MICRO AND SMALL ENTERPRISES, DYNAMIC ECONOMIC GROWTH, AND POVERTY REDUCTION
A REVIEW OF THE CONCEPTUAL AND EMPIRICAL EFFECTS OF MSES ON DEVELOPMENT
microREPORT #62

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DISCLAIMER

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ABSTRACT

The aim of this literature review is to explore the relationship between micro and small enterprise (MSE) development, aggregate economic growth, and poverty reduction in developing countries. MSE development practitioners espouse certain beliefs about the contributions and advantages MSEs can make to developing countries, but these beliefs are challenged by skeptics who argue that the extent to which small firms contribute to bottom line economic growth and development is far less than is asserted. The basis of this debate is that neither researchers nor practitioners have been able to sufficiently demonstrate the causal links between MSEs and economic growth and poverty reduction. The literature review covers the main tenets of this debate by examining some of the more defining characteristics exhibited by MSEs; the role MSEs play within micro and macro economic growth; and the avenues through which MSEs can contribute to poverty reduction.

KEY WORDS

Micro and small enterprises; micro and macro economic growth; poverty reduction; MSE characteristics
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INTRODUCTION

The aim of this literature review is to explore the relationship between micro and small enterprise (MSE) development, aggregate economic growth, and poverty reduction in developing countries. In many developing countries, micro and small enterprises constitute the vast majority of firms and generate a substantial share of both overall employment and output (Nichter & Goldmark, 2005). MSE development practitioners espouse certain beliefs about the contributions and advantages MSEs can make to developing countries, but these beliefs are challenged by skeptics who argue that the extent to which small firms contribute to bottom line economic growth and development is far less than is asserted.

The basis of this debate is that neither researchers nor practitioners have been able to sufficiently demonstrate the causal links between MSEs and economic growth and poverty reduction. One of the main reasons why it is difficult to capture causal links is because a universal definition of a MSE does not exist, given the multitude of different economic, social, and geographic differences within the international context. As difficult it may be to universally define MSEs, the definition of poverty is just as elusive. Since national poverty levels are measured differently, and using specific poverty reduction techniques in one country may not be easily applied to another country’s context, it is also difficult to assess the impact of MSEs on poverty reduction (Corporation for Enterprise Development [CFED], 2004).

Various international donors have provided targeted assistance to advance MSE development in developing countries with the same assumptions: that MSEs positively affect economic growth and poverty reduction. The support for MSE development on an international scale is reflected in the desire to find a middle ground between the structural adjustment focus of the 1980s and a more holistic approach that includes considerations for social development (CFED 2004). The SME sector is believed to be able to bridge the informal and the formal sectors and provide economic opportunities for both the poor and the non-poor, leading to more equitable growth opportunities and outcomes. Support for MSE development generally revolves around presumed comparative advantages of small firms: relative to large firms, small firms are believed to, among other things, create more jobs at a faster rate; be more labor intensive and thus create employment and training opportunities for unskilled labor; be more efficient; serve as a safety net against sudden economic or household shocks; be a seedbed for technological innovation and entrepreneurship; and provide broader non-financial, non-wage benefits to the working poor, such as greater access to health care or education.

Since 2000, USAID, the World Bank Group, the Inter-American Development Bank and other agencies have put forth great efforts to promote private enterprise development (Snodgrass & Winkler, 2004). In the past five years, the World Bank approved more than $10 billion in support for MSE development programs based on the argument that MSEs make special contributions to developing economies by promoting economic growth and alleviating poverty (Beck, Demirgue-Kunt & Levine, 2003). As noted by Kristin Hallberg (2001) of the Inter-American Development Bank (and formerly of the International Finance Corporation), the goal of MSE development programs is to harness the potential human capital and entrepreneurship that already exists in most economies:

“…because they account for a large share of firms and employment, in other words, because “they are there.” Searching for further justification to promote smallness as an instrument of poverty alleviation is not necessary: it is enough to recognize that microenterprises and SMEs are the emerging private sector in poor countries, and thus form the base for private sector-led growth.
This rationale for small enterprise intervention suggests that a small enterprise development strategy is in reality just a “private sector development strategy,” recognizing that the majority of firms are small, that they may face different constraints and opportunities than large firms, and that the types of institutions and instruments best suited to their needs may be underprovided in distorted and segmented markets. It points to government action toward market-completing interventions and the elimination of policy bias by addressing the market failures that create cost disadvantages for small enterprises (such as the costs of acquiring information), restrict their access to markets, or inhibit the development of markets for a diverse range of financial and non-financial services appropriate for small firms.”

This literature review covers the main tenets of the debate over what impacts MSEs may have by examining some of the more defining characteristics exhibited by MSEs; the role MSEs play within micro and macro economic growth; and the avenues in which MSEs can contribute to poverty reduction.

I. COMMON MSE CHARACTERISTICS
There are many common assumptions about the characteristics MSEs possess, such as: they employ few workers, are run out of the home, do not generate high income nor experience much growth, and do not produce for markets outside their local environment. Different assumptions are also held for entrepreneurs, depending on their characterization. Some might consider the economic activities of the poor to be “petty commodity production” rather than “entrepreneurship,” the latter of which is expected to lead to capital accumulation and growth (Eversole, 2003). Based on her research on poor businesses in Bolivia, Guatemala, and Peru (with less than $5,000 to $100 in capital), Eversole argues that even the smallest business owners have the desire to act entrepreneurial and “grow” their business, but maintaining a steady income stream is more desirable for those with high poverty rates. Poor, self-employed people (often referred to as survivalists) and those with enough capital to produce growth (often referred to as entrepreneurs) are one and the same as they both produce products for consumption but face different obstacles in growing their businesses based on the type of resources each may have access to. The “macro-level” question asked by Eversole is not “Do petty-commodity producers have different goals than capitalist entrepreneurs?” but “what resources are lacking, and what obstacles exist, that keep many microentrepreneurs in low-yield activities, with little opportunity to grow their resources?” Within this context, for example, the only difference between a supermarket and a woman selling fruit from a street stall is the scale of the enterprise.

The following demonstrates the common characteristics and diversities of MSEs and is largely based upon a review of micro-level studies of firm dynamics in nine countries in Africa and Latin America (Liedholm 2002). These studies reveal the reasons and patterns for enterprise births, survival or closure, and growth, along with the determinants of these change components:

Share of firms and employment. In many developing countries, microenterprises and small-scale enterprises account for the majority of firms and a large share of employment, mainly consisting of small firms with one person working alone or with unpaid family members. Self employment is a central element in these economies. In Ecuador, for example, firms with fewer than 50 employees accounted for 99% of firms and 55% of employment in 1980. However, the relative importance of small producers varies significantly across countries and, within a given country, across stages of development over time. In low-income countries, the vast majority of firms are micro- or small-scale, existing alongside a few large-scale enterprises. As countries develop, small-scale enterprises play a declining role. Taiwan and China are
important exceptions to this rule (Snodgrass and Biggs 1996). Micro and small enterprises are a major source of livelihood for a significant proportion of the population in these areas. Based on house-to-house baseline surveys in Africa and Latin America, the small firm sector is far larger than is reported. Liedholm states that estimated employment garnered from MSEs in the African countries is nearly twice that of employment rates for formally registered, large-scale enterprises (Liedholm, 2002).

**Location.** Location can play a central role in determining MSE survival. MSEs located in urban or commercial areas are more likely to survive than their counterparts in rural areas. However, in Liedholm’s profile, over half of the enterprises operate in rural areas. Those that operate in commercial districts or on roadsides typically show greater growth rates than those that are based in the home, although Liedholm points out that this can vary at the country level.

**Gender.** An increasing number of small firms in Africa and Latin America are headed by women. In five of the nine countries women outnumber men as the owners and operators of MSEs; since working proprietors are the single largest category of the labor force, the majority of workers in MSEs are also women. These small firms tend to be concentrated in relatively specific activities like beer brewing, knitting, dress-making, crocheting, cane-work, and retail trading. MSEs headed by women are more likely to be based out of their homes (Mead & Leidholm, 1997). Since home-based MSEs tend to be hidden and overlooked, women owners of MSEs are more likely to be ‘invisible entrepreneurs.’

**Composition of Activities.** A significant number of small firms are involved in manufacturing activities. Among these, three activities have been consistently identified as the most important categories: textiles and apparel, food and beverages, and wood and forest products. Survey results suggest that these three categories comprise about 75% of manufacturing enterprises in urban areas of many developing countries and 90% in rural areas. These regularities mask the wide variations from country to country and between urban and rural areas.

