



Restaurant



New kitchen!



# Policies for SME Growth: What Works, What Doesn't?



Hardware store

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Software developer

# What are SMEs?

- SMEs = small and medium enterprises
- Definition typically based on employees, sales, and/or assets
  - Cutoffs vary across countries and institutions
- 250 = commonly used employee cutoff (e.g. EU)
  - Other definitions may use 100, 300 etc.
- Some definitions impose a lower bound, e.g. 5 employees
  - MSMEs = micro, small, and medium enterprises

## Some examples of (M)SMEs from a study in Mexico



- Data services and call center
- 160 employees



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

Water distribution truck



Main office

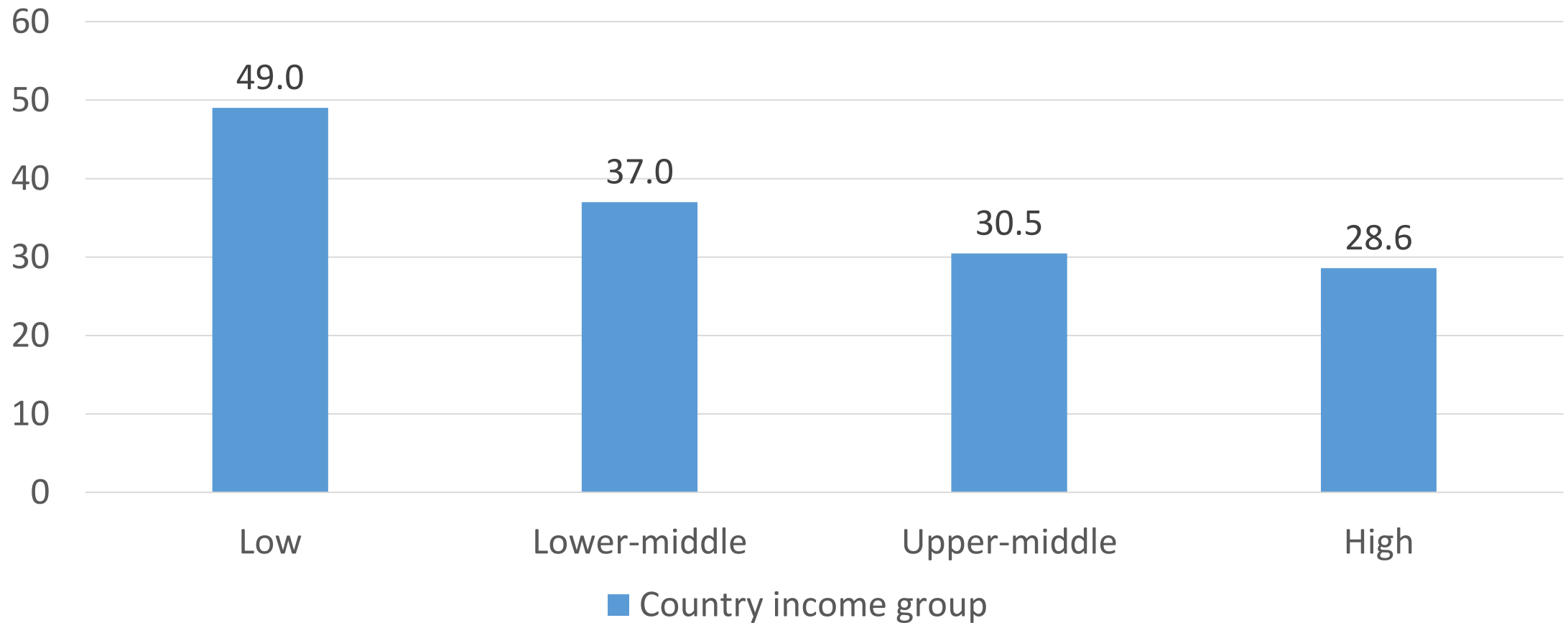


- Water transportation
- 6 employees

# Why care about SMEs?

- SMEs employ about 50% of workers in developing countries (Ayyagari, Demirgüç-Kunt, and Maksimovic 2014)
  - SME growth may raise earnings for many low income households
- SMEs tend to face more constraints than large firms
  - Enterprise Survey data suggests 44% of SMEs in low income countries are involuntarily excluded from applying for a loan vs. 25% of large firms (2014 Global Financial Development Report)
- Less transition from SMEs to large firms in developing countries (“missing middle”)

# % of large firms that start out large (vs. as MSMEs)



Source: Own calculations based on Enterprise Survey data

# Policies for SME growth often include...

- Regulation reform

- Entry regulation: procedures to register a business
- Ongoing regulation: labor laws and taxes

- Access to finance

- Credit infrastructure: credit bureaus, collateral registries
- Credit guarantees
- Matching grants

