

# private sector

## SMEs, Growth, and Poverty

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### Do Pro-SME Policies Work?

**This Note explores the relationship between the size of the small and medium-size enterprise (SME) sector and economic growth and poverty reduction. A new study finds no support for the widely held belief that SMEs promote higher growth and lower poverty. But it does provide some support for the view that the quality of the business environment facing all firms, large and small, influences economic growth.**

To accelerate growth and reduce poverty, international aid agencies provide assistance targeted to small and medium-size enterprises (SMEs) in developing economies. The World Bank Group, for example, approved more than US\$10 billion for programs supporting SMEs in the past five years. Does this pro-SME policy work?

#### The arguments for and against

Advocates of the pro-SME policy make three core arguments for its effectiveness. First, they argue that SMEs enhance competition and entrepreneurship and thus have economywide benefits in efficiency, innovation, and productivity growth. So direct government support of SMEs can help countries reap social benefits. Second, proponents often claim that SMEs are generally more productive than large firms but are impeded in their development by failures of financial markets and other institutions. Thus, pending financial and institutional improve-

ments, direct government support of SMEs can boost economic growth and development. Finally, some argue that the growth of SMEs boosts employment more than the growth of large firms because SMEs are more labor intensive. So subsidizing SMEs may help reduce poverty.

Even as international donors channel a large and growing amount of aid to subsidizing SMEs, skeptics put forth four views questioning the efficacy of this policy. First, some emphasize the advantages of large firms. Large enterprises may exploit economies of scale and more easily undertake the fixed costs associated with research and development, boosting productivity. And empirical evidence from both industrial and developing countries shows that large firms offer more stable employment, higher wages, and more nonwage benefits than small firms, even after differences in workers' education, experience, and industry are controlled for.



Second, skeptics challenge the assumptions underlying pro-SME arguments. Some research finds that SMEs are neither more labor intensive nor better at creating jobs than large firms. Moreover, recent work finds that underdeveloped financial and legal institutions do not hurt only SMEs. Indeed, research finds that such institutions constrain all firms from growing to their efficient size.

Third, skeptics question the validity of considering firm size to be an exogenous determinant of economic growth. According to this “institutional” view, natural resource endowments, technology, policies, and institutions help determine the industrial composition and optimal firm size in a country. For example, some countries may have endowments providing a comparative advantage in goods produced most efficiently in large firms, while others have a comparative advantage in goods produced most efficiently in small firms. Similarly, in countries open to international trade, the optimal firm size may be larger than in countries that are less open. And some argue that firm size reflects the margin between intrafirm transaction costs and market transaction costs, such that as market transaction costs fall relative to intrafirm transaction costs, the optimal firm size falls. For institutional and technological reasons, this margin varies across industries and countries. So in this view pro-SME policies could distort firm size and potentially hurt economic efficiency.

Fourth, some skeptics, taking a “business environment” view, doubt the crucial role of SMEs and instead emphasize the importance of the business environment facing all firms, big and small. Low entry and exit barriers, well-defined property rights, effective contract enforcement, and access to finance—all factors conducive to competition and private commercial transactions—may encourage SMEs. But these skeptics focus not on SMEs, but on the environment facing all businesses. So, like other skeptics, they question the policy of subsidizing the development of SMEs.

Much research has evaluated pro-SME arguments at the level of the firm, industry, or country. But cross-country studies of the relationship between SMEs and economic development have

been hampered by the lack of comparable cross-country data. A new study provides the first cross-country evidence on the links between SMEs and economic growth and poverty reduction.

### The provocative findings

Comparable cross-country data are notoriously hard to come by. For starters, countries define a small or medium-size enterprise in many different ways. Moreover, by definition, the data exclude the informal sector, where many such firms operate in developing countries. So the data used in the analysis are the best available, not the ideal.

The study carries out an econometric analysis using two newly compiled indicators of the SME sector based on its share of manufacturing employment (box 1).<sup>1</sup> The study also builds an

#### Box Measuring the SME sector

The study compiled two SME indicators for the econometric analysis. One is the share of the SME sector in the total official labor force in manufacturing, with 250 employees taken as the cutoff for defining an enterprise as small or medium-size. This indicator provides a consistent measure of firm size distribution across countries. The second indicator is the share of the SME sector in the total official labor force in manufacturing based on the official country definition of a small or medium-size enterprise, with the cutoff ranging from 100 to 500 employees. This indicator takes into account that a country’s economic and institutional characteristics might determine whether a firm is defined as small, medium-size, or large.

These indicators have shortcomings. For example, information on SME employment outside manufacturing (such as in agriculture and services) would be useful to have, but no cross-country data are available for the share of SMEs in other sectors. Another potential problem is that the definition of SMEs is restricted to formal enterprises, yet informal enterprises may account for an important share of output in some economies. The analysis controls for the importance of the informal economy, however, by incorporating estimates of the size of the informal sector relative to the formal sector in each economy. Here the analysis relies on earlier work estimating the market value of output produced by the informal sector as a share of measured GDP. It uses measures of informal activity rather than the informal labor force because few countries have data on the size of informal sector employment.

indicator of the quality of the business environment facing firms of all sizes—an aggregate measure of entry and exit costs, contract enforcement, and property rights protection. Countries are considered to have a more effective business environment if property rights are well protected, the costs of contract enforcement and business registration are low, and the insolvency process is cheap, fast, and efficient. The data show that the importance of SMEs in manufacturing varies greatly across countries and that those with a smaller share of SMEs also have a business environment that is hardly conducive to doing business (table 1). The cross-country econometric analysis yields some interesting results.