**Sector Distribution.** Small firm survival rates vary significantly by sector – small retail trading firms face the highest risk of closure. Real estate, wood processing, wholesale traders, and non-metallic mineral enterprises are the least likely to close, while trading, transport and chemical MSEs are the most likely to close.

**Initial Enterprise Size.** The survey data do not support the expected direct relationship between an MSE’s initial size and its survival chances; initial enterprise size has no significant influence on firm survival. So, smallness, by itself, is not an impediment to firm survival in these countries. However, growing enterprises are more likely to survive than those that remained the same size. The survey results from Zimbabwe indicate that for every one percent increase in employment, the MSE reduced its likelihood of closing during the year by five percent. Such findings are consistent with the notion that expanding MSEs become more efficient and thus are more likely to survive.

Liedholm’s surveys found high overall growth rates exhibited by the existing (surviving) MSEs, such that the average annual compound employment growth rate since start up was 13.6% across six countries – a growth rate that was almost double the GDP growth rate in the 1980s for these countries. These rapid growth rates are even more impressive when it is realized that the majority of the small firms in the survey countries did not grow at all, making the growth rates of the growing small firms even higher. Also interesting to the study is the fact that the firms that did grow did so by only adding fewer than four new employees.

**Firm Creation/Contraction.** MSEs are constantly changing; not only are new firms being created (new starts or births) while others are closing, but existing (surviving) firms are expanding and contracting in size. These changes are usually summarized in two concepts: Net firm creation (new starts minus closure), and...
“mobility” or net firm expansion (firm expansion minus firm contraction) (Liedholm, 2002). The determinants of new starts differ between high and low return (profit) activities. For high return activities, barriers to entry like initial capital requirements are found to be inversely related to the new start rate; for low return activities, new starts rates only inversely relate to the aggregate level of economic activity.

**Labor Intensity.** Small firm expansion boosts employment more than large firm growth because small firms are more labor intensive, coinciding with the factor market structure of most developing countries. Many analysts argue that, within industries, for a given scale of production, small firms are more labor intensive than large firms. However, other evidence suggests that enterprise scale is an unreliable guide to labor intensity because many small firms are more capital-intensive than larger firms in the same industry. Labor intensity exhibits more variation across industries than among firm-size groups within industries – leading some authors to suggest that efforts to make economic growth more labor-demanding should focus on altering the pattern of demand in favor of labor-intensive industries rather than on supply-side efforts to change the size distribution of firms. The fact that small firms employ a large share of the labor force in developing countries may be more a reflection of the product composition of production in those countries than the inherent labor-intensity of small firms (Snodgrass & Biggs, 1996).

**Job Creation.** Apart from labor intensity, it is often argued that small firms are important for employment growth (i.e. job creation). While small firms experience both high job creation and destruction rates, it appears that job destruction during recessions is lower in small enterprises than in large enterprises – perhaps due to greater wage flexibility in small firms. In other words, small firm owners may temporarily accept lower compensation during recessions in order to hold on to their business (Snodgrass & Biggs, 1996).

The net job creation of MSEs is not necessarily higher and is frequently lower than for larger enterprises. The lion’s share of job creation disproportionately resides in large enterprises. Larger employers offer better jobs in terms of wages, fringe benefits, working conditions, opportunities for skill enhancement, and job security (Biggs, 2002; Hallberg, 2001).

Evidence presented by Beck, Demirguc-Kunt and Levine (2003) support this assumption. They claim that the large firm destruction rate prohibits many small firms from growing. In developed countries, net job creation rates (gross job creation less gross job destruction) do not exhibit a systematic relationship to firm size. For example, in the United States between 1973 and 1988, despite a widespread belief to the contrary, small manufacturing firms did not consistently create more jobs on a net basis (after allowing for jobs eliminated and firms that went out of business) than large firms (Nasar, 1994, as cited in Snodgrass & Biggs, 1996). There is some evidence that the same conclusion holds for developing economies: the closure rate of small firms exceeded 20% per year in the early 1990s in Africa and Latin America and most closures occurred in the early years of a firm’s existence. In fact, in Botswana, Kenya, Swaziland, and Zimbabwe, over 50% of the small firms closed within three years of start-up and the rate peaked before the end of the first year (Liedholm, 2002). Since small firms have higher gross job creation and destruction rates than large enterprises, small firms may offer less job security than larger firms. In the U.S., for both new and already existing jobs, job durability increases with firm size (Davis, Haltiwanger, & Schuh, 1993).

**Wages and Benefits.** While there are many exceptions to the basic pattern, the evidence suggests that larger employers offer better jobs in terms of wages, fringe benefits, working conditions, and opportunities for skills enhancement, as well as job security. In low-income countries, small enterprises have much lower productivity levels than larger firms, which lead to the lower wages and non-wage benefits paid by small firms compared to large firms. There is some evidence that this divergence in labor productivity and wage rates between small and large firms narrows as countries become more developed in terms of industrialization.
(Snodgrass & Biggs, 1996, p.32); though in the U.S. the gap in wages paid by small and large plants has widened over the past 20 years. However, while wages may typically be lower in small firms, MSE growth may lead to a more equitable distribution of income among MSE owners and workers who are in the lower half of the income distribution (Hallberg, 2001).

**Efficiency and Innovation.** There has been a substantial difference detected in economic efficiency among enterprises of varying sizes. Liedholm (2002) cited data that showed the returns per hour of family labor for those enterprises with two to five workers is significantly higher than the returns of a one-person enterprise. Even a small increase in the size of the enterprise can lead to a substantial increase in economic efficiency, and continues to increase for enterprises with six to nine workers, although the results become more ambiguous thereafter.

Other studies show that the smallest firms are the least efficient, and there is some evidence that both small and large firms are relatively inefficient compared to medium-scale firms (Little, Mazumdar, & Page, 1987). In the U.S. manufacturing sector, industries in which larger firms have a greater market share also exhibit greater productivity growth. While small firms may bring innovations to the marketplace, the contribution of innovations to productivity often takes time and larger firms may have more resources to adopt and implement them (Acs, Morck, & Yeung, 1997). Therefore, MSEs do not possess a comparative advantage in technological innovation or in creating budding entrepreneurs (Biggs, 2004). It is often argued, however, that small firms are more innovative, particularly when they follow “niche strategies,” using high product quality, flexibility, and responsiveness to customer needs as means of competing with large-scale mass producers (Snodgrass & Biggs, 1996). Large firms do most of the formal worker training, and their employees are responsible for a significant share of new firm formation. However, size is more dependent on factors such as natural resource endowments, technology, and openness to trade (Beck & Demirguc-Kunt, 2003; Hallberg, 2001).

Measures of enterprise efficiency (e.g., labor productivity or total factor productivity) vary greatly both within and across industries. Financial market imperfections, such as information asymmetries, transactions costs, and contract enforcement costs are particularly binding on the poor who lack collateral, credit histories, and connections (Beck, Demirguc-Kunt, & Levine, 2004). Policy imposed distortions may reduce the number of MSEs below efficient levels by imposing fixed costs that bear more heavily on MSEs.

MSEs also play a distinctly subordinate role in export creation. As suppliers for exporters, MSEs often add flexibility and efficiency to the development of competitive advantage, but export development is generally instigated and sustained by large enterprises (Biggs, 2002).

**Market Linkages.** Market linkages amongst small firms are quite limited. The majority of small firms in these areas sell directly to final consumers, although some use subcontracting and clustering. The studies suggest that those MSEs that sell to traders and manufacturing firms are more likely to grow than their counterparts who sell directly to final consumers. The linkages to smaller suppliers may be stronger, as well, given their smaller size or limited scope. Smaller businesses may import fewer intermediate goods than large firms, which may produce a “larger local multiplier effect” in which a greater amount of products are purchased from labor-intensive SMEs. This, in turn, can lead to increased opportunities for locally sustainable growth and employment (Small Enterprise Assistance Funds [SEAF], 2004).

The preceding section presented several examples of the conceptual and empirical contributions MSEs may have to growth, efficiency, and job creation. Given MSEs’ significant role in many poor economies, one might expect them to drive overall increases in output and income levels. However, Nichter and Goldmark’s
(2005) data show that only a small percentage of MSEs grow – despite decades of donor interventions and policy reform efforts supported by international agencies and developing country governments. Some argue that the smallest firms generate a relatively minor share of national output since they typically operate in less capital-intensive industries where workers often produce relatively less output per hour than those in more capital-intensive sectors.