- Business skills and practices

- Workshop training
- Consulting

# Why business registration reform?

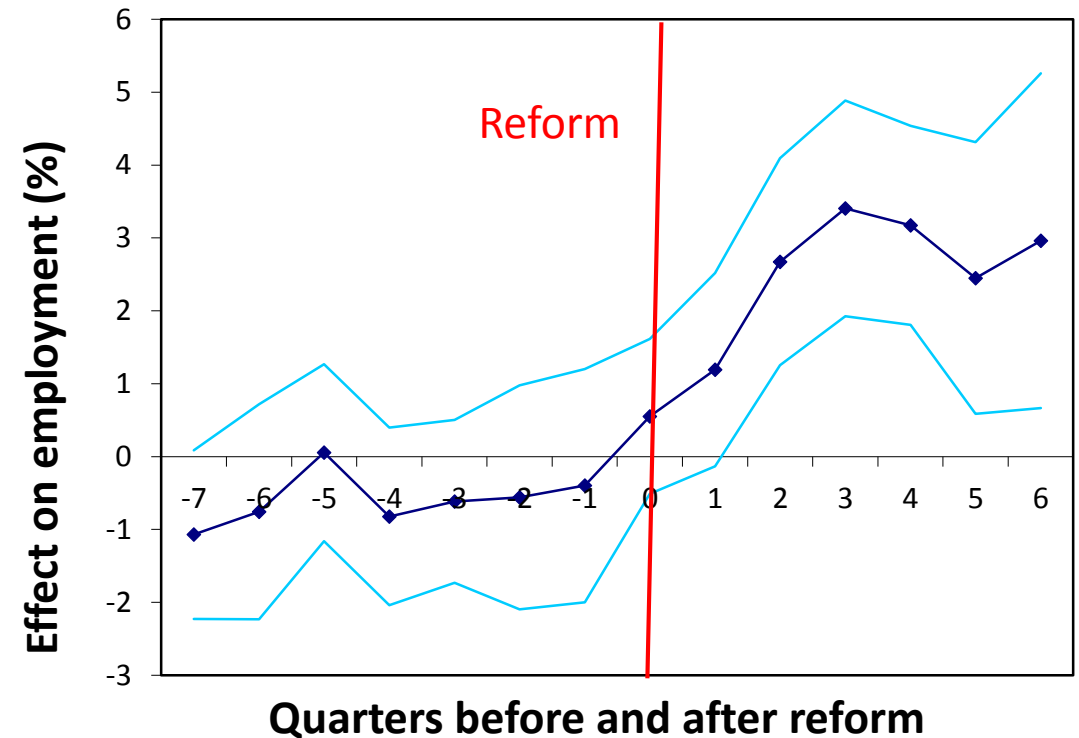
- During the past five years, on average 46 reforms per year to regulation for “starting a business” (Doing Business 2016)
- Making it easier to register a business may allow informal entrepreneurs to formalize, giving them access to markets and services and leading to firm growth (Hernando de Soto)
- Simpler entry procedures may also spur new business creation



# Evidence on business registration reform

- Positive effects on registration of informal firms, new firm creation and employment; no effect on income on average (Bruhn REStat 2011, JDE 2013)
  - Competition from new businesses lowered prices and income of incumbents
  - 85% of informal businesses remain informal after a reform in Mexico