### SMEs and growth: correlation or causality?

Regressions of GDP per capita growth, averaged over the 1990s, on either of the two SME measures and an array of other country characteristics that can account for differences in growth across countries show a strong relationship between the importance of SMEs and economic growth. This relationship still holds when the analysis controls for the importance of the informal economy and excludes transition economies and Sub-Saharan African countries whose growth path might vary from those in other regions.

But the results do not take into account the possibility of reverse causation—that high growth might lead to the emergence of many small enterprises. Moreover, the results could be the outcome of a third factor, not included in the estimations, that might drive both the high share of SMEs and the high growth of the economy. Regressions that explicitly control for reverse causation and the possibility of such a third factor erode the significance of the relationship between SMEs and economic growth. This finding is consistent with the view that a large SME sector is a characteristic of fast-growing economies but not a cause of their rapid growth.

When the analysis focuses on income growth among the lowest income quintile rather than the overall population, it again finds no evidence for the importance of SMEs. Nor does it find any statistically significant relationship between the importance of SMEs and the depth and breadth of poverty across countries.

### Business environment and growth

While cross-country comparisons provide no evidence that SMEs cause economic growth or reduce poverty, cross-country regressions provide qualified evidence that an effective business environment does cause growth. Cross-country regressions of GDP per capita growth on the business environment indicator

**Table** Size of SME sector and quality of business environment, selected countries, 1990s

Country	Average GDP per capita, 1990–99 (constant 1995 US\$)	Average annual GDP per capita growth, 1990–99 (percent)	Percentage of manufacturing labor force in SMEs <sup>a</sup>	Business environment index <sup>b</sup>
Brazil	4,327	0.63	59.80	–0.34
Cameroon	653	–1.74	20.27	–1.98
Germany	30,240	1.43	70.36	0.82
Indonesia	963	3.09	79.20	–1.37
Korea, Rep. of	10,508	5.41	78.88	1.03
Turkey	2,865	2.49	61.05	–0.12
Ukraine	1,190	–7.17	5.38	–0.56
United States	28,232	1.93	52.54	2.26

a. Small and medium-size enterprises are classified on the basis of the official country definition.

b. The business environment index is a composite of four measures relating to the protection of property rights, the costs of contract enforcement and business registration, and the cost and efficiency of the insolvency process. It has an average value of zero and a standard deviation of one. Higher values indicate a more effective business environment.

Source: Meghana Ayyagari, Thorsten Beck, and Asli Demirgüç-Kunt, “Small and Medium Enterprises across the Globe: A New Database,” Policy Research Working Paper 3127, World Bank, Development Research Group, Washington, D.C., 2003.

and an array of other potential growth factors show a strong relationship between an effective business environment and economic growth. Moreover, they show that this relationship still holds when the analysis takes into account the possibility that faster-growing countries might adopt more effective business regulations or that a third factor might drive both an effective business environment and economic growth. So, unlike for SMEs, there is evidence that an effective business environment is not just a characteristic of successful economies but also plays an important part in their success.

Cross-country comparisons show that the positive relationship between an effective business environment and income growth holds as much for the lowest income quintile as for the rest of society. But there are limits: the results do not show that a good business environment has an effect on poverty reduction beyond its positive effect on GDP per capita growth.

### Policy implications

Cross-country comparisons suggest a strong positive association between SME development and economic growth. But this relationship does not hold up when the analysis controls for reverse causation or for a third factor that might drive both growth and the emergence of many SMEs. Moreover, cross-country comparisons do not show that SMEs do much to boost the incomes of the poor or that they have a significant relationship with the depth and breadth of poverty. So while a thriving SME sector is a characteristic of flourishing economies, the results do not support the contention that SMEs accelerate growth and reduce poverty, calling into question the policy of directly subsidizing their development.

But cross-country comparisons do point to the potential benefits of policies that strengthen the business environment in ways that foster competition and facilitate commercial transactions for all firms, large and small. The results show that a measure of the business environment—an index incorporating information on entry and exit barriers, the protection of property rights, and the efficiency of contract enforcement—is associated with the growth rate of GDP per capita. But while a sound business environment tends to help the poor by acceler-

ating aggregate growth, the results do not suggest that the business environment has an effect on poverty beyond its effect on the overall economy.

Together, these findings have important policy implications. They suggest that rather than directly subsidizing SMEs and aiming for a large number of small enterprises, policymakers should focus on creating a business environment that allows easy entry and exit for firms and assures entrepreneurs and financiers that property rights and contracts will be enforced.

### Note

1. The raw data were collected from national and international sources, such as the United Nations, Inter-American Development Bank, and Organisation for Economic Co-operation and Development. For details see Meghana Ayyagari, Thorsten Beck, and Asli Demirgüç-Kunt, "Small and Medium Enterprises across the Globe: A New Database," Policy Research Working Paper 3127 (World Bank, Development Research Group, Washington, D.C., 2003).

## viewpoint

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