2. REGIONAL EXAMPLES OF MSE IMPACTS

This section will assist the reader in conceptualizing the impacts of MSEs in employment and income generation, firm creation and destruction, and contributions to broader economic growth by offering regional examples that complement the theoretical and empirical ideas discussed in the literature review thus far.

EAST ASIA

In his review of SME sector contributions to the growth and development of East Asian economies, Harvie (2004) notes the sectors’ increasing importance to the region’s recovery of sustained economic growth, employment, trade, investment, and the development of globally competitive economies. The definition of a SME varies throughout the region; however, Harvie points out that 95% of these firms employ less than 100 people which allow broad comparisons to be made across the region:

- By the late 1990s, small firms comprised well over 90% of regional enterprises and were estimated to contribute 50% to 88% of total employment in individual regional economies.

- Small firms make up over 70% of employment in China, Japan, Thailand, and Vietnam. However, in many regional economies, approximately 80% to 90% of small firms are microenterprises that employ less than five people. Hence, microenterprises (as opposed to small firms more generally defined) contribute only 10% to 20% of employment in these regions.

- About 5% to 20% of microenterprises die each year and a similar amount are born each year. If there is a net gain of births over deaths then this tends to add to overall economic growth even though the average micro firm itself does not grow much in size.

- Small firm wage payments typically contribute over 50% of GDP in these regional economies.

- Small firms have typically been estimated to contribute approximately 30% to 60% of GDP (Hall, 1995) and contribute about 50% to value added or sales on average. Small firms contribute approximately 50% of output in China and Philippines, for example.

- It is the sustained growth of a relatively small group of successful (or high growth) firms, perhaps 5 percent or less, that significantly contributes to economic growth. These firms typically survive for more than eight years, and often experience growth rates exceeding 30 percent per annum. Only a relatively small percentage of small firms significantly contribute to overall growth in this way. (Hall, 2002).

- Half of all Indonesian workers are employed in firms with fewer than five workers, and two thirds of workers are employed in firms with fewer than 20 workers (Berry, Rodriguez and Sandee, 2002).

- The percentage of micro, small, and medium enterprises in selected East Asian economies are as follows:

MICRO AND SMALL ENTERPRISES, DYNAMIC ECONOMIC GROWTH, AND POVERTY REDUCTION
<table>
<thead>
<tr>
<th>Country</th>
<th>Micro-Enterprises</th>
<th>Small-Enterprises</th>
<th>Medium-Enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>N/A</td>
<td>96.1</td>
<td>2.8</td>
</tr>
<tr>
<td>Indonesia</td>
<td>95.6</td>
<td>3.8</td>
<td>0.5</td>
</tr>
<tr>
<td>Philippines</td>
<td>88.4</td>
<td>9.8</td>
<td>0.8</td>
</tr>
<tr>
<td>Thailand</td>
<td>79.4</td>
<td>18.5</td>
<td>2.0</td>
</tr>
</tbody>
</table>

**SUB-SAHARAN AFRICA**

Daniels and Mead (1998) analyze the level of income earned among small firms (defined as enterprises with 10 or fewer workers), drawn from previous survey work to examine the determinants of enterprise births, closures and expansions in five African countries (Botswana, Kenya, Malawi, Swaziland, and Zimbabwe) they conclude that while some micro and small enterprises generate very low returns, other MSEs produce substantially higher returns, particularly for those who participate as owners or as workers. The authors explore the extent to which small firms generate very low returns in “survivalist” type activities and their potential to generate higher incomes:

- Non-farm MSEs employ 17% to 27% of the adult population in five African countries; another 60% to 90% of the labor force works in agriculture.
- Although many people assume that MSEs are primarily part time businesses, the data show that 76% of MSEs in Kenya are in operation more than the FTE of 195 hours per month.
- Urban-based MSEs in Kenya are in operation more hours, on average, than rural based MSEs. The authors suggest that this could reflect higher proportions of MSEs in rural areas that are operated by households that are also engaged in other activities such as agriculture. Similar findings show that MSEs owned by men are in operation more hours than MSEs owned by women.
- There is no statistical difference in income between MSEs in rural or urban locations, although MSEs owned by men tend to earn significantly higher profits than MSE owned by women.
- In the five countries, MSEs generated nearly twice the level of employment as registered by large-scale enterprises in the public sector.
- Official statistics suggest that Kenyan MSEs generate over 13% of GDP. However, some experts argue that their role may in fact be much more prominent, contributing up to 40% of GDP. This discrepancy illustrates the idea that official statistics may frequently underestimate the role of MSEs in terms of number of firms, as well as employment and output contributions. Small, informal firms
may be all but invisible if they are located within the household, within the agriculture sector, or if their owners operate clandestinely for fear of harassment or sanctions from public officials. Liedholm and Mead estimate that the actual number of MSEs in many countries may actually be double that of official statistics.

**LATIN AMERICA**
A study conducted by Orlando and Pollack (2000) assessed poverty in the microenterprise sector (MIC) in Latin America by examining household income per capita and individual earnings using Inter-American Development Bank surveys from 14 LAC countries (where a microenterprise is defined as employing 5 workers or less) and tabulations prepared by the Economic Commission for Latin America (where a microenterprise is defined as employing 10 workers or less). They found that those in the microenterprise sector:

- Represented 54% of total employment in Latin America in the mid 1990s; between 1990 and 1995, an average of 84 out of 100 new jobs were created by MSEs.
- Measures of MSEs’ participation in GDP ranged from less than 10% to 50%, depending on the country and method of estimation.
- The incidence of poverty was almost twice as high for MIC workers than for non-MIC workers, and the pay gap between the two groups increased during the decade.
- More than one-third of households (in a subset of LAC countries) generated at least 50% of their income generated from the MIC sector; those with a significant amount of income from the MIC sector also tended to have higher poverty rates.

**EASTERN EUROPE/FORMER SOVIET UNION:**
Microenterprise development was introduced as a poverty-alleviating strategy in Central and Eastern Europe almost immediately after the collapse of communism in late 1989 (Uhrinova and Bussard, 2005). It did not, however, produce a booming economic result because proper institutions and infrastructures were not in place and because of the “relative technical and commercial backwardness of these enterprises in most transition countries” (Dallago 2003).

Using the Amadeus Database to review the financial information available for 97,000 firms in East and Central Europe, Klapper, et. al. (2003) discuss the extent to which Eastern European firms participate in their respective national economies:

- Overall, the SME sector in Eastern Europe is associated with young firms (85% of all firms age 0-3 years are SMEs.)
- Although the percentage of SMEs compared to the total number of firms is high throughout Eastern Europe, the percentage of employment that is attributable to the SME sector varies considerably. For example, in Russia the participation of SMEs in the total employment is 8%, while in Estonia it is 71%.
- The Estonian SME sector contributed 71% of total employment and is typified by very small firms with a median of 21 employees (excluding firms with less than 10 employees).
• There are 3.5 million companies registered in Poland, of which 98.8% are considered small or medium-sized businesses (SMEs), operating “with a varied capital mix” (Hunter and Ryan 2005).

Statistical discrepancies between countries of the Central and East European region result from the lack of a standard definition of a MSE. For example, Hungary has adopted the European definition for SMEs, (micro: <10 employees; small <50; medium-sized <250) while Russia has not distinguished SMEs from large firms for many years (and the size definition has itself varied through time). The most striking feature of the comparison is that the number of SMEs is roughly similar in the two countries, although Russia’s population is nearly 15 times larger than Hungary’s. The reason for the discrepancy is that the average size of an SME in Russia is a multiple of the average size of a SME in Hungary: 7.6 employees compared to 2.6 employees. In addition:

• In Russia there are 842,200 small enterprises with 6.4 million full-time employees, with an average of 7.6 employees per business (USAID 2001).

• In Hungary there are 638,400 small enterprises with 1.7 million employees, with an average of 2.6 employees per business (at the end of 1996). (Dallago, 2003).

• Russian statistics do not register individual entrepreneurs (3.4 – 4 million individuals in 2001), but they are registered in Hungary (Dallago 2003).

