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Deutsches Institut für  
Entwicklungspolitik



German Development  
Institute

Discussion Paper

10/2015

# Micro and Small Enterprises as Drivers for Job Creation and Decent Work

*Caroline Reeg*

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Bonn 2015

Discussion Paper / Deutsches Institut für Entwicklungspolitik

ISSN 1860-0441

Die deutsche Nationalbibliothek verzeichnet diese Publikation in der Deutschen Nationalbibliografie; detaillierte bibliografische Daten sind im Internet über <http://dnb.d-nb.de> abrufbar.

The Deutsche Nationalbibliothek lists this publication in the Deutsche Nationalbibliografie; detailed bibliographic data is available in the Internet at <http://dnb.d-nb.de>.

ISBN 978-3-88985-676-0

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*This report has been funded by the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH Sector Project "Employment Promotion in Development Cooperation" on behalf of the Federal Ministry for Economic Cooperation and Development (BMZ). The analysis, results and recommendations in this paper represent the opinion of the author(s) and are not necessarily representative of the position of the GIZ or the BMZ.*

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## Abstract

The World Development Report 2013 on 'Jobs' estimates that, in the coming years, hundreds of millions of new jobs need to be created to keep up with demographic changes and population growth in low and middle income countries (LMICs). This will even be necessary to keep unemployment and underemployment rates at their current levels – let alone to substantially improve the employment situation. Further, evidence suggests that the majority of current jobs in LMICs do not lift people out of poverty. Thus, in order to reduce poverty, we do not just need more jobs; what we need as well – and more importantly – are more productive and thus better paying jobs, along with decent working conditions.

Across high-, middle- and low-income countries, micro and small enterprises (MSEs) constitute the largest share of private-sector enterprises and account for the bulk of employment, at least in LMICs. Even though a large share of these MSEs are informal, they are also accountable for most of the job creation in low- and middle-income countries. However, much of the employment in MSEs is low productivity, low income and low quality employment. As a result, substantial controversy remains over the underlying growth assumptions, the job creation potential and the net contribution of MSEs to national employment. Here, job creation within MSEs is defined as the creation of new employment in existing MSEs as well as the job contributions that arise from new MSEs, such as through start-ups and the self-employed.

This report argues that not all jobs created by MSEs are productive and hence conducive to economic development and poverty reduction. It is shown that only if MSEs implement innovation activities and thereby improve their competitiveness and market share can they contribute to the creation of productive jobs. However, only a very small group of affluent micro- and small entrepreneurs have shown that they have the potential to drive job creation and improvements in job quality. It is argued that various factors play a role in driving the enterprise growth and employment: (i) human capital (education, training and work experience) and private wealth; (ii) sector/industry focus; (iii) R&D and market research; (iv) workforce training and incentives; and (v) supportive networks. As the majority of MSEs lack the access to these enabling growth factors (that is, human, social and financial capital) few manage to overcome growth constraints, expand in employment and improve working conditions.

The policy consequence resulting from this observation should, however, neither be an approach targeted exclusively on 'gazelles', that is, high-growth MSEs, nor a withdrawal of small enterprise promotion policies. The author argues that the uneven distribution of financial, human and social capital inhibits productivity and employment gains amongst disadvantaged MSEs and further enhances structural inequalities in society. In order to drive productivity growth, job creation and decent work amongst all MSEs, policymakers should not forget to undertake more fundamental policy reforms and interventions. While there is no single policy approach applicable to all LMICs, this report shows that a variety of policy measures exist that can assist MSEs in productivity-enhancing and labour-friendly investments.

## Acknowledgements

The research for this report was funded by the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ). The author is grateful for detailed comments on an earlier version provided by Markus Loewe, Tilman Altenburg, Eva Weidnitzer and Sina Thiessen. Of course, any remaining errors are mine alone.

