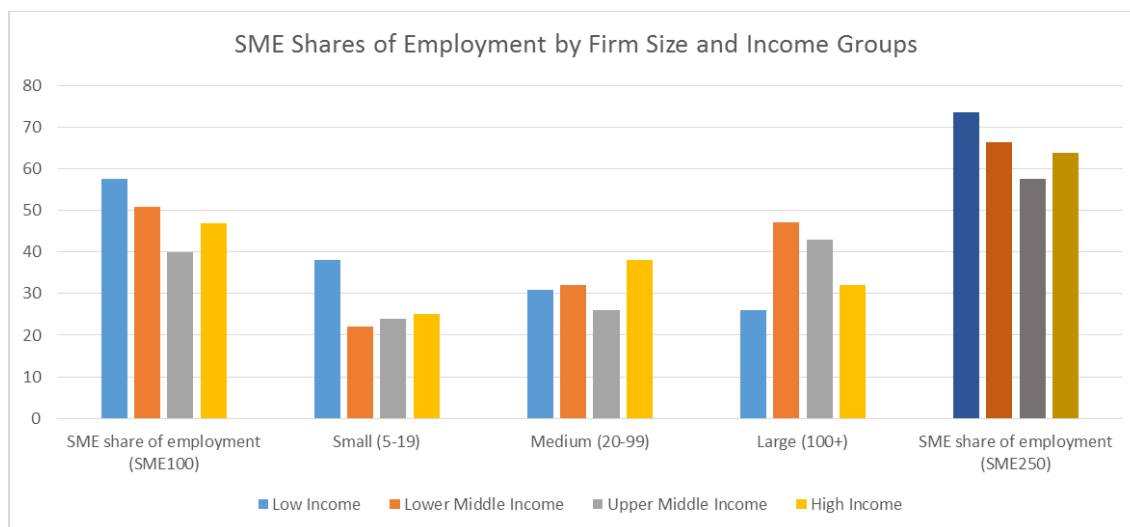
Source: Adapted from Ayyagari (2007 and 2011). Entry density is defined as the number of newly registered limited liability firms per 1000 working age people- ages 15 to 64. (World Bank Entrepreneurship Database)

2. **Employment: The empirical evidence of SME contribution to jobs is much more robust and clear. In summary, SMEs contribute the largest share to stock of employment globally across all income groups, and specifically in the low income countries.** In the long run, the number of jobs in countries may also increase through the indirect spillover employment effects of SME growth which become linked to larger eco systems. Within the firm size class, it is the smaller and younger firms that contribute more to dynamic employment growth. In terms of productive jobs, when measured by wages and labor productivity, it is the medium sized firms that have a dominant share. More specifically,
  - a. **SMEs have large shares of employment in developing countries though this employment share exhibits a U shape as one moves from low income to high income countries.** More than 50 percent of formal jobs in developing countries are in small firms<sup>6</sup>, and SMEs provide approximately two thirds of jobs in all countries, both developed and developing countries (Ayyagari, 2011). This data is based on formal nonagricultural enterprises and excludes micro and informal firms. Therefore, the share is even higher if the latter were taken into account.<sup>7</sup> The share of SME employment in total employment however declines for middle income countries before rising again, thereby creating a U shape as shown in Figure 4.

<sup>6</sup> This is assuming cut off of 100 employees to define SMEs. When the definition expands to firms with less than 250 employees, this percentage share of employment goes up to over 70 pc in developing countries.

<sup>7</sup> For example, a literature review of evidence on size and age of firms identifies a study of manufacturing firms in India that indicates that micro enterprises (1-5 employees) account for 84 percent of total manufacturing employment. (Hasan and Jandoc, 2009)

**FIGURE 4: SME SHARE OF EMPLOYMENT BY FIRM SIZE AND INCOME GROUPS**

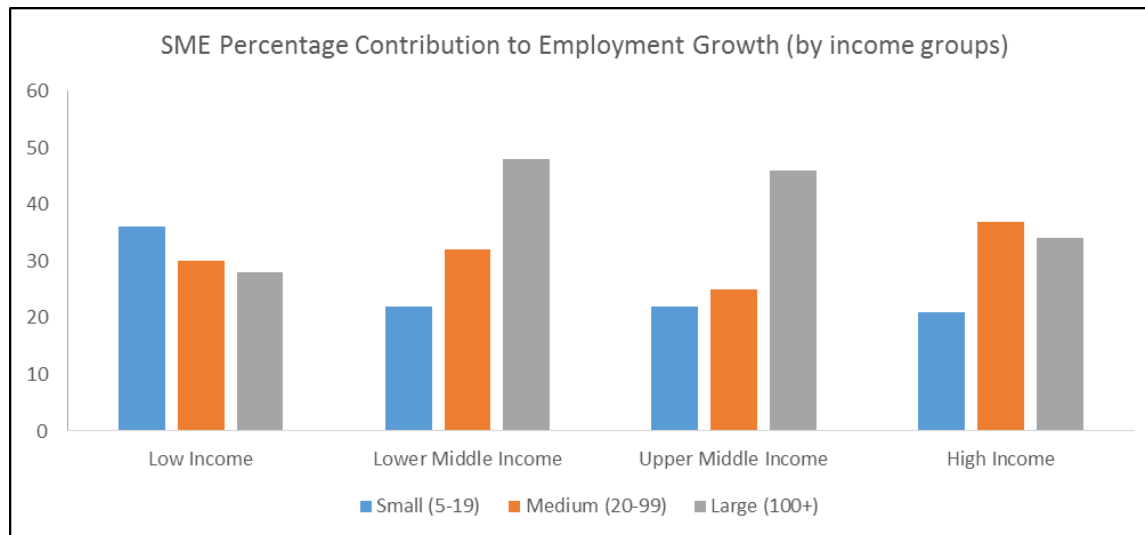


Source: Ayaggari, 2007 and 2011

In the long run too, SME growth contributes to employment which are observable at the economy wide level, as productive firms survive, grow and create jobs directly, and indirectly through linkages to eco-systems.

- b. SMEs are also larger contributors to employment *growth* compared to larger firms.** Figure 5 highlights empirical analysis that indicates that for a majority of countries, both developed and developing, more than 50 percent of total net employment creation can be attributed to firms with fewer than 100 employees (Ayaggari 2011). Within regions too, the two size classes (small and medium) contribute to more than 50 percent of employment growth. In South Asia, this share is close to 100 percent. Larger firms with more than 100 employees contribute a fraction to job growth. Further, in countries which witness net job losses, it is the small firms that show net positive job growth rates, implying that the jobs destroyed by larger firms far outweigh the job creation by smaller ones. This trend of small firm contribution to job creation is also seen at the country level. For instance, evidence from Ethiopia indicates that relative employment growth is largest for the smallest firms (+6 percent for firms with 10 to 19 workers) (ILO 2013). Firm analysis in Tunisia indicates that between 1996 and 2010, for every year, firms with fewer than 10 employees account for about 55 percent of total net employment growth and those with less than 100 employees account for 73 percent (Aga 2015).

**FIGURE 5: SME CONTRIBUTION TO EMPLOYMENT GROWTH**

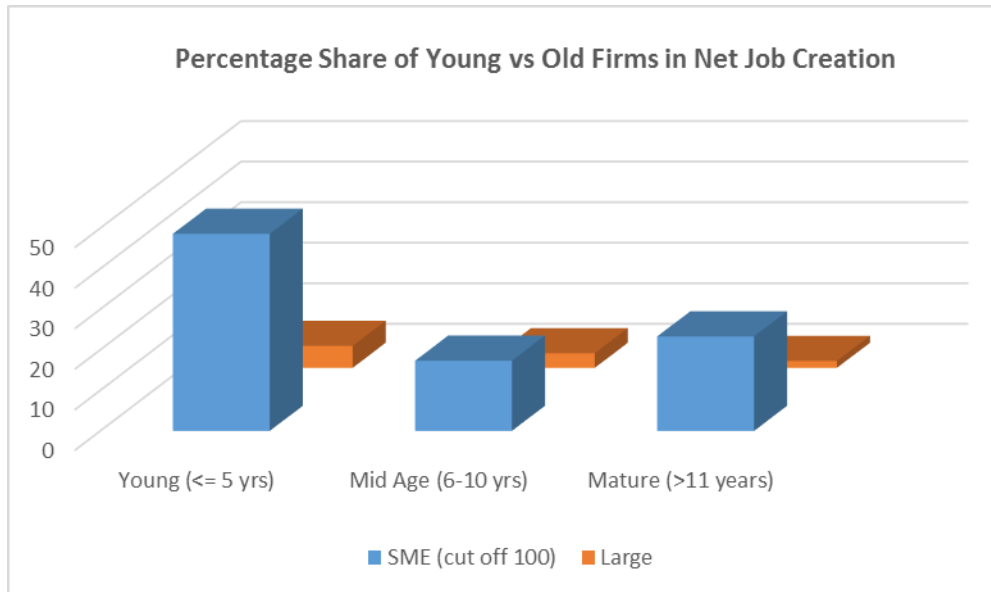


Source: Ayaggari, 2013

- c. **Older firms contribute larger shares to stock of employment compared to younger firms, while it is the *young* small firms that are larger contributors to net employment growth.** This pattern has been identified in several empirical analyses for firm data in developed countries (Haltwinger, Klette et al, Criscuolo) and also for data from developing countries. In the latter, data from the Enterprise Surveys indicates that firms 11 years and older contribute the largest share to stock of employment (about 35 percent).