In European Union accession countries (Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovak Republic, Slovenia, and Turkey); the breakdown of SMEs for 1999 is the following:

<table>
<thead>
<tr>
<th>Micro</th>
<th>Small</th>
<th>Medium Sized</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enterprises (1000)</td>
<td>5540</td>
<td>205</td>
<td>45</td>
</tr>
<tr>
<td>Total employment (1000)</td>
<td>11760</td>
<td>4430</td>
<td>4890</td>
</tr>
<tr>
<td>Occupied persons/enterprise</td>
<td>2</td>
<td>21</td>
<td>107</td>
</tr>
</tbody>
</table>

4. MSES AND GROWTH

While it is not the purpose of this literature review to comprehensively review the vast literature on growth, it is important to note that the growth field is ambiguous and still evolving. Under increased empirical scrutiny over the past decade, core neo-classical economic growth assumptions such as the inherent value of trade and capital market liberalization, as well as the expected convergence of income levels between rich and poor countries have been found to be highly conditional. The difficulty of expecting the growth benefits of such seemingly “accepted” macroeconomic tenets accordingly challenges the validity of using growth as the ultimate measuring stick for assessing progress. Concurrently, there has been a growing appreciation for the contributions such nontraditional concepts such as institutions, human capital, and democracy make to growth.

This literature review is especially concerned with the growth literature that reflects the impacts of growth on small firm development, specifically among developing countries. At an aggregate level, micro and small enterprises are believed to demonstrate impressive growth, especially when compared with larger firms. However, many individual MSEs grow slowly or not at all – in some cases, due to a conscious decision on the
part of the business owner (Nichter & Goldmark, 2005). In this sense, the growth theories discussed here will relate to efforts to increase wealth in poor countries such that welfare is improved concurrently.

4.1 GROWTH WITHIN INDIVIDUAL FIRMS

A white paper on El Salvador’s (1999) microenterprise sector shows that only a very small fraction of small firms have the potential to grow. They characterize three types of small firms that can be distinguished in terms of the types of people (with different skill levels) involved, their capital and their income-generating ability: subsistence, simple accumulation, and broad accumulation or “micro-top.” Only the “micro-top,” which accounts for a very small portion of the firms, have the potential to grow:

- **Subsistence microenterprises**: Those whose productivity is so low that they only manage to generate enough income for immediate consumption; they work on the basis of “getting by.”

- **Simple accumulation microenterprises**: Those which generate income sufficient to cover their activities, although without enough surplus to permit capital investments.

- **Broad accumulation microenterprises, or ‘micro-top’**: Those enterprises with sufficient productivity to accumulate a surplus and invest it in the growth of the business. "Micro-top" business make up is the smallest segment (4 percent of the total in El Salvador, 1999).

MSE growth is defined by Nichter and Goldmark (2005) as an increase in the number of employees over time because MSE owners are usually able to remember the number of employees over time, even if they fail to maintain reliable written records. This definition also circumvents the need to deflate figures, often necessary when using revenue and other monetary metrics. Eversole (2003) explores the opportunities for and constraints of MSE growth within poor MSEs in Latin America. She finds that MSEs grow in several different ways, usually “little by little” since margins and production levels are usually small. MSEs can also grow through “reinvestment” whereby a portion of the entrepreneur’s income can be set aside to fund other activities for the business, such as buying additional sewing machines, while another portion can cover household expenses. Through reinvestment, enterprises can maintain their business and incrementally grow their capital. Other pathways to growth include expanding the product range and investing in their own materials to produce a small line of ready-made products.

**Determinants of Firm Size.** Unfortunately, even if a business does grow, entrepreneurs may find themselves hitting a ceiling in which they cannot produce the amount of product they would like due to staffing, financial, or market access constraints, thus limiting their expansion. Many entrepreneurs overcome this obstacle through diversification, one of the most common growth options for MSEs (Eversole, 2003). MSEs also choose to diversify the products they produce because they realize the limits of the markets they are working in; at times it may not be realistic to try to expand a business when demand is low. As a result, the main business may not appear to be growing since its surplus may be directed towards other opportunities that may make better economic sense. Entrepreneurs may also take advantage of seasonal products, changing what they produce depending on the season or even the day. Diversifying is a popular practice among MSEs as quoted by Buechler and Buechler (1992) in Eversole (2003):

> “The high competition and low earnings in many occupations and the economic and political uncertainly in Bolivia have forced many small-scale producers, or at least their households, to engage in more than one economic activity at once, either to increase their income or to spread the risk.”
Therefore, it is difficult to measure the growth of MSEs through conventional means, as growth in the MSE context may not be captured so directly. Biesebroeck (2004) provides empirical evidence which implies that some small firms might never grow. In a sample of manufacturing plants from nine sub-Saharan African countries, large plants are found to be extremely important. They achieve higher productivity levels and are more likely to survive, similar to more developed economies. In contrast, the commonly found higher growth rates for small plants are not replicated in the African sample and the distribution of plants changes very little over time. Plants are more likely to have started out large than to have grown to a large size.

Using theories of the firm they classified as ‘technological’ or ‘organizational,’ Kumar, Raghuram and Zingales (1999) analyzed the determinants of firm size across industries in a sample of 15 European countries and determined:

“We find that, on average, firms facing larger markets are larger. At the industry level, we find firms in the utility sector are large, perhaps because they enjoy a natural, or officially sanctioned, monopoly. Capital intensive industries, high wage industries, and industries that do a lot of R&D have larger firms, as do industries that require little external financing. At the country level, the most salient findings are that countries with efficient judicial systems have larger firms, and, correcting for institutional development, there is little evidence that richer countries have larger firms. Interestingly, institutional development, such as greater judicial efficiency, seems to be correlated with lower dispersion in firm size within an industry. The effects of interactions (between an industry’s characteristics and a country’s environment) on size are perhaps the most novel results in the paper, and are best able to discriminate between theories. As the judicial system improves, the difference in size between firms in capital intensive industries and firms in industries that use little physical capital diminishes; a finding consistent with "Critical Resource" theories of the firm. Finally, the average size of firms in industries dependent on external finance is larger in countries with better financial markets, suggesting that financial constraints limit average firm size."

**Firm Size and Firm Growth Rates.** Demand is a key factor for enterprise growth and is represented by the size of the overall domestic market which consists of private and public consumption and investment. Small domestic markets usually hinder the development of enterprises at some certain stages, so expansion needs to turn to the regional and global market for continued growth. This has been proven by the much faster average annual sales growth rate of the exporting small firms than their non-exporting counterparts in India and China (De Wilde, 2003).

Private sector supply response is also crucial to firm growth and refers to the ability of private enterprises to meet demand for goods and services. It is strengthened when enterprises can access appropriate financial and business services. Fast and efficient supply response adds critical flexibility and provides “just-in-time” benefits to the supply chain, which constitute important aspects of competitive advantage in international markets (Porter, 1985). “Niche strategy,” one of the three competitive strategies, is especially suitable for small firm entrance into the market by leveraging the distinctive small firm advantage and targeting the specific market segmentations (Porter, 1985). Evidence from Taiwan, Hong Kong, and Italy has shown that it is possible for MSEs to compete directly in export markets and excel. Working through industry-based “clusters,” small firm exporters in these countries have created competitive niches in world markets and prospered.

However, Biggs (2002) points out that the propensity of small firms to export is quite low, particularly in developing countries (the low propensity of small firms to export is seen in data for Africa in Bigsten et. al.
1998, Biggs et. al. 1995; Asia, Regnier, 1993; Latin America, Cortes, Berry, & Ishaq 1987). There are exceptions, of course, in Hong Kong, Taiwan and a few other countries. But even in these exceptional cases large trading companies play an important role in facilitating the exports of small firms. If small firms are involved in world markets at all, they tend to be involved as indirect exporters, supplying intermediate inputs or subcontracting to larger export firms. The reason for this is the high transaction costs of participation in international markets, which can be exceedingly high for small firms, as they generally face higher transaction costs per unit of transaction than large firms (Nooteboom, 1993). Analyzing the role of MSEs in the global value chain seems a fruitful method, yet rigorous analysis in this area is still in its infancy.

One classical view about firm size and growth rate is “Gibrat’s Law” which states that expected firm growth rates are independent of firm size. However, this conventional wisdom has been challenged (Cabral, 1995; Hall, 1987) by empirical evidence and many theories following in the footsteps of Hymer and Pashigian (1962). For example, Hall (1987) finds most of the change in employment at the firm level in any given year is permanent, that year-to-year growth rates are largely uncorrelated over time or with prior characteristics of the firms, and that there is almost no measurement error. Gibrat’s Law is weakly rejected for the smaller firms in Hall’s sample but accepted for the larger firms.

The most recent finding on growth rate and firm size from Teitelbaum & Axtell (2005) state that firm growth rates are not normally distributed, but have strong "tails" among slower and faster growing firm, rate distributions do not differ much by type of industry, and growth rates do not depend on the size of the establishments studied. De Soto (1989) notes a divergence among firm size distribution when he claims that small firms tend to be classified as informal while large firms gain formal status. This is often referred to as “the missing middle” problem.

