

## EarthTrends Featured Topic: The Role of Small- and Medium-Sized Enterprises in the Futures of Emerging Economies

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The private sectors of many emerging economies today are hindered by a "missing middle" (Kauffmann, 2005). Investors, policymakers and development professionals dedicate most of their efforts to either large corporations of over 500 employees or very small businesses with perhaps five employees; larger enterprises and multi-national corporations (MNCs) are frequently the main targets for tax incentives and corporate subsidies whereas organizations like the World Bank and the United Nations Development Program have devoted a significant amount of attention and aid toward promoting micro-enterprises.

Between these two extremes lies the small- and medium-sized enterprise (SME) sector with businesses that employ between 10 and 100 people. SMEs are often seen as being too minute to serve as significant drivers of economic growth (and therefore unworthy of policy consideration by governments), yet too large to benefit from non-profit and microfinance institution schemes such as joint-liability programs. While the challenges to the SME sector can be daunting, there have been many promising initiatives to support this crucial sector in emerging economies by civic, investment and business leaders who recognize the clear role of SMEs in sustainable development.

### Benefits of SMEs

Definitional issues and a paucity of data in some areas makes any analysis of SME impacts difficult (see Text Box 1). For example, the role SMEs play in community development often remains obscured by the informal nature of their actions--a phenomenon that is often called "silent corporate social responsibility" (Medina Muñoz and Medina Muñoz, 2001). However, anecdotal and quantifiable evidence exists in a number of studies on small business and the environment, providing a sense of how important this sector is for sustainable development in emerging economies.

Many researchers conclude that SMEs, being less mobile than large corporations, are more likely to have ties of dependence and familiarity to their communities, which will ensure they protect their reputation and relationships among neighbors and customers. One study of European SMEs notes that on average, 67.5% of them report practicing some form of external socially responsible activity on a regular basis, such as supporting a local charity (European Commission, 2002). The main reasons cited for these efforts were "improvement of the loyalty of customers" and "better relations with the community" (European Commission, 2002).

The presence of SMEs also correlates with several economic factors, including the growth of a nation's gross domestic product (GDP). Although evidence for a direct causal relationship remains

limited in most cases (see Beck et al., 2005), there are many acknowledged benefits of SMEs in growing an economy (e.g., Levine, 2005). For example, one major investment firm ordered case studies of ten businesses in its SME portfolio and found significant benefits for employees, the community and the local economy.<sup>1</sup> Recent bodies of research, including a report produced by the United Nations Industrial Development Organization (UNIDO), support these findings, showing that there is widespread consensus that SMEs:

- Are labor-intensive, providing more opportunities for low-skilled workers;
- Are correlated with lower income distribution inequality;
- Are an important part of the supply chain for large MNCs (Luetkenhorst, 2004);
- Are necessary for agriculture-dependent nations transitioning to an industrial- and service-oriented economy<sup>2</sup>;
- Are excellent "beta-sites" for innovation and sustainable initiatives due to their inherent flexibility and risk-taking ability (Raynard and Forstater, 2002)--examples include *Verdant Power* or *Energia Global*; and
- Provide all of these crucial benefits in developing countries despite their relatively smaller

presence (Patricoff and Sunderland, 2005).

micro-enterprises comprise 93% of the total number of businesses in each economy with SMEs accounting for only 6.7% (2002).

favorable investment climate, which includes a low cost of doing business and a short average time to start an enterprise (Figure 2).

### Challenges for SME Growth

It is clear that a vibrant SME sector can bring great benefits to developing countries (though these impacts are often overlooked due to the SME's "missing middle" status). However, emerging economy private sectors tend to be dominated by large corporations or micro-enterprises that often times employ five or fewer people, creating substantial barriers to SME growth.