However, in terms of contribution to *net employment growth*, data from developed countries indicates that younger firms (less than 2 years) are the biggest contributors to net job creation. Analysis from the Kaufmann Institution shows that virtually all net jobs in the United States over the period 1980- 2012 were created by firms less than five years old. While young and old firms have similar job destruction rates, gross job creation rates decline with firm age. In developing countries, it is firms less than 5 years that grow faster in terms of employment, but size matters. As Figure 6 shows, it is the *smaller*, younger firms that are key contributors to employment growth. Census data from Chinese manufacturing firms over 1998 to 2007 also indicates that net job growth rates decline with firm age; i.e. younger firms contribute more to net job growth. Older and larger firms also have high gross job creation rates, but given their higher job contraction, their net effect in job creation is smaller than younger and smaller firms. *It is this cohort of firms within the broader sector, sometimes called gazelles, or high growth SMEs, or transformational entrepreneurs or startups, that are key contributors to job creation.*

**FIGURE 6: SHARE OF SME'S VS LARGE FIRMS BY AGE ON NET EMPLOYMENT GROWTH**

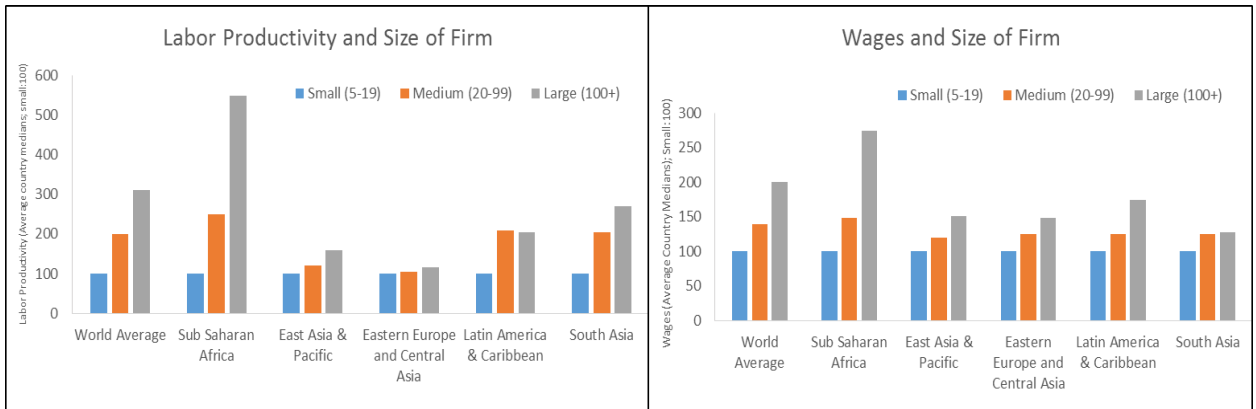


Source: Aga, Francis, Meza, 2015; based on initial sizes of firms

- d. **SMEs, though primary contributors to jobs and creation of jobs, are less productive and contribute less to productivity growth than large firms.** Figure 7 highlights this difference in labor productivity and wages by size of firms across different regions. Smaller firms are more constrained for key factors of production, and less able to overcome these constraints compared to larger firms which adversely affects their productivity. According to the World Development Report 2013, larger firms are more productive and innovative, and pay higher wages. Small firms command a wage premium of the order of 10-30 percent compared to micro enterprises, and large firms exhibit a premium of 20-50 percent compared to small firms. Evidence from Africa indicates that firms with 30 employees have twice as much value added per worker than firms with 5 employees (Page & Soderbom 2012). For firms with more than 100 employees, it is three times as much. Smaller firms, whose objective is basic income stabilization, are also less likely to engage in innovative activities that come with increasing capital intensity. A firm with 100 employees on an average employs 3 times more capital than a firm with 10 employees.

Similarly, on wage differential, the above analysis shows that the earnings of the average worker in a 100 worker firm is about 80 percent higher than his counterpart in a 5 worker firm. Finally, there is some evidence from data in Ethiopia (Page et al) that wages in small firms do not catch up to those in large firms even as they grow.

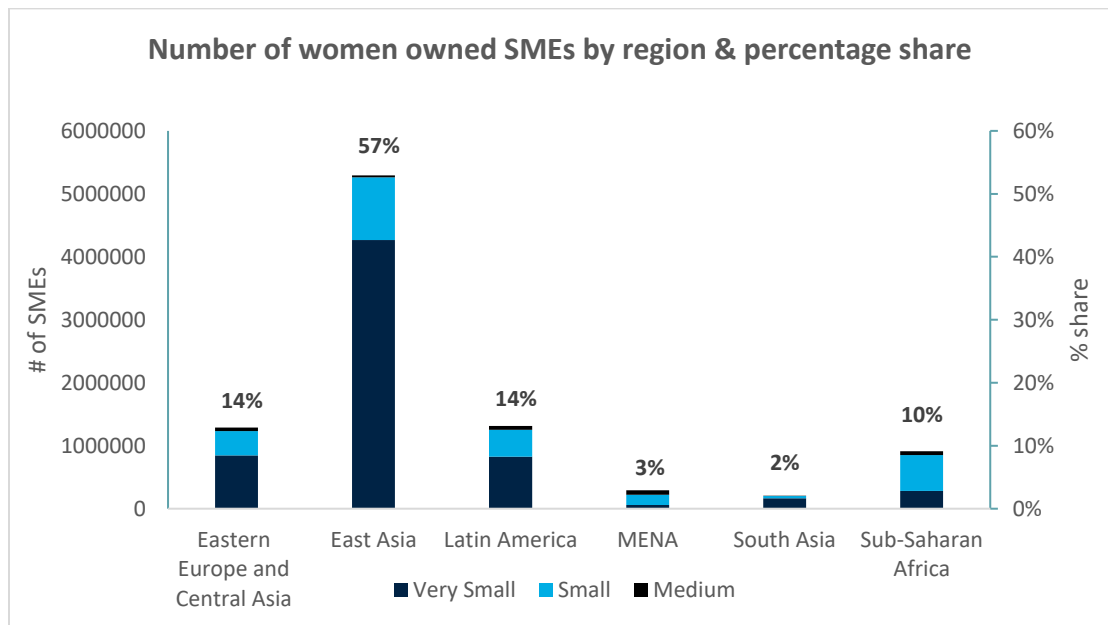
**FIGURE 7: SMEs AND CONTRIBUTION TO PRODUCTIVITY**



Source: Small and Medium Enterprises and Decent and Productive Employment Creation, ILO, 2015

- e. **SMEs have an important contribution in creating inclusive opportunities for women.** As mentioned earlier, women-owned SMEs comprise 30 to 37 percent of all SMEs in emerging markets, totaling about 8 to 10 million SMEs. Figure 8 shows regional differences and that women-owned SMEs are fewer in MENA, South Asia and Sub Saharan Africa. Within size class, women own smaller enterprises, and about 20 percent of medium-sized enterprises. Further, a majority of women-owned SMEs are in the retail and wholesale sector (about 40 percent). Data suggest that employment in women-owned SMEs is not necessarily higher than in those owned by men. In fact, given their smaller size, the total employment is marginally less. However, women start businesses at a faster rate than men, they are expected to create approximately 50 percent of new small business jobs by 2018 (IFC 2016).

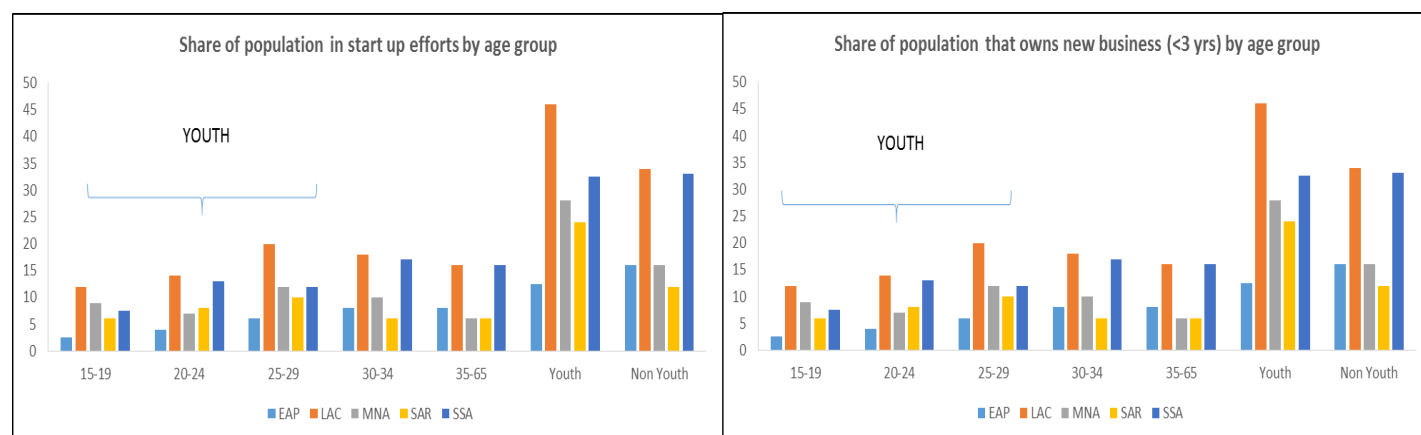
**FIGURE 8: SHARE OF WOMEN-OWNED SME'S BY REGION**



Source: IFC Enterprise Finance Gap Database, 2011

- f. **Youth are an important segment in specific SME sectors as they are 1.6 times more likely to display entrepreneurial skills.** Figure 9 shows the higher contribution of youth on an average to start up efforts and ownership of new business. Within the young, it is the 25-29 year olds on an average who are the most active age groups in startup efforts and in running businesses that are less than three years old. To the extent that startups and young firms are important for job creation as discussed previously, focusing on the needs for this set of firms driven by the youth is important. Young entrepreneurs are also more likely to employ younger people and are usually active in high growth sectors.

**FIGURE 9: CONTRIBUTION OF YOUTH TO START UPS AND NEW BUSINESSES**



Source: Towards Solutions for Youth Employment, 2015

**All of the above evidence points to the fact that within the SME sector, different types of SMEs are more likely to create more and/or better jobs.** Therefore, it is important to differentiate and target interventions to specific sub segments within the SME sector depending on whether the objective of interventions is job creation, diversification of the economic base, or growth of the private sector. For example, Fafchamps and Woodruff (2011) suggest tools for identification of SMEs with growth and job creation potential such that programs can be targeted. SMEs that are unlikely to expand and are in survival mode are more likely to require interventions to mitigate risk or stabilize their income. This would include basic training and skill building, access to reliable sources of steady finance etc. These approaches however may or may not have significant employment effects.

**On the other hand, the high growth SMEs, or the high growth start-ups, or transformational entrepreneurs, have different constraints and will require a different set of interventions.** As mentioned earlier, these small share of firms contribute to disproportionately large shares to job creation (ranging from 38- 50 percent) and also tend to pay wages that are higher than national averages.<sup>8</sup> Focusing on their specific needs and designing suitable instruments to address their constraints will contribute to the

<sup>8</sup> Global Entrepreneurship Monitor, 5-year study of 800,000 entrepreneurs found that while high growth was 4%, they generated 38% of all jobs. Research on 925 Colombian companies from Enterprise Surveys found that high growth was 8% but represented 45% of new job creation. NESTA paper showed 6% of UK firms were high growth. High growth SMEs are also called transformational SMEs, graduate enterprises or gazelles.



agenda of creating more and better jobs.<sup>9</sup> For example, the suite of interventions for these firms would include more sophisticated products and services such as advanced training around employee management, focus on R&D and innovation, establishment of management information systems or formal linkages to markets etc. Since these firms are more productive and pay higher wages, removing barriers to growth for such SMEs would also translate to better quality of jobs. The challenge is to be able to identify these SMEs. There is innovative work using psychometric testing that is being applied in some World Bank Group projects that will be discussed later. Further, as will be outlined in the section on access to finance interventions, different SME types require different types of financing. An understanding of this is critical for the intervention to achieve its desired outcome.