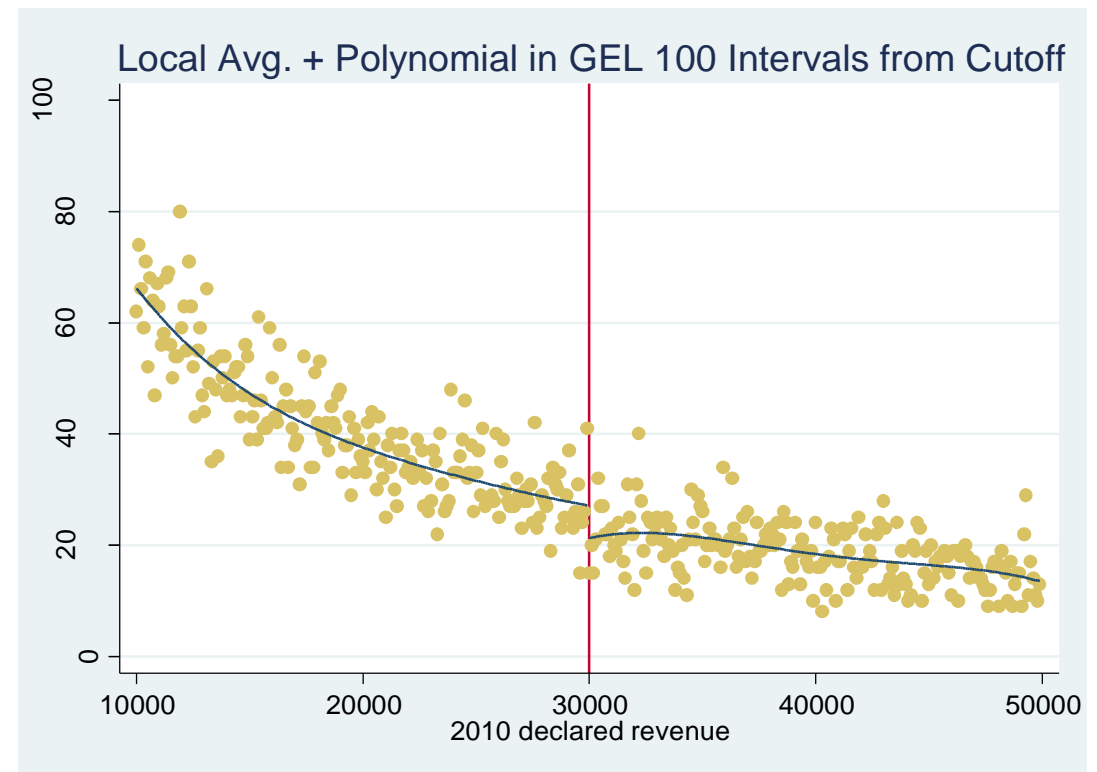
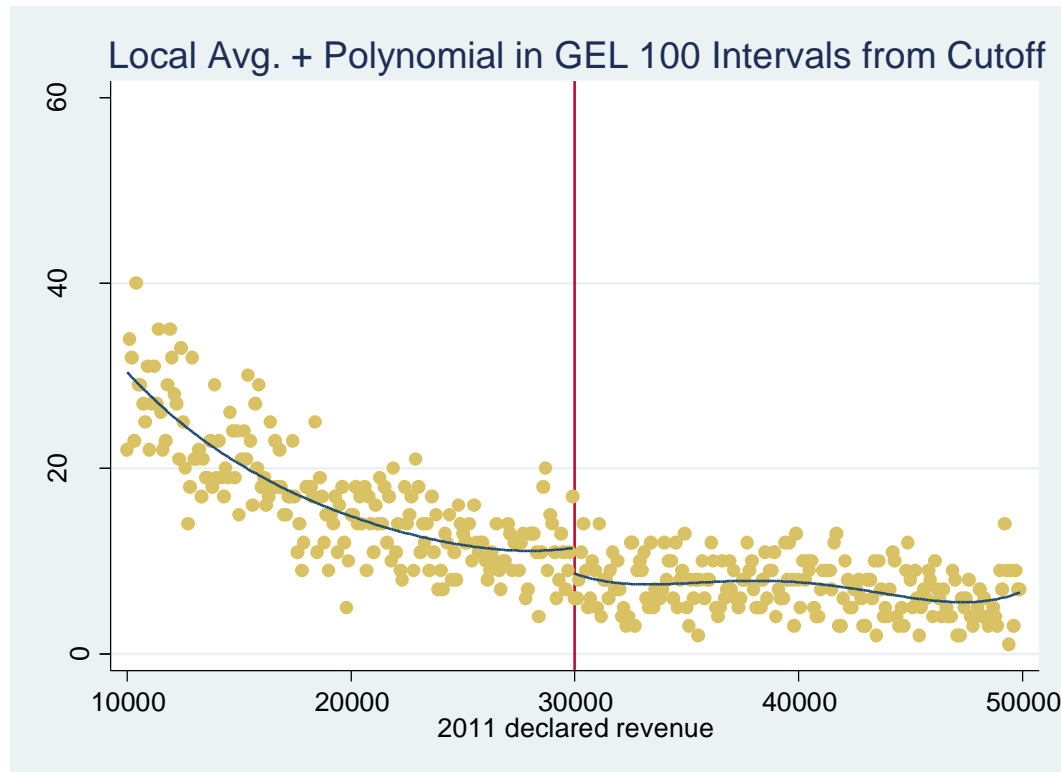
→ Business registration reform is useful also since it lowers costs of registration for all firms, but it does not seem to have a large effect on SME growth