**Firm Size, Firm Growth, and Business Environment.** Most agree that firm growth is reported to be constrained in countries with underdeveloped financial and legal systems, and Snodgrass and Winkler (2004) suggest that firms are shaped by the business environment in which they operate. A key characteristic of the business environment is that it is outside the direct control of individual markets, especially for small firms. A favorable country setting or overall enabling environment for enterprises provides economic and political stability, offers low costs for business transactions, and allows for efficient business operations that lead to greater amounts of innovation and creativity. De Soto (1989) argued that a key factor contributing to poverty in the developing world were the barriers placed by governments in the path of small-scale entrepreneurs, more explicitly, government rent-seeking and bureaucracy. However, this is not supported by a study by Erickson (2002), which examines the impact of institutional factors on small enterprise growth in the formal versus informal sectors. By constructing a simple general equilibrium model of the informal sector and using cross-country data to test its empirical implication, Erickson (2002) finds that the model cannot predict patterns of firm-size distribution.

However, Erickson also concludes that there is indeed a bias against small firms. Overall (that is, for the world sample) small firms report more problems than medium-sized firms, which in turn report more problems than large firms. In particular, smaller firms face significantly more problems than larger firms with financing, taxes, regulations, inflation, corruption and street crime, making it more likely for them to slip into informal arrangements in order to avoid excessive regulations.

These findings are reiterated by Beck, Demirgue-Kunt and Maksimovic (2002) in a unique firm-level survey that included 54 countries. They investigated whether different financial, legal and corruption issues affect firm growth rates. The results show that the extent to which these factors constrain a firm’s growth depends on size; consistently the smallest firms are most adversely affected by all three constraints. Firm growth is
more affected by reported constraints in countries with underdeveloped financial and legal systems and higher corruption. Thus, policy measures to improve financial and legal development and reduce corruption are well justified in promoting firm growth and particularly the development of the small firm sector.

MSEs, particularly subsistence MSEs, may feel that risks associated with entrepreneurial costs may outweigh the benefits of a steady stream of income, especially when a household’s survival is vulnerable, as when income is used to subsidize a household weathering the death of a primary income earner or other economic shock (Eversole 2003).

However, there is evidence that growth can occur within smaller firms given the right environment. SEAF (2004) used a case study approach to evaluate the impact of its investments in 10 firms (5 in Central and Eastern Europe, 5 in Latin America) with the number of employees ranging from 4 – 308. On average, every dollar invested by SEAF was found to generate an additional ten dollars in the local economy, with a range from $4 to $24. Two-thirds of total employment in the firms has gone to low-skilled workers, strengthening the assumption that small businesses generate jobs suitable for poor workers. In fact, wages for low-skilled workers grew by 29% and grew by 34% for high-skilled workers. When the SMEs expanded, they also paid more taxes, up to 20% of total revenues.

While the study cited here focuses on SMEs and not MSEs, it is important to note the impacts they can have on economic development and poverty reduction given that at least some MSEs do grow and expand into larger firms, augmenting their impact on the local economy as they grow. Even for the majority that does not grow, it is important to understand the different types of small businesses (subsistence versus non-subistence) that operate as they give a picture of the advantages and constraints these different firms may face in their local environments.

4.2 GROWTH AT THE MACRO LEVEL

Brinkman (1995) drew a conceptual, and unorthodox, distinction between economic growth and development. In mainstream economic theory, it is assumed that the quantitative statics of economic growth are synonymous with the processes of economic development. However, the dynamics of institutional adjustment, the transformation of values, and the impact of technology on cultural evolution are beyond what scholars usually study in economic growth. A frequent distinction between growth and development is that growth refers to a quantitative increase in GNP/capita and development can be conceptualized as qualitative changes in institutions and structure, relevant to the “noneconomic” variables emphasized (among others) by Myrdal (cited in Brinkman, 1995).

Growth, more generally, is a defining characteristic of ‘globalization’ in this relationship between rich and poor nations: “Growth is exposing a deep fault line between groups who have the skills and mobility to flourish in global markets and those who either don’t have these advantages or perceive the expansion of unregulated markets as inimical to social stability and deeply held norms” (Rodrik, 1997). Rodrik goes on to claim that the “most serious challenge for the world economy in the years ahead lies in making globalization compatible with domestic social and political stability…in ensuring that international economic integration does not contribute to domestic social disintegration.”

However, work on understanding the relationship between economic growth and enterprise growth is still in its infancy. Snodgrass and Winkler (2004) point out that enterprise growth is an element of economic growth, for its favorable impact on the income and employment levels of targeted populations and as an engine of
economic development. However, no other link between these two has been disclosed other than the usually acclaimed roles of small firms.

In their paper “SMEs, Growth, and Poverty” (2003) Beck, et. al., find neither a direct causal relationship between small firm development and economic growth, nor evidence that support given to small firms can lead to poverty reduction. Their primary skepticism lies in the large firm advantage – the idea that large enterprises may exploit economies of scale and more easily undertake the fixed costs associated with research and development and thus contribute more effectively toward national GDP growth. This increase in stability and higher employment quality, they claim, is a more effective measure to reduce poverty. Using a cross-country MSE data set of to assess whether the presumed comparative advantages of MSEs hold true in practice, they found that there is a robust, positive relationship between the relative size of the MSE sector and economic growth, even when controlling for other determinants of economic growth. However, the causal relationship between the size of the MSE sector and economic growth is not robust after controlling for simultaneity bias. In addition, a significant relationship between MSEs and poverty alleviation was not found. Specifically, the size of the MSE sector is not significantly associated with the income of the poorest quintile of society, the percentage of the population living below the poverty line, or the poverty gap when controlling for the level of GDP per capita.

Growth and Financial Development: Beck, Demirgüc-Kunt, Laeven, and Levine (2004) find that small firm industries grow disproportionately faster than large firm industries in economies with well-developed financial systems. Moreover, financial development disproportionately boosts the growth rate of industries that are more dependent on external finance. The results are robust when using alternative definitions of small firms. This finding has three implications:

- Financial development exerts a particularly strong and positive growth effect on industries that are technologically more dependent on small firms. Thus financial sector reforms that enhance financial development will have sectoral as well as growth implications.
- Financial development removes growth constraints on small firm industries. Even controlling for cross-industry differences in external dependence, financial development disproportionately accelerates the growth of industries that for technological reasons are composed of small firms.
- Policy reforms that improve the operation of the financial system will boost the growth of small firms relative to large firms.

In another study, Beck, Demirgüc-Kunt, and Maksimovic (2004) find that small firms use significantly more external finance than large firms (particularly from banks and the equity market) and that they benefit disproportionately from higher levels of property rights protection. Other findings and implications of the study include:

- Small firms use significantly more informal finance than large firms; however, financing from informal sources is very limited. On average, the proportion of investment financed using informal finance is less than 2 percent. Thus the use of informal financing does little to relax the financial constraints faced by small firms in developing countries.
- Financing from leasing or trade finance does not fill the financing gap, since the use of these financing sources is positively associated with the level of development of financial institutions and equity markets.
• Firms that report greater financing obstacles are the ones that use more external finance from all sources, except equity finance.

• Firms in countries with better financial and institutional development finance a greater proportion of their investment externally.

• Financial development is associated with the use of more bank finance, while stronger property rights protection contributes to greater use of bank and equity finance.

• Small firm size, financial development, and property rights protection are important factors in explaining the variation in financing patterns across developing countries.

5. THE ROLE OF MSEs IN THE INFORMAL ECONOMY

A large, undocumented percentage of MSEs are thought to operate in the informal economy when entrepreneurs believe the formal enabling environment is too costly to operate in. It is important to explore MSE contributions to this sector because attempts to accurately estimate their impacts on economic growth and poverty reduction are limited by a lack of reliable data about their size, income, and outputs. Due to its intrinsic heterogeneity, there are many ways of defining and analyzing the informal economy, which can be just as heterogeneous as the formal economy. “The Informal Economy” (Becker, 2004) provides a comprehensive study of the informal economy’s role, structure, interaction with government, and the donor’s perspective:

• The informal economy has been observed to have more of a fixed character in countries where incomes and assets are not equitably distributed. It seems that if economic growth is not accompanied by improvements in employment levels and income distribution, the informal economy does not shrink. The situation is therefore that the informal economy is continuously increasing in most developing countries, even in rural areas.

• In all developing countries, self-employment comprises a greater share of informal employment than wage employment. Specifically, self-employment represents 70% of informal employment in Sub-Saharan Africa (if South Africa is excluded, the share is 81%), 62% in North Africa, 60% in Latin America and 59 percent in Asia. Consequently, informal wage employment in the developing world constitutes 30% to 40% of the informal employment outside of agriculture.

