Job Creation in the Formal Sector:
The role of Private Sector Development Support to SMEs

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What are SMEs?

• SMEs = small and medium enterprises

• Definition typically based on employees, sales, and/or assets
  • Cutoffs vary across countries and institutions

• 250 = commonly used employee cutoff (e.g. EU)
  • Other definitions may use 100, 300 etc.

• Some definitions impose a lower bound, e.g. 5 employees
  • MSMEs = micro, small, and medium enterprises
Some examples of (M)SMEs from a study in Mexico

- Data services and call center
- 160 employees

- Pet and toy store
- 8 employees (in 3 branches)
Water distribution truck

Main office

- Water transportation
- 6 employees
Why care about SMEs?

• SMEs employ about 50% of workers in developing countries (Ayyagari, Demirgüç-Kunt, and Maksimovic 2014)
  • SME growth may raise earnings for many low income households

• SMEs tend to face more constraints than large firms
  • Enterprise Survey data suggests 44% of SMEs in low income countries are involuntarily excluded from applying for a loan vs. 25% of large firms (2014 Global Financial Development Report)

• Less transition from SMEs to large firms in developing countries (“missing middle”)
% of large firms that start out large (vs. as MSMEs)

Source: Own calculations based on Enterprise Survey data
Policies for SME growth often include...

• Access to finance
  • Credit guarantees
  • Credit infrastructure: credit bureaus, collateral registries
  • Business plan competitions

• Business skills and practices
  • Workshop training
  • Consulting
  • Matching grants
• Improved access to finance in Mexico (through Banco Azteca) helped small businesses stay in operation and increased employment and income

• Effects are higher for low-income individuals and those located in areas with lower pre-existing bank penetration
Policies for improving SME’s access to finance

• Direct government interventions, such as government banks and credit guarantees, are difficult to implement since design matters a lot and they may be subject to political capture
  • Additionality – do these interventions support firms that would otherwise not have received credit?

• Market-oriented policies, such as collateral registries or credit bureaus, tend to be more successful

• Only about 50% of countries have a credit bureau (Doing Business 2016)
  • Banks may be reluctant to share proprietary credit information (Bruhn, Farazi and Kanz 2013)
Can psychometric credit scoring provide valuable credit information on SMEs?

• SME owner takes a “personality” test as part of the loan application that measures
  • Potential for business success
  • Integrity or intention to pay back a loan

• The Entrepreneurial Finance Lab (EFL) developed such a test based on work in Africa and then also piloted it in Latin America, in collaboration with the IDB
  • Arráiz, Bruhn, Ruiz, and Stucchi study the effect of passing the EFL test on access to loans, using a sample of about 1,900 SME owners who applied for business loans with a bank in Peru
Passing a psychometric test leads to increased loan access for SMEs in Peru

Probability of taking out a new SME loan within 6 months of loan application increased from about 55 to 75% at EFL score cutoff (SME owners with scores above the cutoff were offered a loan as part of the study)
In terms of repayment, psychometric credit scoring works well for applicants WITHOUT a credit history.

Applicants WITHOUT a credit history who were offered a loan based on the psychometric tool had similar credit scores two years later as those who received a loan based on conventional screening (implying they repaid their loans at similar rates).
BUT psychometric credit scoring does not replace credit bureau information

Applicants WITH a credit history who were offered a loan based on the psychometric tool had lower credit scores two years later than those offered a loan based on conventional screening (they were more likely to default on their loans). Why? As part of the study, loans were offered even to applicants with a bad credit history
Business plan competitions can increase start-up, survival and employment (McKenzie 2015)

• Competition for young entrepreneurs in Nigeria with US$50,000 prizes
• For new firms, winning the competition increases the likelihood that the
  • Entrepreneur is operating a firm three years later by 37 percentage points
  • Firm has 10 or more workers by 23 percentage points
• For existing firms, winning results in a
  • 20 percentage point increase in survival over three years
  • 21 percentage point increase in the likelihood that the firm has 10 or more workers
• Competition winners generated 7,000 more jobs than the control group
• Cost per-job-year is lower than for vocational training, business training, wage subsidies, and small grants to microenterprise programs
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Mixed evidence on business training’s effect on business start-up and employment