# What about tax reforms?

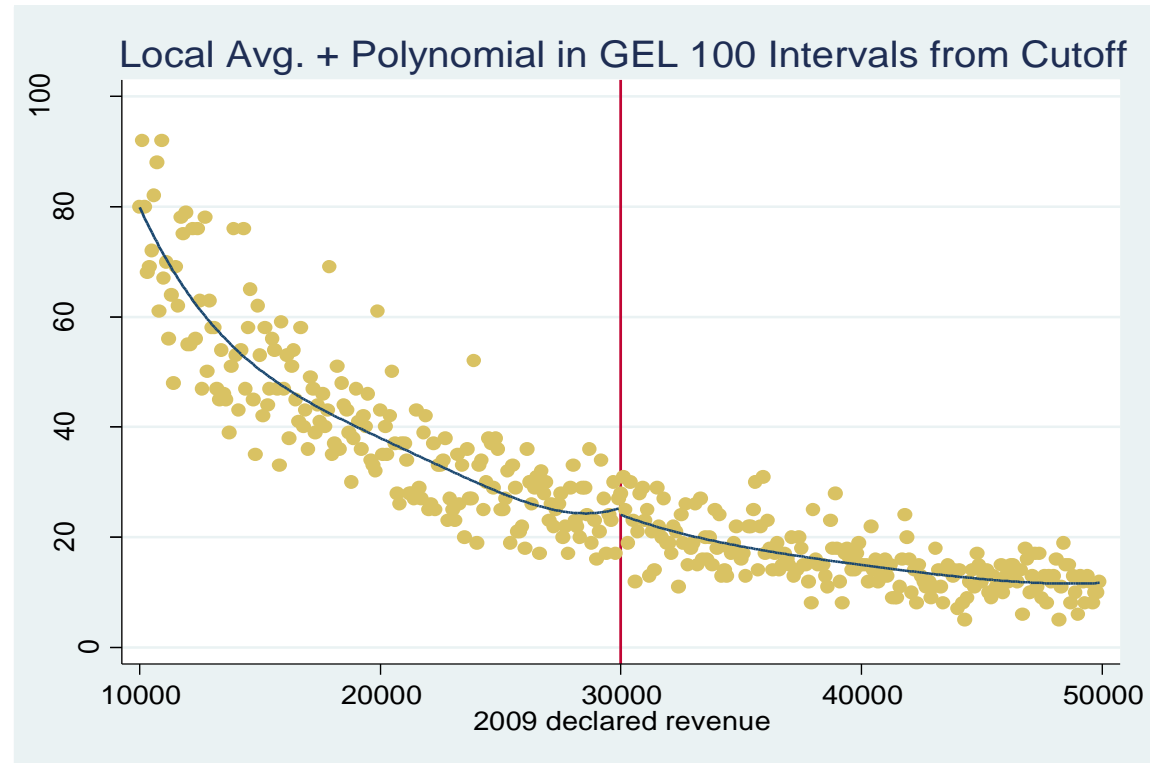
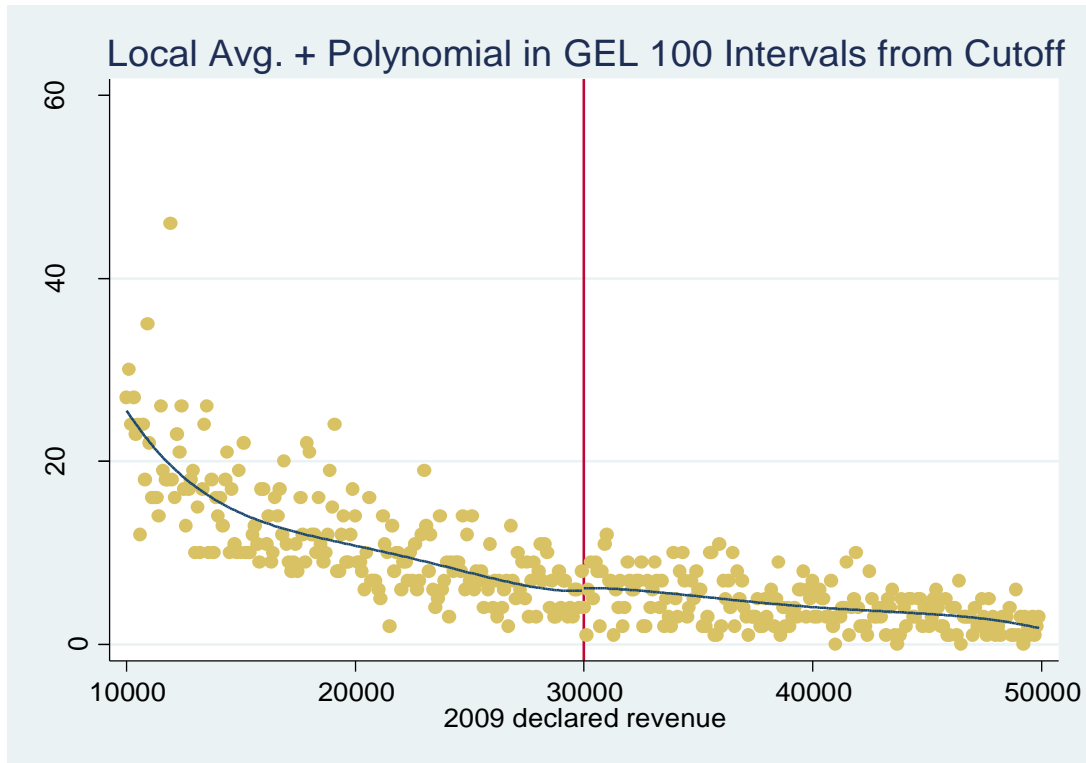
- Can have large effects on SME performance since tax payments are recurring and often large compared to one-time registration costs
  - Bruhn (2011) “Reforming Business Taxes” World Bank FPD Viewpoint
- Tax reform can be challenging since government needs to balance lower tax rates for firms with need for tax collection
- Many governments implement special tax regimes for SMEs, with simplified procedures and (sometimes) lower tax rates
  - But these can also provide incentives for firms to stay small

# Tax reform in Georgia (Bruhn and Loeprick ITAX forthcoming)



- Collaborative work with the Bank's tax team, who had advised the Georgian authorities on the reform
- New tax regime with 0% tax for firms with revenue below GEL 30,000 (US\$ 18,255) led to an increase in
  - Firms that register with tax authority for the first time (by about 40%)
  - Firms that were already registered and that continue to declare revenue below the threshold (by 20%)