• The transition from an informal to a formal status is gradual and it is important to acknowledge the relevant processes that could assist enterprises to reach a more formal existence. However, it has been observed that many informal enterprises choose to expand horizontally and diversify their lines of businesses instead of expanding vertically and formalizing themselves.

• The benefits for entrepreneurs who operate in the informal economy include the avoidance of costly and burdensome government regulations as well as high and complex taxes. Entrepreneurs in the informal sector weigh the “costs” of formality against the “benefits” of informality based upon the monetary burdens and bureaucracy that may be associated with formal registration and taxes.

As is the case in formal economies, significant heterogeneity can be found among small enterprises in the informal urban sector in West Africa (Trager, 1987). Teltscher (1994) finds that informal vendors (traders) in Quito, Ecuador are differentiated through a variety of characteristics ranging from pure survival to ownership of well-established businesses. Even in the trade sector, considerable differences can be found in terms of
levels of capital accumulation and potential upward mobility. Other studies that find significant heterogeneity in the informal sector include Portes, Blitzer, and Curtis (1986), Peattie (1982), and Alonso (1983), and Bromley (1988) and Bromley and Birckbeck (1979).

These findings have potentially important implications for linking MSEs to growth. Namely, in studying the contribution of small enterprises to economic development, it is important to acknowledge the heterogeneity of the sector and to incorporate this into the analysis. Treating the sector as an undifferentiated whole is likely to give a distorted picture of the sector’s contribution to economic activity and regarding its linkages with other sectors in the economy.

The nature of economic linkages is not only complex to identify but may change over time. What is necessary is an examination of the linkages in terms of particular types of activity. Only by looking at particular informal sector domains of activity can we gain a better understanding of the ways in which small enterprises are linked to the formal sector and how the enterprises are affected by those linkages.

Trager (1987) finds important linkages exist between the informal sector and the rural agricultural sector. Linkages are particularly important in terms of food distribution and food processing. Urban-based small enterprises are the primary outlets for the distribution and sale of agricultural produce. Market traders of agriculture produce not only buy and sell the commodities but also organize their distribution and movement from place to place within the marketing system.

A different linkage exists between informal commerce and formal production. Of vendors who buy directly from suppliers, 36.7% buy from large factories. Small merchants support large enterprises as cheap distributors of products, while they remain unprotected from market fluctuations. Furthermore, they have to buy large quantities, which require access to capital and creates the need to sell large amounts in order to meet payments.

Other important findings on the informal sector include:

- The organization of trade carried out for the most part by urban based intermediaries is crucial to relatively effective distribution of agricultural produce in much of West Africa. These intermediaries, the vast majority of whom are women-owned small enterprises, have well-established links with rural suppliers.

- According to Teltscher (1994), trade adds value in that the distribution of goods, which is as essential to the functioning of the socio-economic system as production. Street retailing also plays a role in encouraging consumption, both by selling at relatively low prices and by making items available in a wider range of locations and for longer periods of time on each day of the week.

- Several historical and empirical studies have been carried out that have demonstrated the links between small scale informal activities and the formal economy. These include Birkbeck (1979), Peattie (1982), and Alonso (1983).

- Field research in Quito finds that distinct types of relationships between vendors and other sectors of economy that are crucial for determining the levels of capital accumulation and economic success. The work situations among small traders can be identified through analyzing product supply and capital supply linkages. Whereas in manufacturing subcontracting chains wage and employment relationships dominate, in commerce, product supply chains and credit linkages determine different levels of economic well-being and autonomy of small vendors. Access to products and access to
capital are crucial variables that define the interrelationship between informal commerce and other sectors of urban, national, and international economies.

- Two aspects play an important role in determining the levels of potential capital accumulation or profits: (1) the competitiveness of a product and (2) the relationship between vendor and supplier.

- The relationship between informal commerce and formal commerce allows informal vendors to buy small quantities and thus change products more frequently if market changes require it.

- Capital supply is the second economic linkage that ties informal trade to the economy. It affects the vendors’ economic activities, profits, and potential business growth.

- In informal trading (where few wage relationships exist), other relationships associated with access to products and capital determine different opportunities, economic upward mobility, growth potential, and socio-economic well-being of individual workers.

- Local/urban, national, and international product and capital supply links incorporate small, informal vendors into economic systems that operate not only at the micro-level but also at the meso and macro levels. These findings contradict previous assumptions that most traders are self-employed workers who operate without direct linkages to national and international processes.

- The nature of integration of informal activities into the overall economy defines differences among informal workers with respect to income and profit levels and the resulting socio-economic well-being. Linkages in trade are different from those in manufacturing. In informal manufacturing, we often find employment and production relationships which influence informal workers levels of potential capital accumulation and economic development. In informal trade, we find product and supply capital links, which determine different levels of economic performance and well-being.

6. SMALL FIRM DEVELOPMENT IN THE US CONTEXT

Due to concerted efforts to create a viable and sustainable SME sector, small and medium businesses make up a large share of the US economy and play a substantial role in contributing to its growth. Although the (CFED, 2004) Desktop Study on SMEs and poverty reduction in the US and global contexts focuses on small and medium (defined by fewer than 500 employees), rather than micro and small businesses, the following principal components that have aided the development of a successful enabling environment in the US are repeatedly cited throughout the literature on what can promote MSEs’ contributions to economic growth:

- Sophisticated capital markets that offer the full range of financial products, ranging from seed capital to secured debt.

- Public policies that provide incentives to private financial institutions to lend directly to SMEs

- Comprehensive public delivery system for business development services supplemented by innovative private and nonprofit initiatives.

- Tax incentive for SME development and expansion.

- Legal and regulatory protections that provide incentives for innovation, ease business entry and exit costs, and reduce business risk.
- Public policy that promotes the creation, analysis, and dissemination of data on the SME sector.

The study also points to the significant barriers that remain to the growth of US businesses, including barriers to financing, uneven quality of BDS provided to SMEs, and the reluctance of capital markets to pioneer and innovate in areas where the relationship between risk and return has not been fully quantified. According to these national and international desktop studies, CFED (2004) contends that the data shows a positive relationship between SMEs and economic growth, but stops short of stating whether SMEs are a cause or an effect of healthy economies. The two most often cited reasons why direct links between SMEs (and MSEs) and economic growth have not been made is a lack of consensus on the definitions of small or micro business, and the lack of data, particularly from developing countries, on the extent to which these business play a role in generating economic growth. It is particularly difficult to analyze these roles in developing countries that have large micro and small business sectors in both the formal and informal economies.

The following table shows the market share of each type of business in the US economy:

<table>
<thead>
<tr>
<th>Type of Enterprise</th>
<th>Number of Firms (millions)</th>
<th>Share of Total Firms</th>
<th>Percentage of Total Sales</th>
<th>Total Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-4 employees</td>
<td>2.9</td>
<td>12.1%</td>
<td>5%</td>
<td>$848 billion</td>
</tr>
<tr>
<td>5-100 employees</td>
<td>2.3</td>
<td>9.7%</td>
<td>24%</td>
<td>$4.3 trillion</td>
</tr>
<tr>
<td>100-499 employees</td>
<td>.6</td>
<td>2.5%</td>
<td>12%</td>
<td>$2.1 trillion</td>
</tr>
</tbody>
</table>

The data demonstrate that the US context is similar to most other economies: the greatest market share is taken by a majority of small and medium business that produce the greatest amount of sales, while the smallest employers comprise the smallest number of firms and contribute only a modest amount to sales. Although the data provides a snapshot of the contributions to the formal economy, estimates of contributions to the informal economy include 10% of national GNP ($10,678 billion). The majority of workers in the informal sector tend to earn less than $30,000 annually while self-employed workers earn on average $4,061 in income and $3,364 in assets per year, suggesting that informal enterprises can play a role in reducing poverty by providing additional income streams, similar to strategies employed by entrepreneurs in developing countries.

7. MSEs AND POVERTY REDUCTION

It is clear that GDP figures alone cannot reflect the comprehensive effects of social development, specifically those intermediate economic outcomes that are important to long-term economic growth (e.g. improving the business environments, upgrading the skills of workers, helping people maintain their living standard in times of severe economic recession, etc). While many entrepreneurs might want to see their businesses grow, achieving and maintaining a steady source of income is sufficient enough for many, contributing to at least some level of prosperity for the poor and guarding against economic or household shocks. In interviews with poor entrepreneurs in Latin America, Eversole writes, “Money earned by microenterprises is not a salary, but it often is the only income microentrepreneurs and their households have” (Eversole, 2003).