• A typical business training course is offered in a classroom setting and takes about a week
  • ILO Start and Improve Your Business program has trained 6 million people in more than 100 countries
  • IFC’s Business Edge program has trained 200,000 people in 54 countries

• Half of the existing impact evaluations find an increase in the likelihood of business start-up (McKenzie and Woodruff 2014)
  • But often no increase in probability of employment (switch from wage work)
  • Effects go away over time (control group also starts opening businesses)
Example: Business training for youth in Bosnia (Bruhn and Zia 2013)

- Microfinance clients between the ages of 18 and 35 were offered business training
  - 39% take-up rate
  - Improved business knowledge
- 178 youth were planning to start a businesses
  - Only 1 of them did
- 267 youth already had a business (2 employees on average)
  - No significant difference in survival across treatment and control groups

![Survival rate 1 year after training](chart.png)
Classroom business training (Bosnia)
Business practices may matter a lot for firm growth

• Business practices vary widely across countries and within countries and firms with better practices tend to perform better (Bloom, Van Reenen & coauthors; McKenzie and Woodruff)
  • Accounting, marketing, financial planning

• How to improve business practices?
  • McKenzie and Woodruff (2017) argue that improvements in business practices generated by training programs are not large enough to translate into improved performance → need more intensive interventions
Consulting services lead to firm growth

- Randomized control trial with 432 micro, small, and medium enterprises in Puebla (Bruhn, Karlan, and Schoar 2018)
  - Firms received one year of management consulting services
  - A survey right after the program ended shows improved accounting, marketing, "entrepreneurial spirit", and productivity
  - Two to five years after the intervention, administrative data from Social Security Institute (IMSS) shows 50% increase in employees and wage bill
On-site consulting services (Mexico)
Matching grants

• One of the most commonly used policy tools for small and medium enterprise growth

• Consulting program in Mexico implemented via a matching grant
  • Beneficiaries paid only 10 to 25% of the cost of the consulting services (US$12,000 on average), depending on firm size
  • Other share paid by the state government
  • One of the first rigorous impact evaluations of a matching grants program

• Are these subsidies really needed?
### Self-Reported Reasons for Not Using Consulting Services in Control Group Firms

<table>
<thead>
<tr>
<th>Reasons for not using consulting services</th>
<th>% of enterprises mentioning this reason (multiple mention)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Would be a good investment, but don't have funds</td>
<td>46.3</td>
</tr>
<tr>
<td>Don't know what the benefits would be</td>
<td>22.2</td>
</tr>
<tr>
<td>Simply hadn't considered it</td>
<td>18.5</td>
</tr>
<tr>
<td>Didn't need the services</td>
<td>13.9</td>
</tr>
<tr>
<td>Other</td>
<td>11.1</td>
</tr>
<tr>
<td>Didn't know these services existed</td>
<td>7.4</td>
</tr>
<tr>
<td>Not worth the cost</td>
<td>5.6</td>
</tr>
<tr>
<td><strong>N</strong></td>
<td><strong>108</strong></td>
</tr>
</tbody>
</table>

This table includes all control group firms that, at the time of the follow-up survey, reported never having used consulting services.

Source: Bruhn, Karlan, and Schoar (2018)
Can simply providing information improve SME performance (and take-up of consulting)?

• Ongoing work in Brazil (with Caio Piza)
  • SME owners will fill-out a questionnaire on business practices
  • Randomly select sample into a control group and 2 treatment groups
    1. Information on benefits: Receive information on the business practices where deficiencies were detected. Information will also state that business practices vary across firms and that better practices are associated with higher revenues
    2. Coaching program: This group will be invited to participate in a coaching program where SMEs work with a consultant for one year

• Compare effect of providing information only to effect of the coaching program
• Test if simply receiving information causes SMEs to seek out improvements and/or consulting on their own
Summary

• Access to finance is a constraint for SME growth
  • Credit bureaus can improve access, but banks may be reluctant to share information
  • Psychometric credit scoring can work well for SMEs without credit history
  • Equity contracts, Angel investors (?)

• Business plan competitions can increase firm start-up, survival and employment

• Business practices matter for SME growth
  • Standard training is not the most effective way of improving practices
  • Consulting services can have big effects on SME performance
  • Matching grants
  • Providing information about returns to business practices (?)