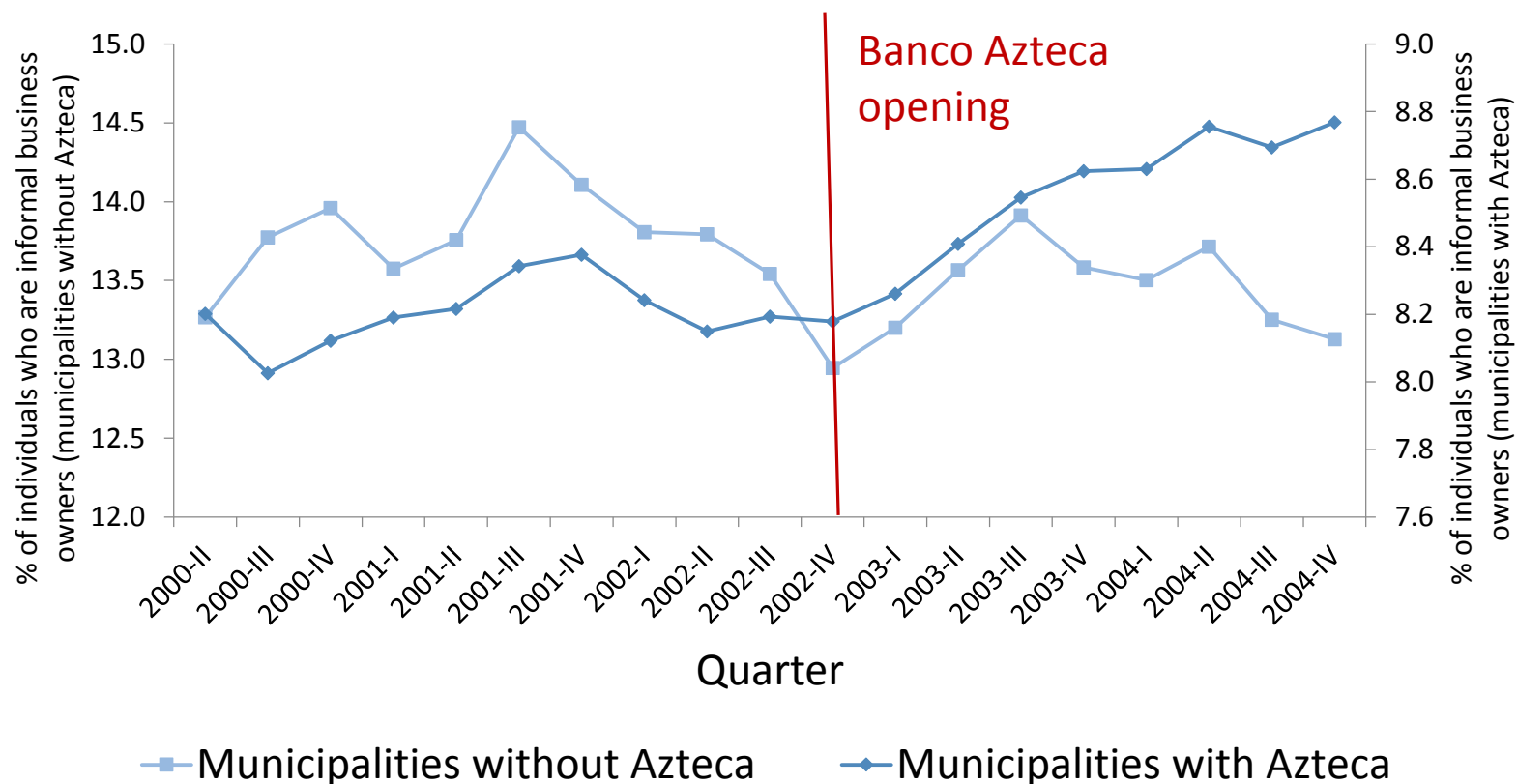
# Tax reform in Georgia (no jumps at cutoff before the 2010 reform)



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  - Matching grants
- Business skills and practices
  - Workshop training
  - Consulting

# Access to finance (Bruhn and Love JF 2014)



- Improved access to finance in Mexico (through Banco Azteca) helped small business stay in operation and increased employment and income
- Effects are higher for low-income individuals and those located in areas with lower pre-existing bank penetration