Income from MSEs serves to cover consumption needs, and when favorable, is put towards reinvestment for expanding the business; such investments can not only sustain consumption needs in the short term but can earn resources for the long term. Sustaining a business allows it keep its place in a market, and when market conditions improve, it can then expand, creating more income. Just as MSEs can comprise heterogeneous
sectors, the poverty rates of MSE owners and employees are just as varied. In a survey of MSEs in Latin America, Orlando and Pollack found that rural workers, the young, and women were often the most vulnerable to poverty (Orlando and Pollack, 2000). In fact, approximately 60% of earners in the region under study were a part of these three groups.

In the US, firms with fewer than 10 employees and firms with 10-24 employees were found to have the highest shares of employees working part-time, employees with a high school diploma or less, and employees who were 65 years or older (CFED, 2004). Small businesses can therefore provide opportunities for those that otherwise might not be available to these groups. Measuring the relationship between SMEs and poverty reduction in the US context is also difficult to measure despite the availability of data. The US Census Bureau and the US Small Business Administration tend to focus on wealth creation of the business owners compared to non-business owners. Disaggregated data, when available, tends to be categorized by race and gender, rather than income level, making a direct link to poverty reduction difficult.

In the US example, the main focus of business development efforts are to provide greater economic opportunities; using the same strategy as a way to reduce poverty is relatively new and stems from the recognition that access to these economic opportunities are not always equal for all. According to the CFED (2004), Community Development Finance Initiatives (CDFIs) that provide financial and asset-building services to low-income communities overlooked by private markets have made four lasting contributions to bridge the link between businesses and poverty reduction:

- Demonstrated the credit worthiness of low income entrepreneurs and communities.
- Linked the provision of capital with the delivery of technical assistance services to build both financial and human assets.
- Target public and philanthropic subsidy to incentivize private sector involvement and/or to underwrite the economics of human transformation.
- Positioned themselves as permanent and sustainable civic institutions within their communities that leverage public, private and philanthropic resources on behalf of poverty reduction.

Census data show that households with businesses have more than double the incomes and almost seven times more wealth than households without businesses. The self-employed typically earn about 20% more income and own three times as much wealth as households without businesses. The CFED (2004) study cites the Self Employment Learning Project of the Aspen Institute, which indicates that microenterprises can significantly contribute to household income and poverty reduction: over a five year period, 72% of poor micro entrepreneurs increased their household income and assets by approximately $8,500 and $16,000, respectively, and 53% moved above the poverty line. Fifty-seven percent of microbusinesses were shown to survive after five years, with average revenues increasing by 27%.

In their sample, Orlando and Pollack (2000) noted that years of experience, gender, and age also proved to be determinants of earnings. Workers in the microenterprise sector tended to be older than those in the non-microenterprise sector, indicating that more workers had more than 30 years of experience. In some cases, this may allow for higher earnings and greater upward mobility as workers with more experience are more likely to own their businesses; on the other hand, the prevalence of older workers in the microenterprise sector would indicate a redundancy of available workers in the non-microenterprise sector and high unemployment rates. Earning disparities between women and men were noted to be less in the microenterprise sector in most countries. In Paraguay, women in the non-microenterprise sector earned less...
than 55% of male earning on average; in the microenterprise sector, they earned around 72% of male earnings (Orlando and Pollack, 2000).

Poverty rates for microenterprise workers were also found to be twice as high as those who did not work in the microenterprise sector during the 1990s; the poverty gap between these sectors increased during this decade (Orlando and Pollack, 2000). Workers in the informal, microenterprise sector are also less likely to enjoy non-salary benefits found in formal employment such as employers’ contributions to health insurance, on-site meals, bonuses, pension funds, and emergency funds. In addition to a steady income, employees noted their appreciation for these non-wage benefits, especially health insurance, which most would not receive if they were unemployed or self-employed (SEAF, 2004).

7.1 POVERTY AND ECONOMIC GROWTH

As was demonstrated in the preceding section, MSEs have the capacity to directly reduce poverty in certain contexts; but those found to be most disadvantaged (youth, women heads of households, and older workers) are more likely to work in the microenterprise sector and face high poverty levels. The relationship between MSEs and economic growth and poverty reduction can produce both direct and indirect impacts. The direct impacts can feature expanding output, growth in markets, and larger contributions to the local economy. For poverty reduction, the larger and steadier the incomes of microenterprise workers are, the stronger household livelihoods become. In addition, there exists a third link within this relationship: the indirect impact of economic growth on poverty reduction which reaches well beyond the micro level.

In their assessment of the World Bank’s approach to poverty reduction, Birdsall and Londono (1997) find that an unequal distribution of assets (especially human capital), reduces overall economic growth and the income growth among the poor disproportionately. They contend that a better distribution of assets reduces poverty both directly and indirectly: directly through increased incomes, and indirectly through a reduction in income inequality, which leads to increased income growth among the poor. Other key findings include the following:

- Economic growth is the key to poverty reduction.
- The income growth of the poor also heavily depends on overall capital accumulation.
- A higher initial income inequality is negatively associated with long-term economic growth. Differences in the rate of capital accumulation account for an important part of the difference in growth rates across countries.
- The effect of income inequality on growth reflects differences in the access of different groups to productive assets. The effect of education inequality persists when other determinants of growth are included. Any region-specific effect of income inequality disappears once asset inequality is accounted for.
- Initial inequalities in the distribution of land and human capital have clear negative effects on economic growth, and the effects are almost twice as large for the poor as for the population as a whole.
- Income growth among the poor is negatively affected by the deterioration in the overall distribution of income.
• Approximately 0.5 percentage points of the difference in overall annual growth and 1.4 percentage points of the difference in the annual income growth of poor between LAC and East Asia are explained by the former’s greater initial asset inequality.

• With East Asia’s distribution of assets in 1960, LAC would have half the number of people living in poverty today. The differences would be greater if we were to take into account the effects of growth on poverty reduction. They would be greater still if physical and human capital accumulation were a function of initial inequality.

• A fundamental constraint on poverty reduction is the poor’s lack of access to the assets necessary for increased productivity and income.

• Factors such as property rights, land reform, fair competition, and access to legal systems and financial services are critical to opening up opportunities in previously unequal societies and to eliminating the hidden privileges in asset markets historically enjoyed by the rich.

Other points include:

• Dollar and Kraay (2001) find that the poor gain as much as the rich from economic growth.

• Kraay (2004) finds that the average rate of economic growth accounts for more poverty reduction than changes in income distribution.

• Ravallion (2001) and Besley and Burgess (2003) find that both economic growth and improvements in the income distribution are important for poverty alleviation.

• Beegle, Dehejia, and Gatti (2003) find that transitory income shocks lead to greater increases in child labor in countries with underdeveloped financial systems.

• Benabou (1996) finds that economic inequality slows economic growth, because it generates political and macroeconomic instability, leads to higher fiscal deficits reflecting the median voter’s interests, and (given weak capital markets and resulting liquidity constraints on the poor) reduces savings and investment, particularly in human capital.

Easterly (2002) cites work by Martin Ravallion and Shaohua Chen in which they collected data on periods of economic growth and the ensuing changes in poverty between 1981 and 1999 to determine how aggregate economic growth changed the share of people below the poverty line. Ravallion’s and Chen’s data come from national surveys of household income or expenditure. By defining poverty as the part of the population that had incomes below $1 a day at the beginning of each period, they kept the poverty line fixed within each country. Most importantly, they find that fast growth went in tandem with fast poverty reduction, and overall economic contraction went with increased poverty. The data is summarized below:

<table>
<thead>
<tr>
<th>Activities</th>
<th>Percentage change in average incomes per year</th>
<th>Percent change in poverty rate per year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strong contraction</td>
<td>-9.8</td>
<td>23.9</td>
</tr>
<tr>
<td>Moderate contraction</td>
<td>-1.9</td>
<td>1.5</td>
</tr>
<tr>
<td>Moderate expansion</td>
<td>1.6</td>
<td>-0.6</td>
</tr>
<tr>
<td>Strong expansion</td>
<td>8.2</td>
<td>-6.1</td>
</tr>
</tbody>
</table>
Easterly (2002) reiterates the work of Dollar and Kraay (2001): “A 1 percent increase in average income of the society translates one for one into a 1 percent increase in the incomes of the poorest 20 percent of the population…an additional one percentage point per capita growth causes a 1 percentage rise in the poor’s incomes.” Easterly claims that the findings of Ravallion, Chen, Dollar and Kraay suggest that on average, growth has been much more of a lifesaver to the poor than redistribution.