Berlin, August 2015

Caroline Reeg

# Contents

## Abbreviations

## Summary

<b>1</b>	<b>Introduction</b>	<b>11</b>
<b>2</b>	<b>Micro &amp; small enterprises: drivers for job creation?</b>	<b>14</b>
2.1	Definition, profile and dynamics of MSEs	15
2.1.1	Definition	15
2.1.2	Profile	16
2.1.3	Dynamics	19
2.2	MSEs, job creation and job quality: a conceptual framework	22
<b>3</b>	<b>Enterprise growth and job creation: what matters to MSEs?</b>	<b>29</b>
3.1	Entrepreneur characteristics	33
3.2	Enterprise characteristics	36
3.3	Personal and business networks	41
3.4	The business environment	44
<b>4</b>	<b>Assisting MSEs in driving growth, job creation and job quality</b>	<b>50</b>
4.1	Access to physical infrastructure	52
4.2	Business regulations, labour laws and law enforcement	54
4.3	Access to finance	56
4.4	Access to markets, information and technology	60
4.5	Access to skilled and trained labour	62
4.6	Access of MSE owners to education and training	64
<b>5</b>	<b>Conclusions</b>	<b>67</b>
	<b>References</b>	<b>71</b>

## **Figures**

Figure 1: Stylised phases of an enterprise life cycle	19
Figure 2: Employment growth and job quality in MSEs	26
Figure 3: The onion model	30
Figure 4: Determinants of MSE performance and development goals	33

## **Boxes**

Box 1: The Global Entrepreneurship Monitor (GEM)	21
Box 2: Entrepreneurship, MSE dynamics and economic development	22
Box 3: Definitions: jobs and employment	23
Box 4: Job quality, quality of employment and decent work	27

## **Tables**

Table 1: Policy implications of neoliberal and structuralist views on informal MSEs	51
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## Abbreviations

ALMPs	Active labour market policies
BDS	Business development services
GEM	Global Entrepreneurship Monitor
GVC	Global value chain
HICs	High-income countries
HRD	Human resource development
ICLS	International Conference of Labour Statisticians
ILO	International Labour Organization
IMF	International Monetary Fund
LMICs	Low- and middle-income countries
MSEs	Micro and small enterprises
MSMEs	Micro, small and medium enterprises
OECD	Organisation for Economic Co-operation and Development
R&D	Research & development
ROI	Returns on investment
SMEs	Small and medium enterprises
SSA	Sub-Saharan Africa
TVET	Technical vocational education and training
UN	United Nations
UNIDO	United Nations Industrial Development Organization
USD	United States Dollar
WB	World Bank
WBES	World Bank Enterprise Survey
WDR	World Development Report
WIEGO	Women in Informal Employment: Globalising and Organising

## Summary

In the coming years hundreds of millions of new jobs need to be created to keep up with demographic changes and population growth in low and middle income countries (LMICs) even to keep unemployment and underemployment rates at their current levels – let alone to substantially improve the employment situation. The World Development Report 2013 on ‘Jobs’ estimates this need to an additional 600 million jobs by 2020, if the ratio of employment to working-age population is to be held constant (World Bank, 2013, p. 51). Further, evidence suggests that the majority of current jobs in LMICs do not lift people out of poverty. According to estimates from the International Labour Organization (ILO) nearly half of all workers worldwide still live below the USD 2 a day poverty line (International Labour Organisation [ILO] & International Monetary Fund [IMF], 2010). Thus, in order to reduce poverty, we do not just need more jobs; what we need as well, and more importantly, are more productive and thus better paying jobs and decent working conditions (ILO, 2015). The ILO concept of ‘decent work’ refers to conditions such as the absence of coercion, equity at work, security at work, dignity of work, and decent working hours.

Accordingly, for policymakers and practitioners two critical policy questions emerge: First, how do we create new jobs, and quickly? And, secondly, how do we increase the quality of jobs and provide decent work in order to decrease poverty rates and improve workers’ wellbeing?

For many policymakers and practitioners, micro and small enterprises (MSEs) hold the answer (De Kok, Deijl & Veldhuis-Van Essen, 2013; ILO, 2015). Across high-, middle- and low-income countries, MSEs constitute the largest share of private-sector enterprises and account for the bulk of employment, at least in LMICs (Ayyagari, Demirgüç-Kunt & Maksimovic, 2011, 2014; ILO, 2015; Maloney, 2004). Even though a large share of these MSEs are informal, they are also accountable for most job creation in both low- and middle-income countries (Ayyagari et al., 2014; Jütting & De Laiglesia, 2009). Thus, looking at the figures, for any job-creation strategy to be successful, micro and small enterprises as well as the self-employed in the formal and informal sector must be given central importance. However, much of the employment in MSEs is low productivity, low income and low quality employment. Many MSEs are established out of necessity: because their owners have not been able to find employment elsewhere. And many MSEs absorb additional workers and give them employment even if there is no work for them; they simply distribute the existing work over a larger number of employees thereby lowering the yield and earnings per worker and the productivity of the firm. In order to increase the number and quality of jobs, raising the productivity of MSEs has to be put at the centre of policy efforts.