The next section summarizes the key constraints to the ability of SMEs to grow and do business, which in turn creates jobs.

### C. CONSTRAINTS TO SME GROWTH AND ABILITY TO DO BUSINESS

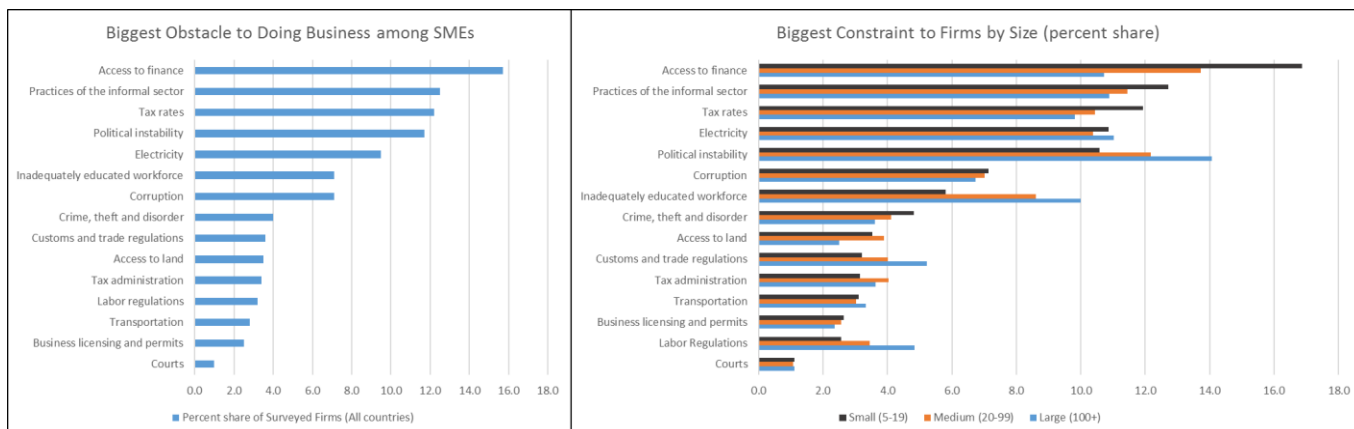
**According to the latest analysis using World Bank Enterprise Survey (WBES) data, managers of SMEs across all countries surveyed consider access to finance the *biggest obstacle to growth*, followed by competition from the informal sector and then taxation.** From an employment perspective, another analysis based on WBES data from 2006-2010 looks specifically at *top constraints for employment growth among SMEs* and again identifies access to finance as the top binding constraint for SME employment growth across all firm sizes and regions (Figure 10). The other constraint for SME employment growth is competition from the informal sector again.

**When grouped by firm size, the top constraints for the small sized firms continues to be the same as above- access to finance, informality and tax rates.** The top three constraints for medium and large sized firms also included access to finance and informality, but it was political instability that mattered more to them than taxation.

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<sup>9</sup> A study of conversion rates of self-employed people to successful entrepreneurs (and hence employers) in developing countries shows that a third of unsuccessful self-employed people (i.e unable to employ others) share the same characteristics as those of their successful counterparts, suggesting they have the potential to grow and become employers but face external constraints. Hence even before reaching the stage of a potential high growth SME, there is entrepreneurial dynamism which gets stunted. However, this is outside the scope of this analysis.

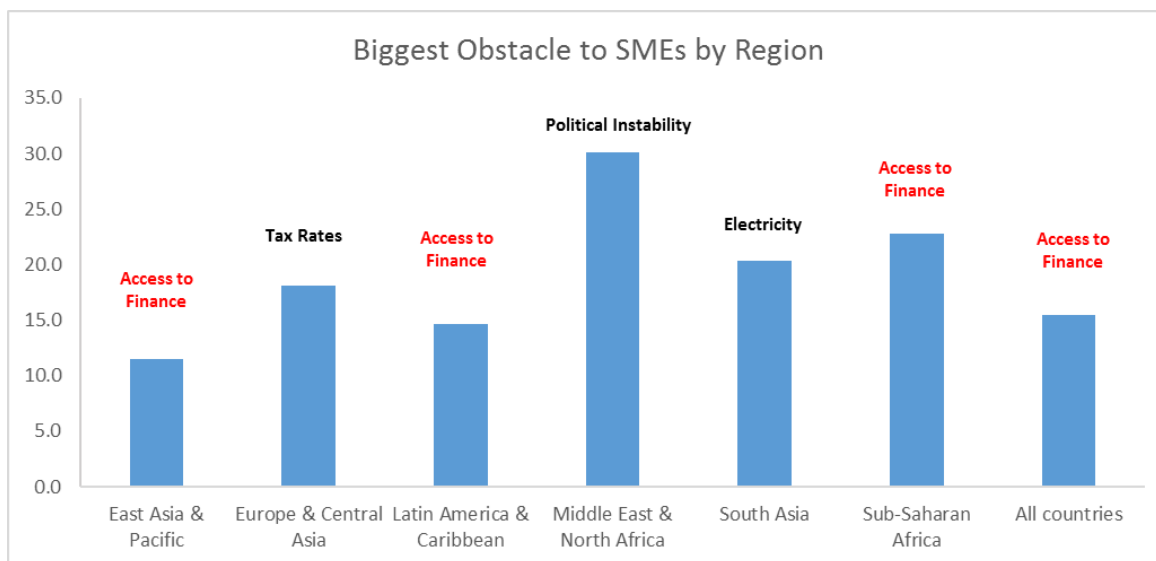
**FIGURE 10: CONSTRAINTS TO DOING BUSINESS FOR SMEs**



Source: World Bank Enterprise Surveys (2010-2016), Enterprise Surveys (<http://www.enterprisesurveys.org>), The World Bank.

**When it comes to regional differences, managers of SMEs in Africa, Latin America & Caribbean and East Asia cite access to finance as the biggest constraint to doing business.** This is highlighted in Figure 11 below. Given their smaller financial size, SMEs are less able to cope with costs that arise from trying to access electricity, transportation, costs of business licensing and taxes and other costs of doing business. SMEs are also less likely to have transparent information on past performance and current operations, which increases the perception of riskiness. Finally, they are typically too small to be able to exploit efficiencies in operations and management. In terms of doing business, SMEs present relatively higher transaction costs; whether it is with financial institutions or larger firms that would allow them access to markets.

**FIGURE 11: BIGGEST OBSTACLE FOR SMEs BY REGION**



Source: World Bank Enterprise Surveys (2010-2016), Enterprise Surveys (<http://www.enterprisesurveys.org>), The World Bank.

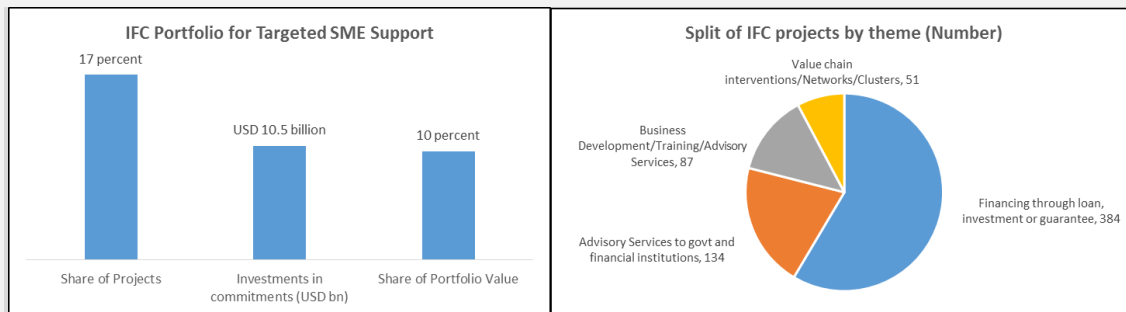
**According to a 2011 World Bank survey of development banks, SME support was the second most important mandate after agricultural development.** As many as 92 percent of responding development banks targeted SME clients. For the period 2006-2012, for the World Bank Group specifically, SME

programs comprised 28 percent of IFC investment projects and 30 percent of IFC advisory projects. The World Bank's SME focused support comprised 14 percent of investment projects and 4 percent of Analytical and Advisory Activities (AAA). Further relevant details are provided in Box 1 below.

**BOX 1: A SUMMARY OF WORLD BANK GROUP SUPPORT FOR SMEs (based on IEG Report, 2013)**

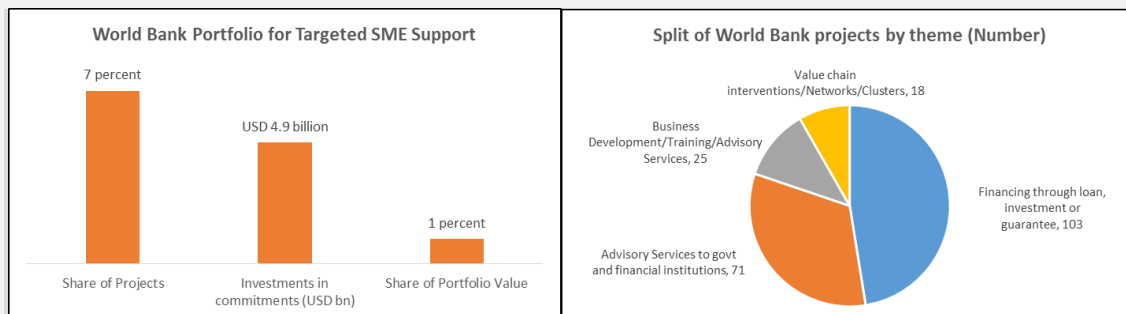
The World Bank Group provides a suite of solutions to help address constraints for SME growth and productivity. These include the systemic policy reforms addressed to improve the business environment for SMEs, and the targeted approach at firm level (TSMEs). The overall number of projects focusing on SMEs for the period 2006-2012 comprised 28 percent of IFC's investment portfolio and 30 percent of its advisory portfolio. For the World Bank, these figures were 14 percent and 4 percent respectively. Of these, more than half of the interventions in both institutions were targeted (TSMEs).

In IFC, the bulk of targeted SME support is for financial support of SMEs. More than half the projects are loans or investment guarantees to financial institutions for onlending to SMEs, or direct investments including leasing and insurance products. In terms of value, of the total USD 10.5 billion committed to TSMEs, USD 10 billion comes from this portfolio. Therefore, about 97 percent of the portfolio is concentrated in the erstwhile Financial Markets industry group. According to the 2013 IEG report that studied the World Bank Group's SME portfolio, the regional spread of IFC's TSME portfolio is predominantly focused in the ECA region with close to 40 percent of the share.