CONCLUSION

As demonstrated by the evidence cited throughout this literature review, MSEs can play a significant role in developing country economies through employment and income generation, both of which directly affect poverty reduction. However, much of this employment and income generation occurs at the micro level, where the impacts upon economic growth are minimal. This makes it difficult to assume that MSEs can affect economic growth beyond the microenterprise, but the impacts on poverty reduction can be substantial if the enterprise can generate a steady source of income, or accumulate enough capital to expand production. Many MSEs also operate in the informal sector, making it difficult to assess the impacts of MSEs on the lives and economies of those who work in this sector.

The two largest obstacles to comprehensively assessing the impact of MSEs, regardless of whether they operate in the informal or formal economies are: 1) a lack of consensus on the definition of a MSE; and 2) a lack of available data on MSEs. The definition of a MSE is dependent upon a country’s economic context: larger economies naturally contain larger-sized enterprises; therefore, the definition (typically based on number of employees) would be higher and focused on a SME rather than a MSE. In countries with predominantly rural-based economies, MSEs are also defined by the number of employees, but these numbers are far lower, usually less than 10 or 5 employees per enterprise.

Many of the findings of this literature review are open to active debate. There is however broad consensus on a small number of issues, which include the following:

- In most developing countries, MSEs and other small-scale enterprises account for a majority of firms, employ a majority of poor workers, and experience growth at such small increments their contributions to the broader economy are often overlooked. These enterprises tend to have the highest poverty rates and are easily susceptible to household or economic shocks. Many also rely on linkages with larger firms for their growth, since they do not have the capacity to reach larger national or global markets. Obstacles to growth also include a lack of capital, limited or lack of access to financial services, skill deficiencies, as well as business environments biased against small firms because of underdeveloped legal and financial systems. Much of the literature suggests that an efficient and fair enabling environment can “level the playing field” among enterprises of varying sizes and significantly expand opportunities for small firm growth.

- In addition, the research also suggests that MSE owners “…must often be the most entrepreneurial, as they manage to eke a survival wage out of a tiny capital stake” (Eversole 2003). Many MSEs employ several techniques to maintain a steady stream of income, including diversifying and expanding their product range, and reinvesting portions of their incomes to fund other activities within the enterprise. A steady stream of income for the poorest entrepreneurs can, at the very least, protect against shocks that can prove disastrous to household livelihoods. In the best case scenario, a steady income stream and a favorable market environment can lead to steady growth within the enterprise and lower poverty levels. Compounded many times over, MSEs in this type of
environment can provide opportunities to impact the livelihoods of larger numbers of people and positively affect the growth of regional and national economies on a greater scale.

**IMPLICATIONS FOR NEXT STEPS IN THE PROJECT**

The present literature has identified both the main avenues of exploration for the project and the challenges it is likely to encounter in the process. Hence, the conceptual and empirical efforts will proceed along two main tracks. Since data availability is constantly identified as the major constraint, the project will do its part in trying to alleviate this concern, launching a small-scale effort in identifying sources of data that could expand existing datasets and provide opportunities for more meaningful statistical analysis of the role of MSES. It will also rely on detailed data available for industrial economies to identify the dynamic role of MSES in economic growth, as an “ideal” that can help identify the institutional constraints that most affect the growth of firms of similar sizes in developing and transition economies. The second constraint—inherent to the design of the project—relates to the necessity to rely largely on secondary data, or at least to limit primary data collection to existing MSE support projects with excellent M&E systems. In more detail:

**Data Availability.** The first step is to identify new sources of data that will allow the team to more carefully analyze MSE contributions. The objective is to complement the existing World Bank MSE database by Beck, Demirgüç-Kunt, and Levine with new data that will add three additional dimensions: time series, sectoral diversity beyond manufacturing, and finer slicing by firm size.

**Dynamic MSEs and Business Environment.** Use data from developed countries where institutional constraints are minimal in order to show the dynamic impact of MSEs on growth under “ideal” institutional conditions. This data will be used to examine the causal links that are most sensitive to institutional weaknesses in developing and transition economies.

**Linkages Among Firms.** Test the assumption that microenterprises contribute to growth primarily through forward linkages with small and medium sized export firms. That is, it is expected that microenterprises that link into the domestic and global value chain in specific subsectors have the greatest growth impact, and most of the micro entrepreneur households will have improvements in such aspects as health, education, consumption, and housing since starting their enterprise.
REFERENCES


APPENDIX


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1 The purpose of this appendix is to provide researchers with a list of additional publications focused on SME development that is not referenced in the literature review.


MICRO AND SMALL ENTERPRISES, DYNAMIC ECONOMIC GROWTH, AND POVERTY REDUCTION 33


DEFINITIONS OF MICRO, SMALL AND MEDIUM ENTERPRISES

MSE “micro- and small enterprise,” SME (“small and medium enterprise”) and MSME (“micro-, small and medium enterprise”) are all widely used in the literature. The statistical definition of enterprise size varies by country, and is usually based on the number of employees or the value of assets. The lower limit for small-scale enterprises is usually set at 5 to 10 workers and the upper limit at 50 to 100 workers. The upper limit for “medium-scale” enterprises is usually set between 100 and 250 employees. For example, Zandniapour et al. (2004) define MSE by employee number—less than 10 for microenterprises and 10 to 100 for small enterprises. USAID limits its definition of microenterprise to an economic activity that employs ten or fewer workers, in which the owner/operator of the enterprise (the ‘microentrepreneur’) is considered poor. More generally, according to Nichter and Goldmark (2005) USAID defines MSEs as firms with up to fifty workers, which are engaged in non-primary activities and sell at least 50 percent of output. This category includes both microenterprises, which have up to 10 workers, as well as small enterprises, which have between 11 and 50 workers. In the case of agriculture, a microenterprise can be dairy, horticulture, small livestock, or any crop or agribusiness that is commercialized. (See USAID MicroLINKS, ADS Policy).

The concept of firm size varies significantly within the different stages of economic development and structure, as well as among the various issues that the authors intend to address (e.g. small business and job creations in the U.S. in Davis, Haltiwanger and Schuh, (1993); and poverty alleviation in developing countries in Morduch and Haley, (2002)). For instance, with regards to small and medium enterprises, countries with large economies like the U.S. and member states of the EU use cut-off points of fewer than 500 workers to describe SMEs. Yet, in developing countries, where both market size and average firm size are much smaller, SME cut-off points are often fewer than 100 workers. Thus, it is very difficult to compare size distributions across countries.

The lack of consistency in employment-based MSE definitions based on the number of employees and viewed in isolation from the size of markets or the economy may be misleading (Biggs, 2002). More importantly, enterprise behavioral characteristics do not correlate perfectly with employee-size (Biggs, 2002; Hallberg, 2001). These characteristics include: the degree of “informality,” the form of ownership, the market power, and the level of technological sophistication, to name just a few. Since small firms have a great overlap with the informal sector, the definition provided by Beck et al. (2003) might pose a serious problem for analysis, as they define small firms as formal enterprises and exclude informal enterprises.

MSEs are a very heterogeneous group. Hallberg (2001) distinguishes MSE from micro-enterprises and suggests that small- and medium-scale enterprises (SMEs) usually include a wide variety of firms – village handicraft makers, small machine shops, restaurants, and computer software firms – that possess a wide range of sophistication and skills, and operate in very different market and social environments. Their owners may or may not be poor. Some are dynamic, innovative, and growth-oriented; others are traditional “lifestyle” enterprises that are satisfied to remain small. In some countries, SME owners and workers are (or are perceived to be) dominated by members of particular ethnic groups.

Microenterprises are normally considered to be family businesses or self-employed persons operating in the semi-formal and informal sectors; most have little chance of growing into larger scale firms, accessing bank finance, or becoming internationally competitive. Serving them often requires distinct institutions and instruments, such as the group-based lending methodologies used by some microfinance institutions. In contrast, small and medium enterprises usually operate in the formal sector of the economy, employ mainly wage-earning workers, and participate more fully in organized markets. Small enterprises consider access to formal finance a desirable possibility, and are more likely than microenterprises to grow and become competitive in domestic and international markets.
In this literature review we refer to small scale enterprises as MSEs, except in the case of necessary distinction.

2 In 1992, the average production worker in a small plant in the U.S. was paid $10.49 per hour, 30 percent less than the $15.09 paid to the typical worker in a large plant (source: comments from Eric Oldsman).

3 A good book detailing the framework of value chain analysis is Porter (1985).