Profitably Promoting Promising Small and Medium Enterprises

By Michael Klein

All over the world governments sponsor a multitude of programs for small- and medium-sized enterprises (SMEs) with typically 10 to 250 employees. Proponents of such policies argue that there is a "missing middle" of firms with access to financial services in many countries, which may thus miss out on income and employment generation.

The evidence about the contribution of SMEs to economic development remains ambiguous. Existing data say that their share in total employment may vary from just around 10% to almost 90% of employees, their share in GDP from below 10% to about 65%. Some studies argue that the majority of net new jobs are created in SMEs, others stress the importance of large firms or the informal sector in this regard.

Recent studies have begun more carefully to assess the role of SMEs. Every year new SMEs enter the market, typically to some 5 to 20 % of all firms. A similar number of SMEs exit every year. Within the first 5 years about 40 to 60% of SMEs fail. This churning process can help in two ways. New entrants may be more productive than old ones thus raising incomes. New entrants may also be a test bed for new business ideas. The big benefits are reaped when an economic system is able to pick out the good firms and enables them to grow. In a well-functioning economy good SMEs grow and become large.

The process varies by country and sector. The key is to create an effective ecology of firms that enables new businesses to be tested, that supports the growth of good ones and that weeds out the unsuccessful ones. SME support-policies should thus support an effective business environment and not favor any particular size. This includes establishing property rights, contract law, creditor rights, and information infrastructure like accounting and credit bureaus. When the business environment improves, private markets provide SMEs with know-how and financial services. Studies show this for over 45 developing countries and the OECD area.

Market failures plague countries with weak business environments and may still be found in some cases for new venture funding in developed economies. Theory has little practical guidance on how to remedy potential market failures. Evidence is also sparse. Evaluations of SME programs abound. Yet, less than a dozen rigorous impact evaluations looking into long-term survival of promoted enterprises have been performed globally. Some show that SME support schemes have worked. At the same time there is evidence that a number of schemes have been corrupted.

The trick then is to design approaches that maximize the chance of success while limiting the scope for abuse. Fundamentally, the potential failures in the market for know-how and finance arise from information problems. As a result "good deals are left on the table". Hence, if governments are successful in their support of SMEs, they should in the aggregate be able to recover the cost of support. This is hard to measure and monitor in a system with highly dispersed program activities undertaken by different government agencies.

Development finance institutions have special advantages to solve the problem. A government can delegate SME support to a DFI and require it to earn profits that exceed the cost of capital. If this discipline is taken seriously the DFI will target promising SMEs that will on average raise productivity. Such an approach is quite similar to pure commercial financing enhanced by a mandate specifically to finance SMEs. Commercial market development can be pursued by requiring some form of co-financing or guarantees.

The typical financial products for SMEs have debt-like features, because these are more easily monitored and enforced than equity-type products. However, DFIs should strive also to develop equity-type structures. As in venture capital many SMEs that initially look promising will fail. A subset, however, will hopefully succeed and make up for failures. Equity-type structures would allow DFIs to capture the upside from the successful SMEs and allow them to reach their profit targets, while absorbing the cost of unavoidable failure. Equity finance for SMEs is hard. Promising approaches include income participation loans and exit mechanisms ranging from put options to liquid equity funds that enhance exit options for equity investors. Here DFIs can yet break new ground.

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