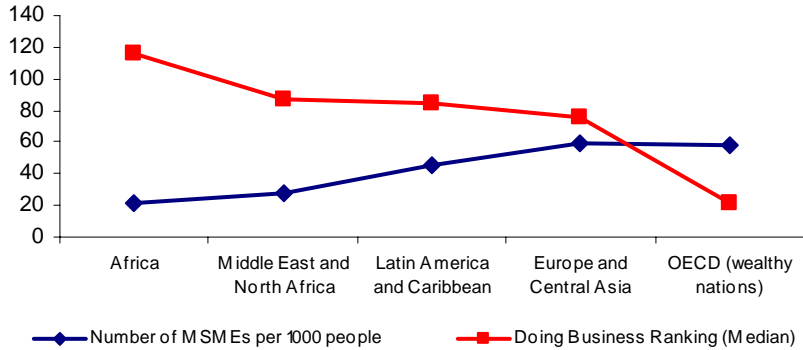
There is a substantial gap between the size of the SME sector in developing and developed countries. Recent data shows a positive correlation between a country's overall level of income and the number of SMEs per 1,000 people (Figure 1); countries with a higher GDP tend to have private-sectors that are more evenly distributed in terms of company size. Regional data illustrates this point more precisely—a study by the Foundation for Sustainable Development indicates that among its member countries in the developing region of Latin America, extremely low-income

The reasons for this disparity are numerous. Most importantly, SMEs face regulations and bureaucratic practices that solidify the dominance of large corporations in the formally regulated economy and incentivize entrepreneurs to operate informally, meaning illegally and out of the government's regulatory reach. These prohibitive factors disproportionately affect SMEs because of their limited human and financial resources. Data from the International Finance Corporation (IFC) shows that the number of formalized SMEs in a country increases with a more

The World Bank Group's *Doing Business* reports emphasize this point, confirming that countries that rank higher on the ease of "doing business" such as New Zealand and South Africa, have smaller informal economies, measuring 12.7% of gross national product (GNP) and 8.8% of GNP, respectively (2006). The opposite is true for those with worse business environments like Burkina Faso, which has an informal economy that contributes 38.4% of GNP (The World Bank Group, 2006).

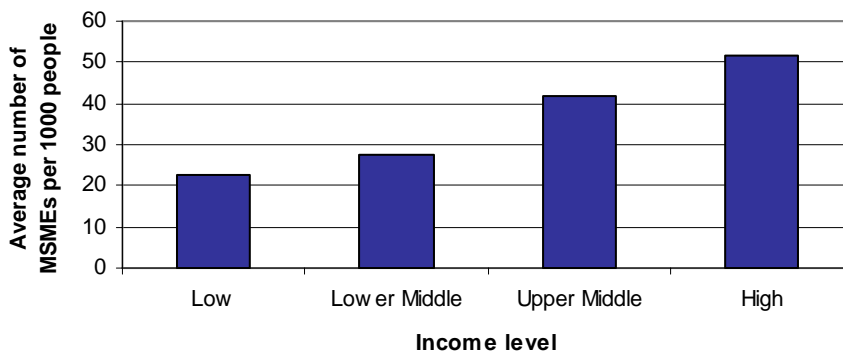
A harsh regulatory environment also has a negative impact on SMEs adhering to pollution standards. The International Organization for Standardization (ISO) 14001 is a set of voluntary environmental standards businesses may adhere to in order to prove their commitment to sustainable practices through a recognized authority. An ISO survey of 1,500 small business employees in 71 countries found that the majority of SMEs refuse to utilize the organization's environmental standards because of inadequate support, time-consuming paperwork burdens and a general

**Figure 2: Micro, Small, and Medium Enterprise Density and Business Enabling Environment**



Adapted from IFC, 2006. "Micro, Small, and Medium Enterprises: A Collection of Published Data."

**Figure 1: Micro, Small, and Medium Enterprise (MSME) Density by National Income Level**



Source: IFC, 2006. "Micro, Small, and Medium Enterprises: A Collection of Published Data."

distrust of external intrusion (Strategic SME Group, 2005).

While large corporations can spread the fixed costs of compliance over a larger revenue base and micro-enterprises generally operate below the purview of government agencies, SMEs are obliged to follow large-scale commercial enterprise norms for assessing and reporting their ecological impact. Government regulations that are designed for enforcement among larger corporations are not suited to smaller businesses, which impairs the ability of the government to protect its natural resources.