elektra



BANCO AZTECA



BANCO AZTECA



# Policies for improving SME's access to finance

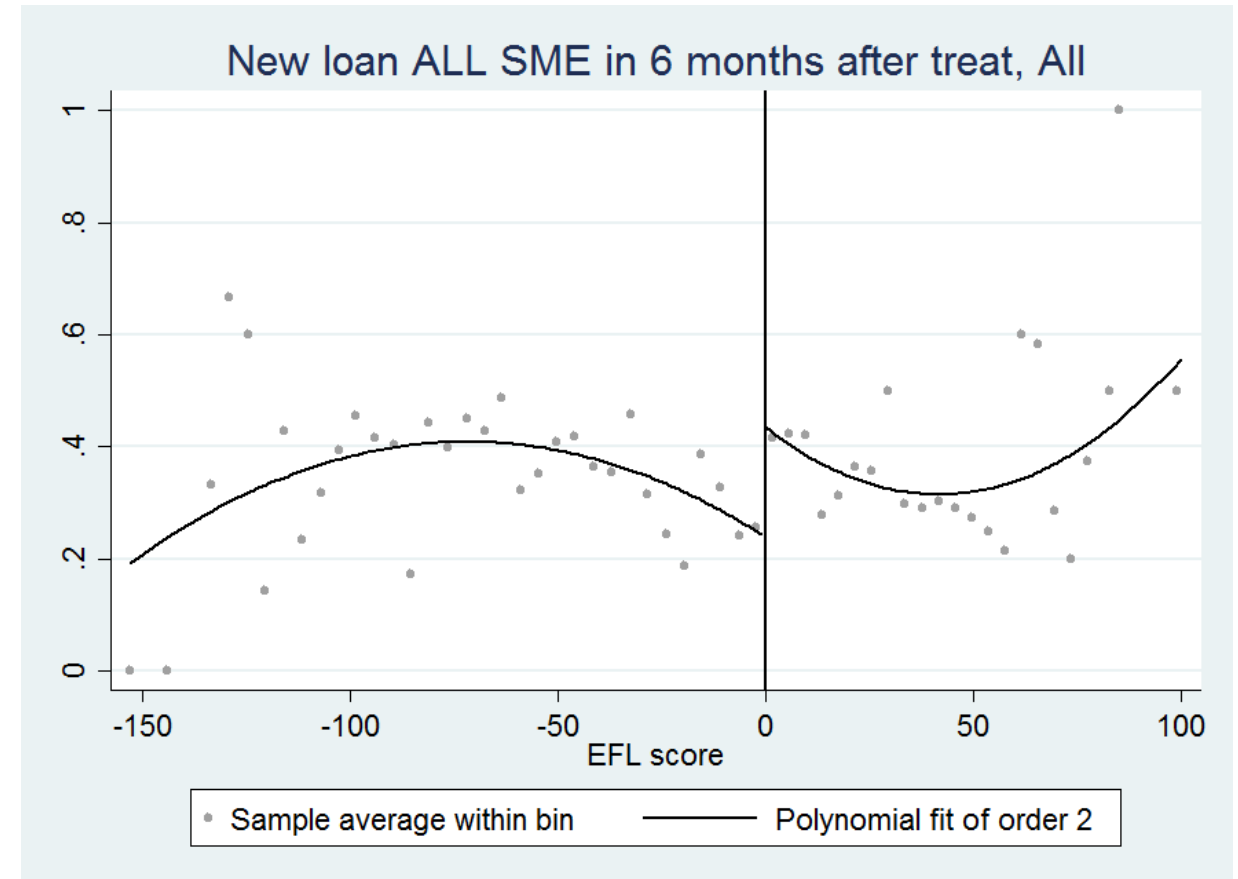
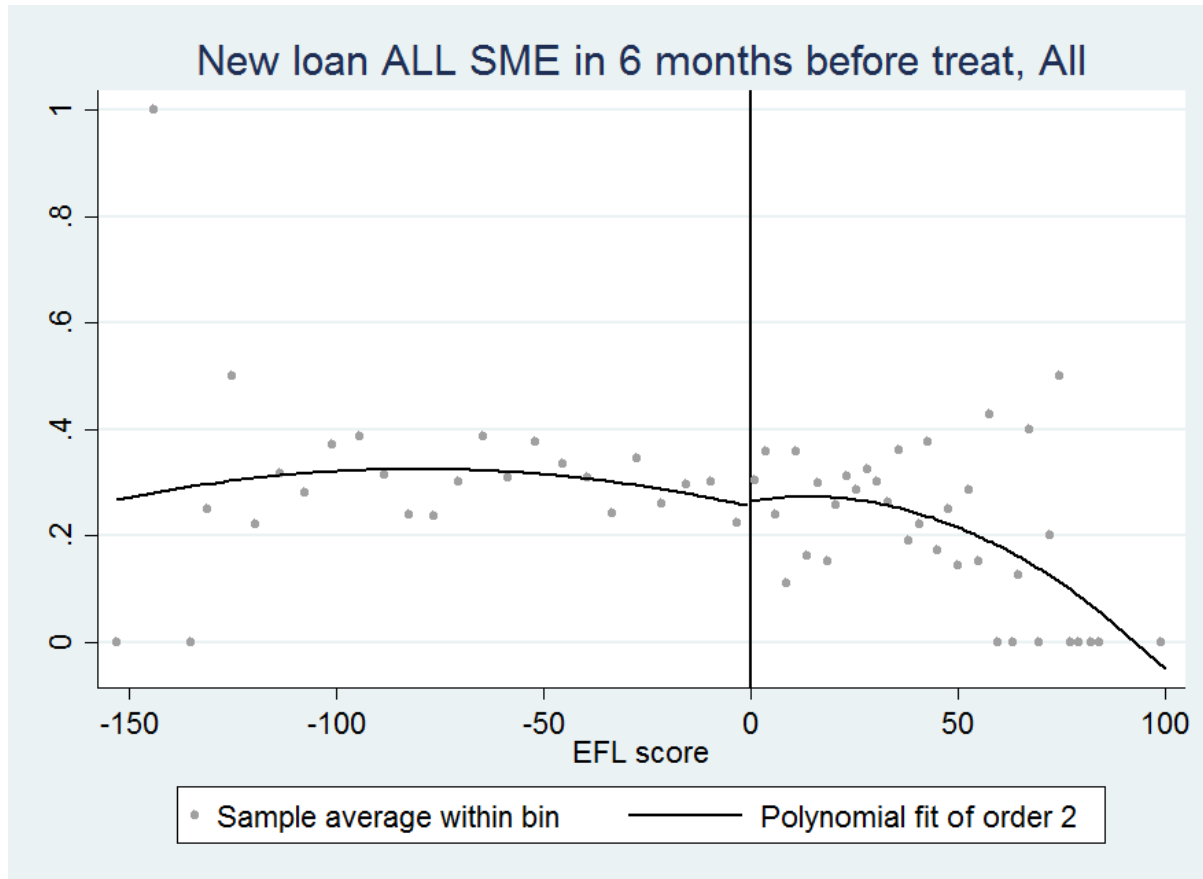
- Direct government interventions, such as government banks and credit guarantees, are difficult to implement since design matters a lot and they may be subject to political capture
- Market-oriented policies, such as collateral registries or credit bureaus, tend to be more successful
- Only about 50% of countries have a credit bureau (Doing Business 2016)
  - Banks may be reluctant to share proprietary credit information (Bruhn, Farazi and Kanz 2013 – background paper for 2013 Global Financial Development Report)
  - Countries are less likely to have a credit bureau if
    - Entry barriers into the banking market are low (greater threat of competition)
    - Bank concentration is high (large banks stand to lose more monopoly rents from sharing information)