Targeted SME support through erstwhile IFC Advisory services comprises half of all SME related services, with a portfolio of about 272 projects being launched in the period 2006-2012, with a total value of USD 170 million. Of this, almost half the projects provide advice to financial institutions, predominantly through SME Banking and Farmer/SME Training products.

Similarly, in the World Bank, a dominant share of targeted SME support takes the form of financing through Lines of Credit (which are channeled through government agencies, state owned banks or financial intermediaries who on lend to SMEs), Partial Risk Guarantees and Matching Grants as financing mechanisms. They comprise over half of the total number of TSME project count, and close to 80 percent of the portfolio by value. A large share of this portfolio was concentrated in the erstwhile Finance & Private Sector Development group (now T&C and Finance & Markets). Regionally, like IFC, about 30 percent of the World Bank's TSME portfolio is focused on ECA.



The World Bank's AAA portfolio for TSMEs is relatively small for this period- 62 relevant projects with a collective expenditure of USD 11 million dollars. This grossly underestimates the work being done to support SMEs because this type of analysis is usually multisectoral and the AAA work is therefore tagged under other categories. Of the 62 identified projects however, the 85 percent related to technical assistance to governments.

The rest of the note will focus on the constraint to access to finance, which has been cited as the most important challenge to growth by managers of SMEs. The note will look at the causal link between interventions that aim to address this particular constraint and try to highlight evidence that measures the impact of how these interventions might impact creation of more, better and inclusive jobs. While we know that SMEs play an important role in job creation compared to large enterprises, there is scarcer evidence on the extent of this impact, and on how different types of access to finance interventions targeted at different types of SMEs fare in employment generation.

## II. ACCESS TO FINANCE FOR SMES AND THEIR EMPLOYMENT EFFECTS

### A. DEMAND OF AND SUPPLY FOR SME FINANCING

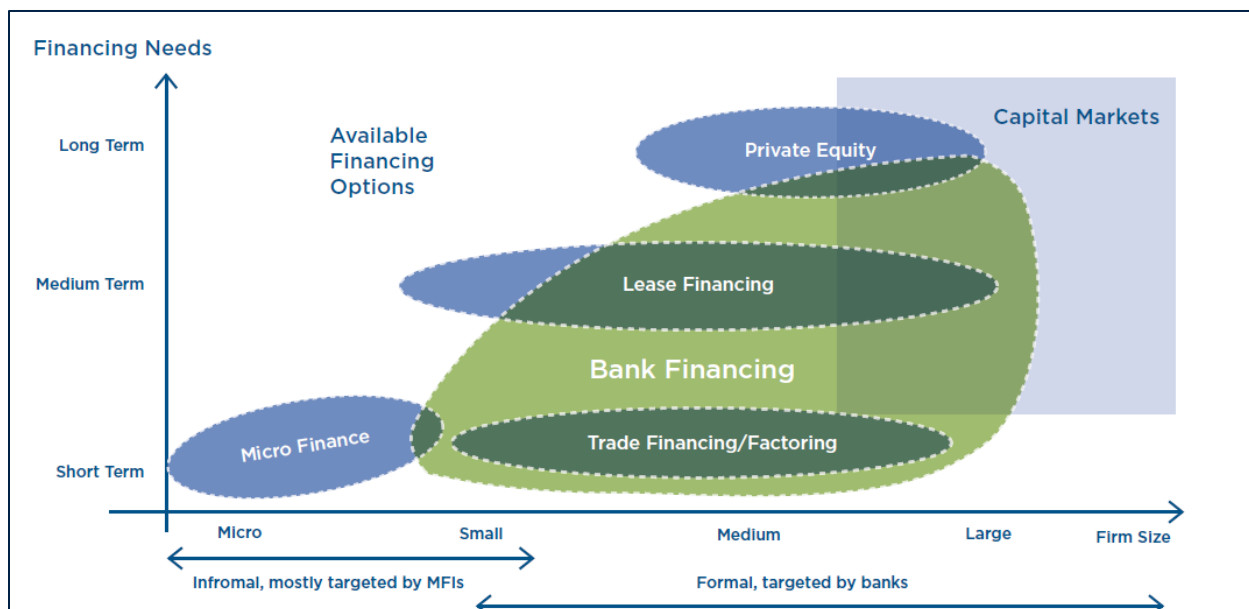
As discussed in the section above, access to finance was identified as the most important to SME entry, growth and survival. This is even more so for the smallest firms, of 5 to 9 employees and in low income countries. The extent of the problem is significant with approximately 55 to 68 percent of formal SMEs estimated to be unserved or underserved by the formal financial sector. This amounts to a credit gap of approximately USD 1 trillion and is equivalent to about 30 percent of current outstanding SME credit. In comparison, about 16 percent of formal SMEs are unserved or underserved in developed economies, amounting to a credit gap of 5-6 percent of outstanding SME credit (Stein 2010).

Regional needs are different with Sub Saharan Africa and MENA requiring the largest increase of 250-350 percent in outstanding SME financing to close the credit gap. Women-owned businesses have an unmet credit need of USD 260-320 billion. Besides the general lack of availability of finance, SMEs are usually provided a narrower range of products from the financial sector. For instance, approximately 30 percent of SMEs also do not have access to deposit accounts, with a deposit gap of USD 300-360 billion (Stein 2010).

The reasons for lack of suitability for SME bankability are many, both on the supply and demand side. On the supply side, these include high transaction costs, lack of collateral and high leverage ratios that arise due to unavailability of equity. Asymmetric credit information and lack of property rights and/or their enforceability also deters financial institutions to lend to SMEs. This is reflected in the restricted SME portfolio among financial institutions. SME loans account for 19 percent of total lending volume of financial institutions in developed countries, and 15 percent in developing countries (IFC 2010). These institutions typically target larger firm and in most developing countries, commercial banks restrict their SME activity to fully secured short term working capital facilities or small loans with short tenures.

The very small firms usually fall in the group of those having to source financing from micro finance institutions that are also limited by their size and financial products such as leasing. It is as firms become large that the financial sector is willing to bear the risk of providing finance to firms, and other sources such as private equity and capital markets become available to them. Figure 12 indicates the available financing options for firms depending on firm size and financing need.

**FIGURE 12: TYPOLOGY OF TYPES OF AVAILABLE FINANCING OPTIONS FOR DIFFERENT SIZED SMEs**

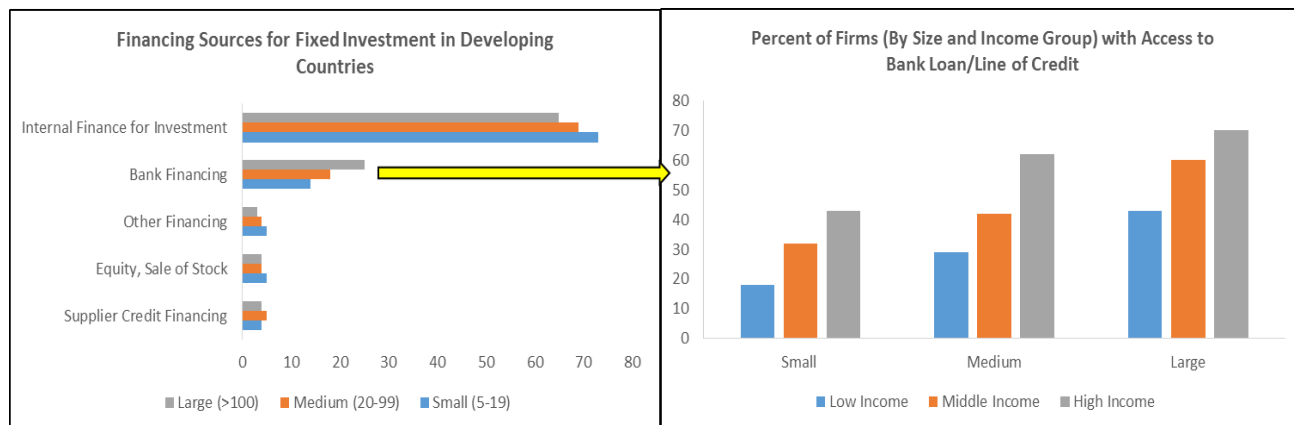


Source: IFC 2010

**On the demand side, SMEs forgo formal financing on account of relatively high credit costs or lack of information about financial products.** Sometimes, the extensive information requirements of lenders are a deterrent to firms, either because of weak reporting systems or cost. Finally, smaller firms, which are unsure about their survival or growth tend to shy away from formal external sources because of potential inability to repay their debts.

**Traditional bank financing sources are available to only 17-32 percent of small firms in low and middle income countries, compared to over 50 percent of small firms in high income countries.** Medium sized firms in low income countries are also constrained compared to their counterparts, but less so. Large enterprises are much less so even in low income countries. (Figure 13). On average, a small firm’s probability of access to a bank loan is less than half of what it is for a medium sized firm and about a third compared to a large enterprise in the same environment.

**FIGURE 13: FINANCING SOURCES FOR SMEs IN DEVELOPING COUNTRIES**

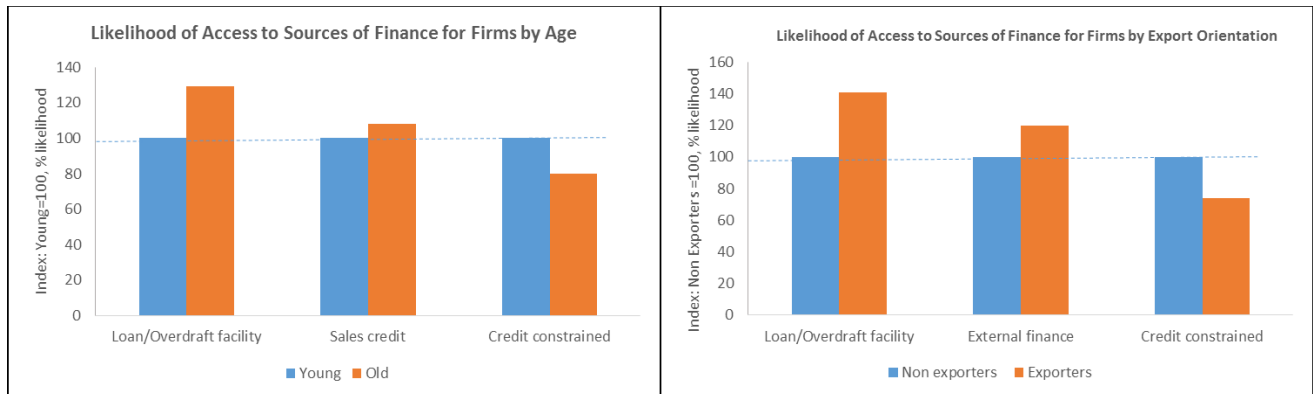


Source: IFC 2010

Besides bank financing, other forms of financing such as private equity that become important for firms to grow, are even more restricted given the higher credit risk for smaller financial needs. The Venture Capital (VC) market is also less mature in developing countries. As of 2009, there were approximately 192 investment funds providing support to SMEs (IFC 2010).