Although the environmental impact of each SME is relatively small, they collectively contribute significantly to ecological degradation. One estimate among EU countries suggests that SMEs are responsible for 50% of pollution and waste (European Commission, 2002). The public-sector as well as environmental non-governmental organizations (NGOs) tend to focus their attention on more prominent enterprises that individually pose a greater environmental risk, but their lack of engagement with SMEs ignores an equally important, widely-dispersed threat.

In addition to these regulatory issues, there is ample evidence that SMEs are significantly underfinanced. A study of southeast Asian countries reports that only 3-18% of SMEs could obtain financing from banks (Wattanapruttipaisan, 2003). The Inter-American Development Bank (IDB) estimates that in Latin America, 90% of entrepreneurs are forced to source much of their financing from personal savings (Smith, 2003). This is mainly because of the logistical difficulties inherent in lending money to small businesses; banks tend to offer loans to SMEs on unfavorable terms because of the high-fixed costs associated with these transactions.

Finally, SMEs are considered to be at a greater risk of failure, partially because company directors may have less collective management experience or business expertise than larger companies (OECD, 2006). Foreign investors often shy away from investing in emerging economy SMEs because of unfavorable investment climates and the uncertainty of sufficient returns. The result is that some SMEs secure financing only by agreeing to a high amount of collateral and shorter pay-back periods while the rest must either rely on their personal networks or high-interest, illegal loans to generate startup capital.

related initiatives and entrepreneurs increasingly engage the public sector. New focus by the development community on national policies that help or hinder the growth of the private sector have given governments the tools necessary to identify and reform regulatory obstacles to a business and investment-friendly environment.

The *Doing Business* reports by the World Bank Group have been particularly useful in encouraging countries such as Georgia and Vietnam to create reforms that allow SMEs to thrive (2006). Where governments fall short, individual enterprises such as Brazil's often take the lead in

## Summary: Analyzing the "Missing Middle"

### SME Benefits

- Available data reflects a vested interest in community development
- Important sources of employment, particularly low-skilled labor
- Source of linkages that strengthen national economic vitality
- More flexibility and innovative capacity as a whole than large corporations

### SME Challenges

- Lack of data and definitional understanding
- High levels of informality and bureaucracy hinder presence in emerging economies
- Environmental regulations designed for large businesses make compliance difficult
- Lack of available finance stifles growth and entrepreneurship

## Solutions: Stepping Up to Fill in the Gap

The various challenges of the "missing middle" are beginning to be addressed as organizations within the development community launch new SME-

engaging civic leaders to promote change and growth within their own sectors (see Text Box 2).

There have been individual efforts within the investment community to create realistic methods for determining the environmental impact of small companies. Most of these efforts

are pragmatic assessments of SMEs within their own portfolio rather than universally-adoptable procedures, and they range from qualitative reviews of potential investees during due diligence to more data-driven assessments such as those used by the Small Enterprise Assistance Fund (SEAF; 2005).

There have also been isolated attempts within the private sector to combine environmentally-responsible technologies and production processes with profitable business models to achieve sustainable growth. These market-based solutions have used the emerging prominence of "green" sectors including clean technology and organic agriculture as vehicles of collective action.

Although many lament that the SME "finance gap" has yet to be understood in a fully quantifiable manner, promising solutions have been brought forth by different groups. Some governments have created departments and loan programs specifically targeted toward financing SME development, such as those implemented in Australia (Mining Technology Services Action Agenda, 2004). A hybrid public-private sector approach to mitigating risk has great potential, and already a handful of fund management firms with SME portfolios have proven that such a partnership can result in investments that are both stable and lucrative (*SEAF, Stratus Investimentos* and *GroFin* are a few examples).