# Can psychometric credit scoring provide valuable credit information on SMEs?

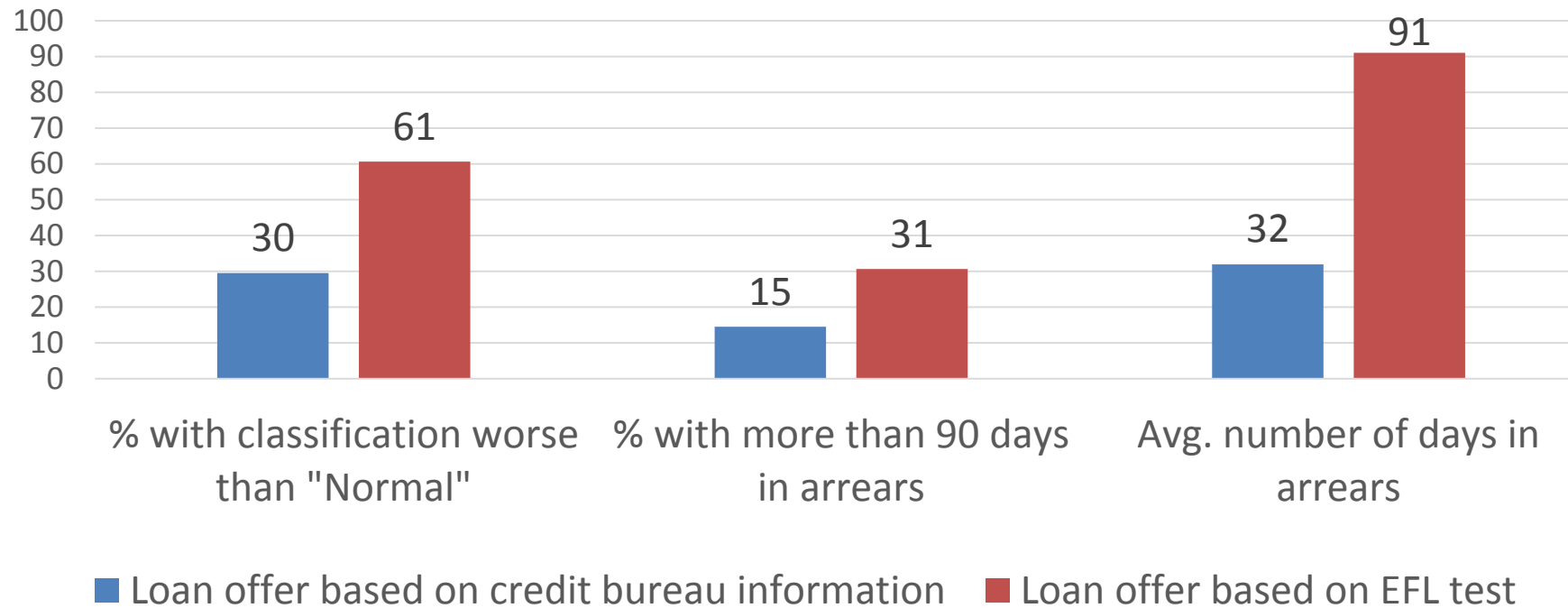
- SME owner takes a “personality” test as part of the loan application that measures
  - Potential for business success
  - Integrity or intention to pay back a loan
- The Entrepreneurial Finance Lab (EFL) developed such a test based on work in Africa and then also piloted it in Latin America, in collaboration with the IDB
  - Arráiz, Bruhn, Ruiz, and Stucchi study the effect of passing the EFL test on access to loans, using a sample of about 1,900 SME owners who applied for business loans with a bank in Peru

# Passing a psychometric test leads to increased loan access for SMEs in Peru



Probability of taking out a new SME loan within 6 months of loan application increased from about 20 to 40% at EFL score cutoff (SME owners with scores about the cutoff were offered a loan)

# Psychometric credit scoring does not replace credit bureau information (yet?)



Arráiz, Bruhn, and Stucchi (WBEP P&P, forthcoming) find that loan repayment behavior is worse for SME owners who got a loan based on their EFL score, but whose application would have been rejected based on their credit bureau information.

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# Business practices may matter a lot for growth

- Business practices vary widely across countries and within countries and firms with better practices tend to perform better (Bloom, Van Reenen & coauthors; McKenzie and Woodruff)
  - Accounting, marketing, financial planning
- “Managerial capital” can affect productivity, as well as quantities of labor and capital used in the firm, affecting firm growth (Bruhn, Karlan, Schoar AER P&P 2010)
- How to improve business practices?