Empirical evidence also indicates that age of firm and its export orientation also affects its ability to access finance. Figure 14 highlights the analysis for firms by age and export orientation and ability to access sources of finance. Older firms are able to secure financing with relatively more ease than younger firms. This is most likely because their longer existence presents less risk and higher credit worthiness to lenders. Similarly exporting firms are more likely to have access to financing compared to firms that serve the domestic market. This could be due to several reasons including linkages to more credit worthy foreign firms and being more productive themselves, besides access to foreign exchange revenue streams. These differences in ability to access finance is important to keep in mind given that these different types of SMEs have different impacts on creation of more and better jobs.

**FIGURE 14: SME ABILITY TO SOURCE FINANCE BY AGE AND EXPORT ORIENTATION**

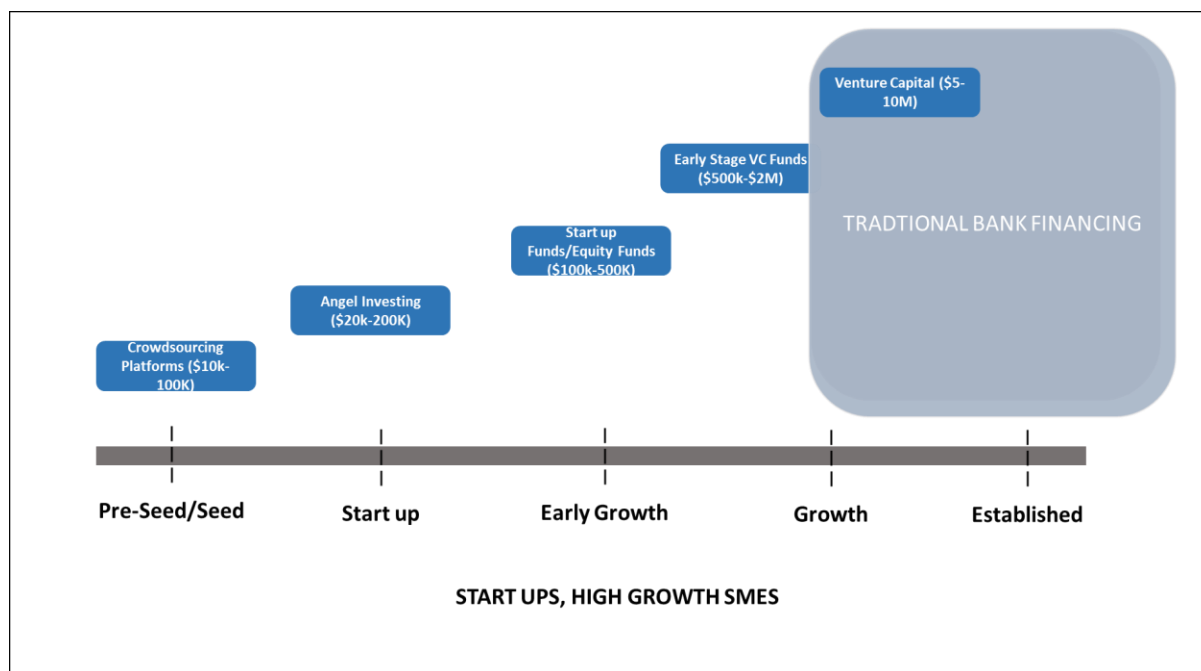


Source: Dinh, 2010

High Growth SMEs and startup firms usually require different types of financing compared to other SMEs, and these requirements change during their growth cycle. High Growth SMEs and startup firms' financing needs usually falls outside of the traditional form of bank financing depending on the stage of their life cycle. As Figure 15 shows, at the nascent stage, they require pre-seed or early seed financing of smaller sizes. As they grow, angel investments and crowdfunding platforms, early stage equity funds and venture capital funds become important. Once they have achieved a critical scale and are in the growth phase, the more traditional forms of bank financing are required. Financing for startup initiatives or firms run by the youth are an important challenge given the propensity of young people to participate in trying to start up or run young firms.



**FIGURE 15: FORMS OF FINANCING NEEDS FOR START UPS AND HIGH GROWTH SMEs**



Source: Adapted from Summary Report of the World Bank Group Working Group on Small and Medium Sized Enterprises, October 2015, World Bank Group

**Finally, the challenge of access to finance for women-owned SME is even bigger.** These SMEs are more likely to cite access to finance constraints as the first or second barrier to business than their male counterparts. Data on availability of finance to women-owned enterprises indicates that close to 70 percent of women-owned SMEs are unserved or underserved leading to a credit gap of about USD 287 billion, or about 30 percent of the total (IFC 2014). Similar to the overall SME sector financing needs, women-owned SMEs have different financing needs. For example, women business owners surveyed in the MENA region cited greater need for long term financing rather than short term working capital.<sup>10</sup> Women-owned SMEs are less likely to receive a loan, and they have a lower formal bank account penetration. While avenues of debt financing has increased for them, they receive a very small percentage of venture capital and equity funding compared to men. According to an IFC report, women-owned businesses attract less than 5 percent of VC funding, even though their requirements for starts up are similar. Yet IFC research indicates that female borrowers have a stronger repayment history and present greater potential for cross sales compared to male entrepreneurs, making them roughly twice as profitable for banks as a consumer segment. A research by the US Small Business Administration indicates that firms that invest in women-owned businesses have higher returns on their investments. Evidence from the financial sector suggests that angel investing and crowdfunding are more attractive to women-owned SMEs in growth mode because they are more egalitarian and transparent.

**All of the above points to the need for adopting a dynamic approach to identifying and targeting of SMEs, both women-owned and overall, in terms of their specific financing needs.** It is important to understand the nature of financial constraint by the types of SMEs being targeted, especially if the end

<sup>10</sup> From IFC, Vital Voices and MENA Businesswomen Network Report, 2013, in Brookings, 2013.

objective is employment. Different SMEs, depending on ownership, life cycle, age and size, might require different financing but will have varying effects on creation of more, better and inclusive jobs.

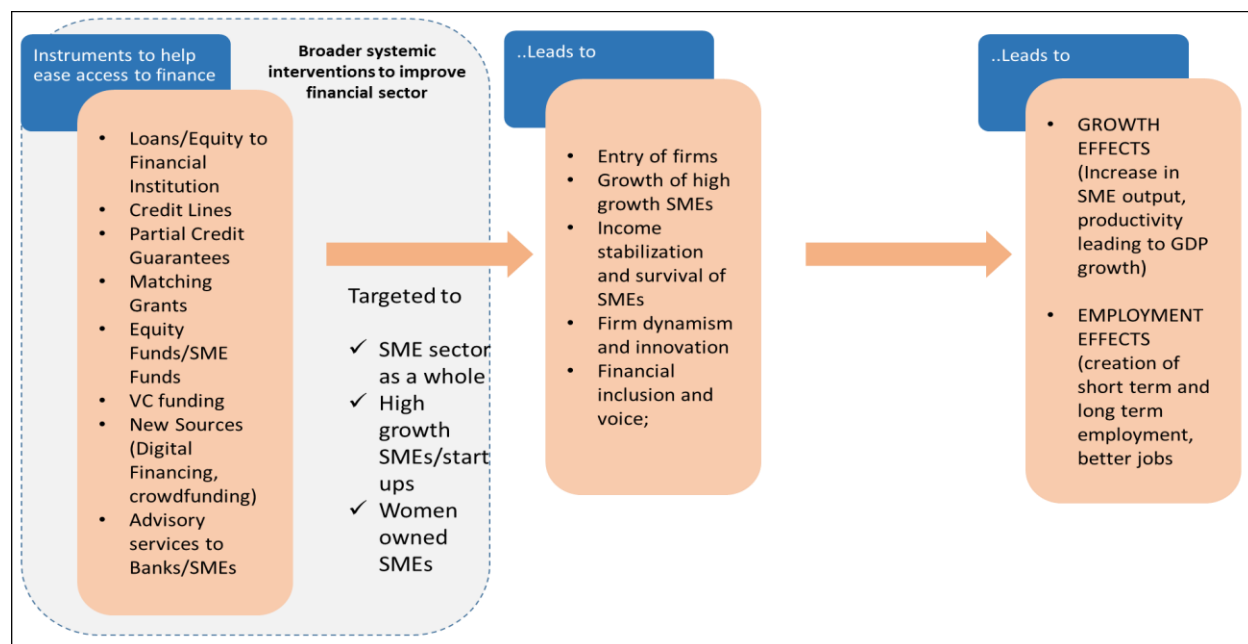
## B. THEORY OF CHANGE: FROM FINANCING INTERVENTIONS TO SMES TO EMPLOYMENT EFFECTS

In the previous section, we have discussed briefly the sources of supply of financing and the different needs for it for different types of SMEs at different stages of their life cycle. Alleviating this critical constraint to doing business for SMEs leads to firm entry, survival and growth, and creation of more and better jobs.

**There are several targeted instruments through which credit constraints to SMEs are sought to be alleviated.** Some of these are indirect- through financial institutions who on lend to SMEs, while others are direct financial instruments for SMEs. Some of these instruments are targeted by types of SMEs; for start-ups, high growth SMEs, and women-owned SMEs, while others are broader for the SME sector as a whole.

**Addressing credit constraints either at a broad systemic level or at the firm level can lead to SME led growth and employment.** A simple theory of change is outlined in Figure 16. Economic growth is fostered through the growth of entrepreneurship and start-ups, firm dynamism and innovation, achievement of optimal and larger equilibrium sizes and firm ability to choose more efficient organizational forms. In most cases, interventions aim to achieve this SME growth and it is through this channel of growth that the objective of employment generation is also achieved. In other cases, targeted interventions are also designed with the objective of helping firm creates more and better jobs explicitly. However, as will be discussed later, evidence of the impact of these types of interventions are scarce.