Finally, as many small businesses in emerging economies lack the management expertise or financial reporting abilities that investors need to make sound decisions, NGOs have stepped in to provide technical assistance and management training for entrepreneurs with strong potential. One example of this is

the New Ventures program of the World Resources Institute. New Ventures has successfully built a pipeline of investment prospects for international financiers, and has secured funding for many of the sustainable SMEs in its portfolio by linking them with global investor networks.

Despite such initiatives by various actors to address the regulatory and financial issues surrounding SMEs, there remains a deficiency of solid information on small enterprises regarding international comparisons between sectors, quantifiable assessments of social, economic and environmental impacts, and a precise idea of the severity and nature of the finance gap for SMEs. Until these topics are fully addressed, it will be extremely difficult to formulate specific policies and programs to invigorate this vital sector, and the "missing middle" will remain a reality. It is now the challenge of governments, businesses, investors and the development community to explore the partnerships and solutions that will allow the SME sector to fully realize its potential as a driver for sustainable development and economic growth.

### Footnotes

1. Among the results of the study done on the portfolio of the Small Enterprise Assistance Fund: two-thirds of the labor pool in the businesses sampled were low-skilled employees; these employees received substantial non-salary benefits; each business contributed actively to community development; they provided important linkages between the informal sector and large formalized export markets. To read the rest of the report, see Small Enterprise Assistance Funds (2005). *The Development Impact of Small and Medium Enterprises: Lessons Learned from SEAF Investments.*

Washington, DC. Online at <http://www.seaf.com/impact.htm>.

2. In a 2002 survey of its developing country members, Asia-Pacific Economic Cooperation (APEC) found that nearly 99% of SME employees were working in the manufacturing and services sectors, up from 55% in 1990. During this same period, the proportion of SME employees working in primary goods dropped from 45% to about 1%. To view the rest of the report, see APEC Small and Medium Enterprises Working Group (2002). "Profile of SMEs and SME issues in APEC 1990-2000." Asia-Pacific Economic Cooperation. Singapore: World Scientific Publishing.

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<http://www.new-ventures.org>

New Ventures supports sustainable enterprises by accelerating the transfer of capital to outstanding companies that incorporate social and environmental benefits. By providing sound investment opportunities in emerging economies, New Ventures demonstrates that investing in sustainable enterprises makes good business sense.

**BOX 1****Definitional Issues**

Any regional or global analyses of SMEs should note that there are definitional issues and statistical gaps which complicate discussions of trends in this sector; cross-country comparisons are especially difficult with highly variable standards for measuring firm size. For example, Romania counts SMEs as having between 10 and 249 employees while Canadian SMEs may employ between 10 and 499 individuals. Other countries, such as Argentina, use total revenue as a measurement of firm size. Similar disparities have led policymakers and analysts to create specific projects focusing on ways to homogenize data for this sector and promote its growth. For a complete review of some of the definitional challenges and policy recommendations, see OECD, 2006. Regardless of these taxonomical details, there is enough international evidence and widespread consensus on the character of SMEs and the barriers they face to engage in a broader discussion without over-generalizing. For the purposes of this article, the most common definition of SMEs among emerging economies will be used: an SME is any company with between 10 and 100 employees.

**BOX 2****The Private Sector Engaging Government**

Oftentimes individual companies take the lead in attempting to foster a business-friendly environment and sustainable practices when the government is slow to act. Brazil's first organic shrimp farmer, Primar, has played this pivotal role within the country's sizable aquaculture industry, which exhibits a high level of informality and ecologically unsound methods. As the founder of Primar, marine biologist Alexandre Wainberg has attempted to reduce this informality by mounting attempts to bring other small shrimp producers into a larger, organized consortium. Though his pioneering efforts to make Primar an organic company earned him accolades as a finalist in the 2004 New Ventures Investor Forum, Alexandre argues that attaining organic certification in Brazil is unreasonably difficult and bureaucratic. He has worked to change this status quo by encouraging other companies to obtain organic certification and publishing a number of papers on the importance of promoting sustainable methods. To view these articles and learn more about the company, visit its homepage at <http://www.primarorganica.com.br/> (Portuguese) or read the company profile at <http://www.new-ventures.org/risingventures>.

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