# Business training often does not improve firm performance

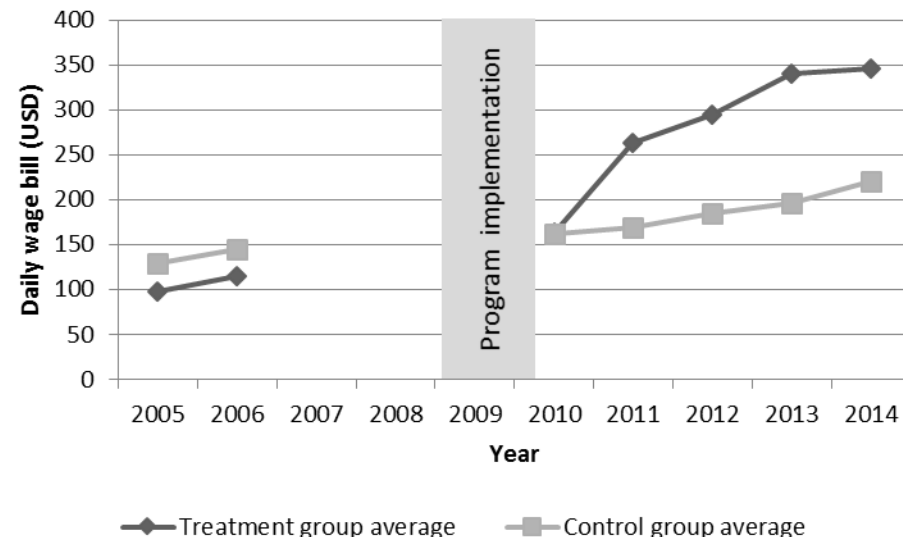
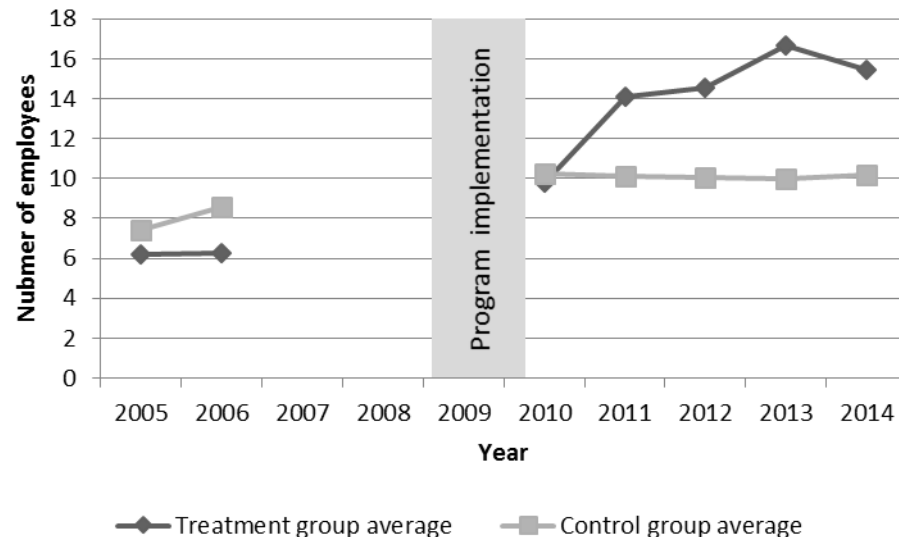
- A typical business training course is offered in a classroom setting and takes about a week
    - ILO Start and Improve Your Business program has trained 6 million people in more than 100 countries
    - IFC's Business Edge program has trained 200,000 people in 54 countries
  - Randomized control trials have found
    - Low take-up rates (39% in Bosnia, Bruhn and Zia 2013)
    - Improvements in business practices
    - BUT little or no impact on business performance (or only for subgroups)
- Try more intensive programs that are tailored to specific needs

Classroom  
business  
training  
(Bosnia)



# Consulting services improve SME performance

- Randomized control trial with 432 SMEs in Mexico where firms received one year of management consulting services (Bruhn, Karlan, and Schoar JPE, forthcoming)
  - A survey right after the program ended shows improved accounting, marketing, “entrepreneurial spirit”, and productivity
  - Two to five years after the intervention, administrative data from Social Security Institute (IMSS) shows 50% increase in employees and wage bill







On-site consulting services (Mexico)

# Matching grants

- One of the most commonly used policy tools for SME growth
- Consulting program in Mexico implemented via a matching grant
  - Beneficiary SMEs paid only 10 to 25% of the cost of the consulting services (US\$12,000 on average), depending on firm size
  - Other share paid by the state government
  - One of the first rigorous impact evaluations of a matching grants program
- Are these subsidies really needed?

# Why don't more SMEs use consulting?

<b>Self-Reported Reasons for Not Using Consulting Services in Control Group Firms</b>	
Reasons for not using consulting services	% of enterprises mentioning this reason (multiple mention)
Would be a good investment, but don't have funds	46.3
Don't know what the benefits would be	22.2
Simply hadn't considered it	18.5
Didn't need the services	13.9
Other	11.1
Didn't know these services existed	7.4
Not worth the cost	5.6
N	108

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

Source: Bruhn, Karlan, and Schoar JPE, forthcoming

# Can simply providing information improve SME performance (and take-up of consulting)?

- Ongoing work in Brazil (with Caio Piza)
  - SME owners will fill-out a questionnaire on business practices
  - Randomly select sample into a control group and 3 treatment groups
    1. Information on benefits only: Receive information on the business practices where deficiencies were detected. Information will also state that business practices vary across firms and that better practices are associated with higher revenues.
    2. Technical content only: This group will be directed to technical content on an online platform related to the practices where deficiencies were detected. This platform contains moderated peer discussion on practices, and an option to request consulting.
    3. Information on benefits + technical content: this group will receive (1)+(2)

# Summary

- Business registration reforms are useful to cut red tape and foster competition, but they don't seem to spur much SME growth
- Special tax regimes for SMEs may have larger effects, but they can also provide incentives for misreporting
- Access to finance is a constraint for SME growth
  - Credit bureaus can improve access, but banks may be reluctant to share information
  - Psychometric credit scoring does not (yet) replace credit bureau information
- Business practices matter for SME growth
  - Standard training is not the most effective way of improving practices
  - Consulting services can have big effects on SME performance