**FIGURE 16: THEORY OF CHANGE FROM INTERVENTIONS TO EASE FINANCE TO IMPACT**

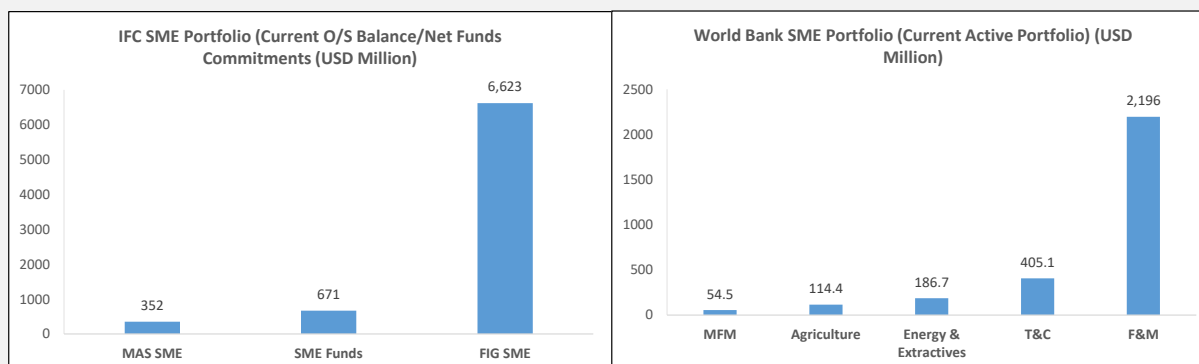


The World Bank Group uses most of the above instruments in its TSME portfolio, details of which are given in Box 2 below.

However, what evidence exists about the actual impact of these instruments when the objective of the intervention is creation of more or better jobs? Findings from rigorous project evaluations are scarce.

**BOX 2: World Bank Group Interventions for Targeted SME Support on Access to Finance**

The snapshot below indicates the targeted SME portfolio for the World Bank Group. In IFC, the largest portfolio is in the Financial Institutions Group (FIG), while in the World Bank this rests in the Finance & Markets (F&M) Global Practice.



- 80 percent of FIG portfolio is lending to financial institutions for on lending to SMEs, reaching USD 4.8 million SMEs annually, creating or maintaining 140 to 365 million jobs.
- SME Funds invest in emerging market private equity funds, taking equity in mostly high growth SMEs. SME Ventures resides here, specifically focused in fragile environments. It has 4 funds covering 6 countries and 61 companies.
- MAS (Manufacturing, Agribusiness & Services) SME lending is through supplier finance products directly to SMEs or through anchor firms.
- IFC Advisory Services span several activities including linkages, training, development
- Targeted SME financing interventions from F&M comprise government led schemes such as Partial Credit Guarantees (PCG), state owned financial institutional lending and direct lending. PCG schemes are currently active in 9 countries, managing a total of USD 422 million. F&M also extends lines of credit to governments through APEX wholesale funding facilities. The Practice also assists in the creation of public- private seed and VC funds, strengthening of nascent angel investors and matching with entrepreneurs.
- T&C assists government clients in creation of public-private seed and venture capital funds. It also builds capacity of nascent angel investors and match them with

Source: WBG Support to SMEs: Snapshot of our Product Offer and Cross Cutting Areas for Further Exploration, World Bank Group, 2015

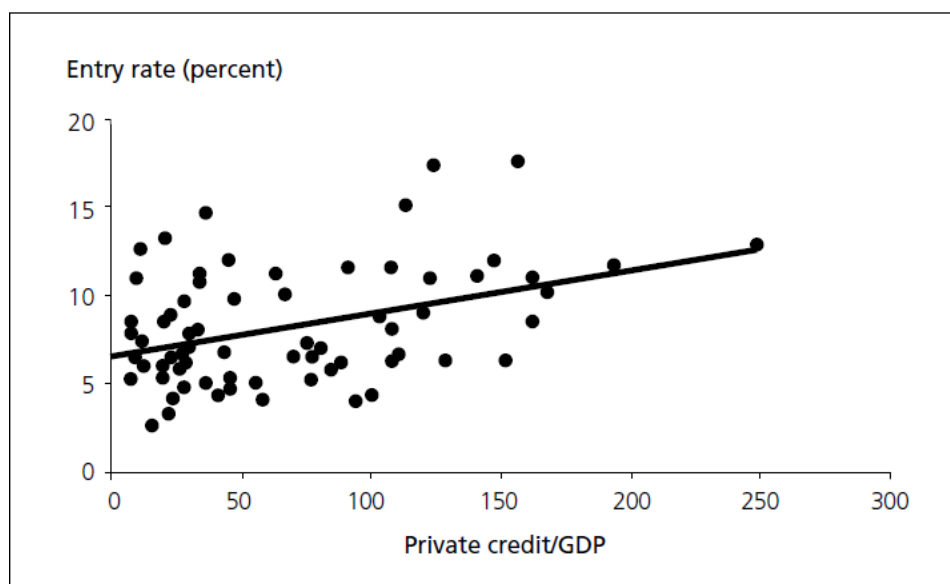
The next section draws evidence from existing literature that sheds light on these causal links.

### C. EVIDENCE OF EMPLOYMENT EFFECTS OF REMOVING ACCESS TO FINANCE CONSTRAINTS

While there is empirical evidence from analysis of datasets of SMEs on employment effects, findings from rigorous evaluations of targeted interventions designed to address finance constraints among SMEs is scarce. An Independent Evaluation Group (IEG) report on the evaluation of the World Bank Group TSME portfolio in 2013 highlighted the lack of this rigorous evidence in literature and among WBG projects as one of the main findings. Several comprehensive meta evaluations find a small share of evaluations of the universe that have a specific objective of employment generation.<sup>11</sup>

At the economy wide level, data indicates that increasing the ratio of private credit to GDP, or access to finance, increases firm entry rate, which is important for a dynamic and productive private sector that can create more and better jobs. Aghion, Fally and Scarpetta (2007) find for a sample of European countries that financial development enhances new firm entry in sectors that depend more heavily on external finance and that the smallest size firms benefit the most in terms of higher entry from higher financial development. On the other hand, access to financial services can help new entrepreneurs survive beyond the first year and can help enterprises innovate at a faster rate (Ayyagari 2011)

FIGURE 17: IMPACT OF INCREASING CREDIT ON FIRM ENTRY



Source: IFC Jobs Study, 2013

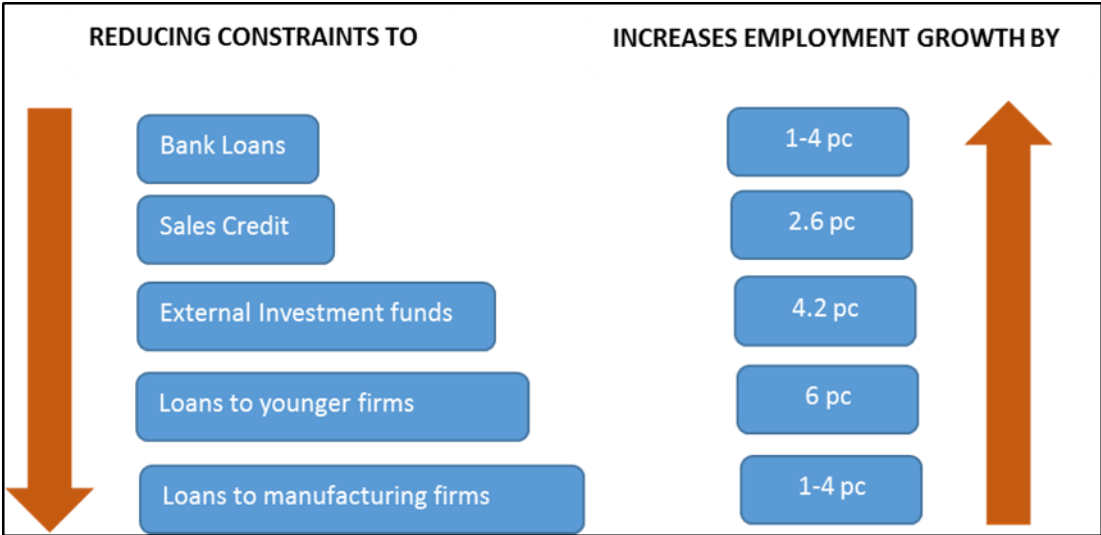
At the sector level, empirical analysis of WBES data and review of literature also finds that a low level of financial sector development in general, and low capital market development in specific adversely

<sup>11</sup> An ILO study found only 7 evaluations over a 5-year period which aimed to study employment impacts. However, these were not rigorous enough. Of these, there were none that looked specifically at impact of interventions for easing access to finance. Two exhaustive meta evaluations of SME programs base their findings on 40-50 evaluations from the universe of programs that have a specific objective of employment generation. A large number of these were found to be focused in the Latin American region.

affects firm growth and hence has an adverse impact on jobs.<sup>12</sup> Data shows that weak financial sectors affect firm size distribution, skewing them towards small and medium sizes, thereby contributing to the ‘missing middle’ phenomenon, which has been mentioned previously. This is even more pronounced in Africa among firms that are credit constrained or perceive credit as a constraint to business. The literature also shows that capital constrained firms grow slower than their counterparts, and that access to finance (along with informal sector competition) are the two most important obstacles for firms across all sectors. This will be discussed in detail later.

**At the firm level, empirical evidence indicates that increasing access to finance leads to job growth.<sup>13</sup>** Further, the strength of this association changes with firm size, with the effect being stronger among MSMEs than larger firms. MSME firms with access to a loan exhibit between a 1-4 percent larger employment growth effect than those without access. This employment effect is also seen to be larger for firms in industries that are more dependent on external finance. Another empirical study indicates that access to sales credit, as a form of finance, increases firm employment growth by 2.6 percent, while access to external investment funds in general increases employment growth by 4.2 percent. Similarly, the effect of easing access to finance is different depending on age of firm, with younger firms expanding more than older firms with access to same form of financing. The effect of easing finance on employment is also higher among manufacturing firms as compared to other sectors such as services or sales. These effects are summarized in the figure below.

**FIGURE 18: EMPLOYMENT GROWTH EFFECTS OF EASING FINANCIAL CONSTRAINTS**



Source: Derived from Ayaggari, 2016, Dinh, 2010

**EVIDENCE OF FINANCING INSTRUMENTS**

Coming specifically to evidence from projects, we first look at findings for specific financing instruments that are targeted at SMEs.

<sup>12</sup> Dinh, 2010

<sup>13</sup> Ayaggari et al, 2016

**Several comprehensive meta evaluations of SME financing programs find overall weak employment effects.**<sup>14</sup> First of all, there are very few evaluated programs with a stated targeted objective of employment creation. A majority focus on income stabilization. Further, nothing is known from project evaluations regarding long term effects or cost effectiveness of the programs (jobs per dollar invested).

**At one extreme, evidence of impact of micro credit schemes indicates marginal employment effects.** This is because these schemes are targeted at micro enterprises with the objective being income stabilization rather than employment generation. They provide small loans of USD100 to USD 2000 which cannot be ploughed back for investment that might lead to employment growth. It is rather used as working capital.

**Other projects that focus on SMEs with the purpose of employment generation exhibit weak effects, but impact depends on country context and the targeted SME sector.** A meta evaluation of 40 rigorous studies (Piza et al)<sup>15</sup> that focused on employment effects of SME interventions indicates that matching grants have a positive effect on both SME growth (sales, profits) and employment depending on the nature of SME. For example, matching grants were found to have a more positive effect on employment in Africa than in similar firms in Latin America & Caribbean (LAC) because of the greater labor intensity of firms in the former. Hence, for firms operating below capacity, credit that allows them to grow has a positive labor effect. *Therefore, the same instrument could have different effects depending on the country of intervention, depending on the existing stage of development of the targeted SMEs.* On the other hand, an IEG evaluation of WBG TSME portfolio found little evidence of jobs impact of matching grants, driven primarily on account of a weak theory of change and unclear targeting of job creating SMEs. This is further highlighted below.

**There is mixed evidence of effects of Partial Credit Guarantees (PCG) on employment.** While panel data for PCG schemes for SMEs in a group of European countries finds a positive effect on employment generation (Asdrubali & Signore 2015), another literature review on PCGs across countries finds little evidence on social benefits of these schemes (Honohan 2008). The IEG Report on analysis of WBG instruments also found little evidence of employment effects of PCGs, though creation of more and better jobs was not the development objective of these interventions to start with.

**Literature suggests that PCG interventions would be more successful if they were designed with a good understanding of the expected theory of change (expected outputs, outcomes and final impact) which could be monitored with a built in system for data collection and/or evaluation.** FOGAPE- a Chilean PCG is an example of an innovative PCG which guarantees loans to small firms, using innovative design elements such as targeting small firms, instituting variable coverage ratio, unique bidding procedure allowing banks to bid for guarantees according to the risk profiles of underlying SMEs and using a risk-based approach with fees. It has an annual reach of 30,000 guarantees but there is no information regarding the employment that this scheme is generating.

**The evidence of impact of Equity finance/VC funds on employment is also mixed, with some studies showing positive effects specifically for skilled workers, and others showing negative short term employment effects.** Some studies have shown that venture capital can reduce unemployment rates but

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<sup>14</sup> Piza et al, Grimm & Paffhausen

<sup>15</sup> This meta-analysis studies 40 rigorous studies with the objective of looking at employment effects of interventions on SMEs (less than 250 employees). A majority of these are in LAC.

mainly for skilled workers. This may be due to a bias towards directing this financing towards the more productive and high potential SMEs, which would have a higher probability of hiring more skilled workers. Some studies have shown that private equity backed businesses have superior management practices than firms with government/family backed ownership. One could argue that to the extent that these practices result in growth of firms, there might be creation of more or better jobs if the recipients are high growth SMEs or medium sized SMEs. Other studies on effect of equity funds did not find any significant effect. Studies show short-term negative employment effect with long-term employment growth between private equity investments and job growth.

**The IEG evaluation (2013) of WBG SME financing portfolio that studied a sample of IFC SME funds found marginal employment effects.**<sup>16</sup> However, the defined objective of the fund was expanding reach to SMEs and SME financial viability rather than employment generation. The evaluation did find that the success of the fund was contingent on successful transfer of management and corporate governance practices to investee companies. One could argue that while access to finance was the primary objective, the growth of the firm was contingent on other inputs such as good management practices that came along with the package.

**This same report also found no evidence of the economic impact of lines of credit, mixed evidence on private equity schemes in developing country contexts, limited evidence of benefits of matching grants and advisory services.** The primary reason for these findings rested on an ex-ante lack of evidence-based understanding for the targeted support which resulted in a weak theory of change to begin with, unclear targeting of SMEs that really needed the support and therefore misaligned expected results which did not monitor job effects. For example, an IEG evaluation of eight closed TSME lines of credit found that while the financing was targeted at SMEs, the justification and theory of change was not clear. The project documents also did not always suggest long term benefits of the interventions, specifically on number or quality of jobs created. This points to the need for a deeper understanding of the SME sector where interventions are being designed ex ante, specifically the potential to identify the high growth SMEs, or young and smaller SMEs, which have the potential for job creation among SMEs.<sup>17</sup>

**However, micro and macro case studies undertaken by IFC to analyze effects of their banking client lending to SMEs finds evidence of direct and indirect employment generation.** For example, a micro case study conducted by IFC in Sri Lanka to estimate job growth through SME lending from IFC client, Commercial Bank of Ceylon (CBC) showed job creation at double the national rate between 2009 and 2012, due to the SME client ability to invest and expand their operations.<sup>18</sup> Two macro case studies of expanding access to banking through IFC operations in Indonesia and Ghana estimated direct, indirect and induced job creation effects of 67,000 jobs (1 percent of total employment) and 15,400 jobs (1.5 percent

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<sup>16</sup> IFC invested USD 1.4 billion in 70 TSME funds from 2006-2012, with the objective of further investing in small businesses. They were predominantly concentrated in South Asia and Sub Saharan Africa. IEG's evaluation of 15 of these (more than 1 billion in 196 companies with investments ranging from USD 100,000 to USD 2.2 million per loan)

<sup>17</sup> Identification of high growth SMEs and start-ups is a challenging task. There is a significant amount of literature that deals with definitions and characteristics of this class of SMEs. (Coad et al). There is also innovative work being done through psychometric credit scoring, business expert panels etc that aim to identify ex ante SMEs and startups that have a high probability of growth and innovation. (eg- Bruhn, Ruiz, Stucchi)

<sup>18</sup> There are several caveats to this data and study including lack of attribution solely to IFC financing or just financing as an intervention, lack of analysis of job destruction during this period, and potential selection bias by the client bank.

of total employment) respectively (Kapstein 2010, 2012). Macro case studies using Input-Output modeling led by IFC in Ghana and Jordan also showed that lending to SMEs through financial intermediaries had a greater impact on direct and indirect employment than lending to firms directly. This was attributable to higher diversification of firms reached in the local economy compared to targeting to more capital-intensive firms that IFC usually invests in. Finally, using a new evaluation approach (expanded appraisals), IFC has results for some of its SME clients that show increase in jobs created due to SME financing. For example, Au Financiers provides financing to SMEs in the transport operators sector. A sample of the SME portfolio showed a CAGR of 11 percent over a two-year period, compared to the national CAGR in employment of 10 percent (IFC 2016).

**Besides these more traditional forms of financing, there is an upswing of new and innovative access to finance instruments.** These instruments allow access to credit outside of conventional bank lending, being facilitated by adoption of mobile, social and cloud technology. It also includes hybrid instruments such as bonds and alternative instruments such as crowdfunding. However, evidence of the impact of these solutions on employment is even scarcer given that these are still new financing interventions for SMEs. It is important therefore, as they get more widely adopted as SME solutions, that appropriate monitoring and evaluation programs are built in.

**As mentioned earlier, for successful financing programs of SMEs, targeting SMEs by their financing needs is important.** Beck et al (2014) use enterprise survey data to study financing constraints for SMEs in Africa and argue that it is important to distinguish between different classes of SMEs with their unique financing needs to ensure successful targeted interventions. The section below looks at the evidence regarding easing financing constraints to specific segments of SMEs.

#### **EVIDENCE OF FINANCING TYPES OF SMEs: HIGH GROWTH SMEs/START UPS, WOMEN-OWNED SMEs**

**High growth SMEs and startups contribute relatively more to job creation but their financing needs may be different from other segments of SMEs which require more traditional and basic forms of financing.** The availability of external finance is positively associated with the number of startups as well as with firm dynamism and innovation. However, as discussed earlier, startups' financing needs are different from traditional bank financing, relying more on riskier early stage financing, equity and VC funding.

**However, evidence of employment effects of these types of less traditional financing interventions is scarce and incomplete.** The Small Business Innovation Company Program of the US Small Business Administration department works with venture capital funds to help invest in innovative SMEs. As of 2014, it has financed about 1,000 SMEs in the US which has created or sustained about 113,000 direct jobs. It is unclear, however, how many direct jobs would have been created without these interventions. Within the WBG, IFC has been supporting SME Funds, some of which were evaluated by IEG and found scarce evidence of job creation. The Finance & Markets (F&M) and Trade & Competitiveness (T&C) global practices, and IFC Ventures are all involved in early stage VC and quasi-equity funds at the \$500,000 to \$2 million range for early growth stage financing. Examples include co-investment funds in Croatia and projects in Morocco, India, Kenya, and Madagascar with Business Partners International, totaling under \$1 million in co-investment and equity-like financing. Two examples of equity financing in the World Bank are the Equity Financing Program for Morocco SMEs and the Lebanon Innovation Program in SMEs. In the former, the objective is to facilitate the increase of early stage private equity finance for innovative SMEs and the results framework will monitor among others, the SMEs being financed. In the latter program,



the objective is to encourage equity investment market to increase supply of early stage investment finance for financially viable, new and existing innovative firms. However, the use of such financing instruments targeted for this segment of SMEs is relatively new in the institution, and evaluations studying the final impacts of these projects are not available. The results framework usually targets number of firms receiving financing and new startups created and do not monitor or track the number of jobs being created, nor the quality of these jobs.<sup>19</sup>

**The meta evaluation of SME programs aimed at employment generation indicates that access to finance programs work better when coupled with skilling programs, specifically entrepreneurship skills for firms that are starting up<sup>20</sup>.** Another evaluation of programs specifically focused on entrepreneurs' highlights similar findings that show that labor market effects are stronger when financing is coupled with training, specifically business development training (Cho & Honorati 2013). However, in the case of women entrepreneurs, access to finance is the binding constraint and not necessarily the training.

**Financing programs whose objective is supporting innovation in SMEs through subsidies also indirectly positively impact employment effects, though there might be a selection bias.** A study of a broad range of publicly provided SME programs in Mexico found that those programs that supported innovation and export orientation among SMEs through fiscal incentives and subsidies (thereby reducing costs) resulted in greater employment effects (Lopez-Acevedo & Tinajero 2010). However, this analysis also finds that the greater impact maybe due to the fact that the targeted SMEs were bigger in size (medium sized firms), more capital-intensive, exporting firms with research that they had already started. So the firms were more already more capable of efficiently using the incentives for further innovation leading to employment effects.

**Given the greater constraints faced by women-owned SMEs to financing, studies find a positive effect of easing this constraint on employment, specifically when combined with capacity building.** Limited access to skills training and networks continues to be among the main cited obstacles for women-owned SME growth, and therefore programs that bundle both have greater growth and employment effects. For example, evidence from an IFC client, the BLC Bank of Lebanon, indicates that building a female-friendly, distinguishable brand and providing a package of non-financial services along with lending and integration of women program in business of banks led to doubling of ratio of loans to women compared to overall value of SME loans. However, there is no data regarding whether this has led to creation of more jobs. Similarly, the Trade & Competitiveness (T&C) practice has an eco-system approach targeting growth-oriented female entrepreneurs offering a suite of programs. Three cohorts of women have gone through the program in Pakistan and two cohorts have gone through the program in Nigeria, with a total reach through these pilot projects of 1,200 female entrepreneurs. IFC's Banking on Women Program is an initiative targeting global, regional, and local financial institutions with SME lending track records. Since the launch of the Banking on Women program in 2010, IFC has committed 28 investments in 18 countries, with a portfolio of \$808 million to women-owned SMEs in Eastern Europe, East Asia, Africa and Latin

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<sup>19</sup> While direct jobs are not part of the World Bank's core indicators, focus on systematic tracking of job creation at a gender disaggregated level has increased for an increasing number of World Bank projects. IFC investment projects track direct employment at project level, though the data does not capture the indirect and induced job effects of these IFC projects. In both sides of the institutions, several initiatives are ongoing to better complement the M&E efforts to understand the job effects of the projects. The 'Jobs' group in the WBG is also coordinating some of these efforts on systematic monitoring of jobs.

<sup>20</sup> Grimm & Paffhausen, 2014.

America. In addition, the IFC cosponsors the Global Banking Alliance on Women, a consortium of financial institutions committed to providing customized products for women entrepreneurs, and the Women's Entrepreneurship Facility, a joint IFC-Goldman Sachs financing facility that provides up to \$600 million to improve access to capital for 100,000 women entrepreneurs. In all the above cases, data on employment effects of these programs is not available, partly on account of the ex-ante objective of the programs being different and partly on account of the difficulties in monitoring employment effects. However, this gap is well recognized within the institution and efforts to strengthen the M&E agenda are underway.

**Besides direct employment impact, studies also find growth effects when SME credit constraints are removed.** Analyzing detailed loan information on 253 Indian SMEs' before and after they became eligible for a directed subsidized lending program, Banerjee and Duflo (2004) find that the additional credit resulted in a proportional increase in sales rather than a substitution for other non-subsidized credit, indicating that these firms were credit constrained before receiving subsidized credit. Similarly, Zia (2008) finds that small non-listed and non-group firms in Pakistan reduce their sales after they become ineligible for subsidized export credit, indicating the existence of credit constraints; in contrast, large, listed and group firms do not reduce their sales after losing access to subsidized credit. (Beck 2008).

Finally, beyond the targeted financial interventions for firms, there is a broad range of systemic programs for policy reforms that are critical for SME growth.

#### **EVIDENCE OF SYSTEMIC INTERVENTIONS AT SECTOR LEVEL<sup>21</sup>**

**Over and above targeted firm level interventions, systemic interventions to help deepen the financial sector are essential to improve access to finance for SMEs which in turn leads to SME growth and therefore potentially employment.** Financial development helps reduce the effect of financing obstacles on firm growth, with a disproportionately beneficial effect for small and medium-sized enterprises. Data indicates that stronger regulation and financial infrastructure are positively associated with higher financing. There is a positive relationship between creditor rights and access to finance measured by the ratio of private credit to GDP and number of loan accounts per adult. The probability of obtaining a bank loan also increased in countries with credit bureaus. Financial development also helps SME growth by creating a deeper sector that offers more financial instruments at lower interest rates. A study gauging the relevance of lending costs on the SME finance gap found that 80 percent of it was linked to high credit costs (IFC 2010).<sup>22</sup> Klapper, Laeven and Rajan (2006) show that high firm registration costs hamper new firm creation and growth, while property right protection and regulations fostering access to finance are conducive to firm creation and growth.

**Prior sequencing of these broader systemic reforms could amplify positive effects of follow on targeted interventions.** This has also been highlighted in the IEG evaluation of the WBG TSME portfolio. For example, a series of earlier legal reforms in Kenya, were credited with improving the environment for MSME credit lending, enhancing the effects of sectoral investments. On the other hand, in another

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<sup>21</sup> While interventions to accelerate SME financing are important for economic growth and job creation, it should be noted that it is also important not to encourage market unfriendly or perverse interventions that can create market distortions. These could include government policies that introduce interest rate caps, limits on interest rate spreads, breaks on liquidity requirements for banks who lend to SMEs, or the establishment of new publicly owned SME banks. The analysis of these interventions is outside the scope of this note.

<sup>22</sup> Cited in IFC 2013.

example, a PCG scheme in Nicaragua had to be abandoned because neither legal nor institutional framework was in place. However, in countries where the state had reasonable credibility with private investors, and where the direction of reform was understood, the perfection of policy was not a precondition.

**Finally, in terms of findings on design of interventions, programs with collaboration of, or delivered by non-state intermediaries tend to perform better.** These include business associations, employer organizations which know target beneficiaries better and also provide non-financial business support services to SMEs along with financial services. Therefore, there is a case to engage with or collaborate with the private sector when it comes to delivery of SME products, including access to financing programs. An example of such a program is Coca Cola's 5by20 initiative, which aims to empower five million women entrepreneurs in its own value chain by 2020. This initiative rests on partnership with many stakeholders including local government, NGOs and community leaders, and seeks to provide a bundle of inputs to women such as skilling, financing and mentoring. Since its inception, it has reached 300,000 women entrepreneurs in 12 countries.<sup>23</sup>

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<sup>23</sup> <http://www.coca-colacompany.com/5by20>

### III. IMPLICATIONS

Given the evidence of targeted financial interventions for SMEs and the impact on creation of more and better jobs, what are some implications for such interventions in the future such that this impact can be more commonly achieved?

- 1. A more dynamic approach through better matching of financial instruments with types of SMEs and their specific financing needs would help clarify theory of change and increase likelihood of achieving the expected impact.** For instance, matching grants will have employment effects in labor intensive SMEs in SSA, while the effect of this intervention may be more evident on growth variables (exports, revenues, profits) in more capital intensive SMEs in LAC. Similarly, interventions that address financing constraints for very small SMEs who are in survival mode, will likely have an income stabilization effect rather than an employment effect. Therefore, clarification of the potential impact in the results chain ex ante is critical to appropriate design of interventions which will increase probability of achieving impact.
- 2. Interventions that focus on credit constraints for high growth SMEs and startups, such as equity financing and VC funding, will have greater likelihood of having an employment effect, by way of more and better jobs.** Following the recommendation above, aligning programs with the financing needs of SMEs that create more and better jobs will have a better likelihood of an employment effect than following a one-size fits all approach. However, this also implies a greater focus on building the tools required to identify these high growth SMEs. Approaches such as psychometric scoring and business expert panels need to be refined and implemented as part of design of programs. Finally, taking a multi-sectoral and multi-institutional approach to addressing high growth/start up financing needs will help support the entire life cycle of these SMEs. At the moment, within the WBG, there is little linkage between activities between non-financial offerings and financial interventions between IFC and the World Bank. There are also relatively few programs that address innovative early stage financing (such as developing angel networks, diaspora linkages, crowdfunding platforms). The WBG's convening power and its extensive reach to the banking and broader Financial Institutions sector can however be leveraged to scale up such efforts.
- 3. Bundling of access to finance interventions with other instruments,** like training, incubation, co-investing, creating networks, will increase likelihood of success of SME growth and therefore employment, specifically among the smallest firms. The WBG offers a suite of interventions at the start up stages of SMEs that include business training, access to incubator and innovation centers, platforms for market access. These types of bundled interventions will maximize employment effects as SME growth accelerates. It is also important to sequence these activities in the context of the broader regulatory environment. As the evidence points out, in some countries, establishing the appropriate regulatory and policy environment is a necessary pre condition for firm level or sector level interventions to bear fruit. Therefore, a deeper understanding of the macro context, the sector profile of SMEs and then targeted financial interventions is needed for development objectives to be met.

- 4. Targeted financing programs for women-owned SMEs also require an integrated approach with a suite of other activities, specifically skilling and capacity building.** While there are several such approaches across the World Bank and IFC, there might be a space to develop joint products where there are similarities in terms of delivery models and end beneficiaries. This could help develop ‘off the shelf’ products that could further help scale up such programs. Given the cultural barriers that sometimes exist for women to participate in income generating activities, exploring and scaling technology based solutions to accessing financing is also an important step. Finally, partnering with the private sector in delivery of these services could be an effective way of scaling up financing programs for SMEs, as in the example of 5by20 given above.
- 5. Significant effort needs to be put in to measure and evaluate specifically the employment effects of SME interventions in general, and A2F interventions in specific.** One of the key findings from this analysis is the scarce body of evidence driven by rigorous evaluations of programs that seek to address SME constraints. This has been underscored in the IEG report of the WBG portfolio. Efforts to address this gap are underway. In the WBG, a comprehensive research work plan to answer questions on employment effects of SME interventions has been committed to and is being led by a multi institution and cross sector group across IFC and the World Bank. IFC has been piloting several methodologies to estimate job creation among its FI clients, and is currently testing a job extrapolation model, partly funded by the Jobs group. The Jobs group is also spearheading efforts to estimate jobs through several estimation methodologies including modeling and more project oriented tracer studies. This body of evidence will go a long way to help inform better design of programs going forward.

## IV. CONCLUSIONS

Evidence regarding SME contribution to employment is quite robust. SME growth by removing constraints to growth is critical to create jobs. Among the many constraints to their growth, most SME managers in developing economies believe that access to finance is the most binding. If these opinions reflect reality, SME financing programs would be an important channel to achieve growth and create more, better and inclusive jobs.

This note combs through interventions that try to address SME finance constraints to identify impact on creation of more, better and inclusive jobs. However, evidence of actual impact is scarce, or mixed at best. So, there is much more to learn. This learning can only take place if projects are designed to capture these lessons clearly and objectively.

One of the key implications for teams designing SME access to finance interventions is to focus on building an appropriate monitoring and evaluation system to document whether the intervention is having the desired effects. Most importantly, it is also important to have in place a clear understanding of the SMEs being targeted and the objective of the intervention, with a logical theory of change. This will help better align program objectives with the actual results and provide critical learning.

To maximize job creation, focusing on the specific financing constraints of high growth SMEs and startups may yield better results. Further, in certain circumstances, it might be appropriate to complement financing with other inputs such as training and capacity building of managers of SMEs. It is also important to keep in mind that SME financing programs do not operate in a vacuum. Systemic interventions that aim to deepen the financial sector through policy and regulatory reform are sometimes necessary prerequisites for the success of the more targeted financial interventions.

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