For this reason, with regard to the potential of MSEs to contribute to more and better jobs, this report addressed the following **three questions**:

- (1) Employment creation: Under which conditions do MSEs create employment; that is, when do they create employment due to increases in sales or productivity? What are the factors driving productivity and employment growth within the MSE segment, and what constraints to their growth exist?

- (2) Job quality: Under which conditions does employment growth not only benefit company owners but also workers: Does enterprise growth (including informal sector MSEs) also translate into additional jobs, an increase of workers' wages and an improvement of their working conditions (for instance, shorter working hours, better working space, more safety at work, basic social security, non-wage benefits such as child-care at work, transportation to work etc.)? What does it take to improve working conditions within a firm?
- (3) Policy support: What type of policy instruments are available to policymakers and development practitioners in assisting formal and informal MSEs to create more and better jobs?

### *Definitions*

While no uniform definition of MSEs exists, this report defines MSEs as formal and informal enterprises with up to 19 regular employees (De Kok et al., 2013; Kushnir, Mirmulstein, & Ramalho, 2010). This rather low threshold is based on evidence in LMICs showing that few MSEs manage to grow into a more complex and systematically organised firm operating with 20 or more employees (Altenburg & Eckhardt, 2006; Liedholm, 2002; Mead & Liedholm, 1998 ). It is this threshold that for many firms constitutes a rough qualitative cut-off point into a more advanced level of organisation – the medium-size bracket.

Furthermore, for the purpose of this paper a broad definition of jobs, set by the World Development Report (WDR) 2013, is used. It defines jobs as “*activities that generate actual income, monetary or in kind, and do not violate fundamental rights and principles at work*” (ibid., p. 66).

### *Conceptual framework*

This report argues that not all jobs created by MSEs are productive and conducive to economic development and poverty reduction. It is shown that only if MSEs implement innovation activities and thereby improve their competitiveness and market share can they contribute to the creation of *productive* jobs (Dutz, Kessides, O’Connell, & Willig, 2011; Schumpeter, 1943, 1949; Szirmai, Naudé, & Goedhuys, 2011).

At the same time, while firm-level innovation is a key driver of MSE growth, it is all but clear whether it also results in a net increase of national employment. Statistically speaking, the relationship between growth and employment varies substantially over time, across countries, and across sectors showing that a given rate of enterprise growth will not automatically lead to a given level of employment growth. Thus:

- First, a firm’s innovative activities may result in the growth of turnover and sales but not of employment. It may, for example, bring about technological advancements and thereby increase labour productivity in a way that the firm needs fewer employees to produce the same amount of, or even more, goods. Innovation would thus destroy rather than create employment.
- Second, a firm’s innovative activities may result in the growth of turnover and sales

but not improvements in job quality. For example, it may occur that growing enterprises reduce wages and benefits in order to stay price-competitive.

- Third, even if innovation at an MSE creates employment within the firm, this may result in the crowding-out of competitors: The innovative firm conquers market shares at the expense of other MSEs who have to reduce their number of employees, pay lower wages, or even close down completely. The net effect on national employment may still be positive, but that should not be taken for granted. And, even if the quality of employment improves while the net effect on the quantity of employment is negative, it is hard to judge whether the overall change is desirable or not (indirect effects).

### *Determinants of enterprise growth, employment growth and job quality*

In order to understand what it takes for an MSE to grow and to translate this growth into additional productive jobs, an increase in workers' wages or an improvement in their working conditions, this report has reviewed two groups of factors:

- (i) internal factors, namely those originating in entrepreneur and enterprise characteristics
- (ii) external factors, namely those originating in networks and the business environment.

Studying MSE dynamics has led to the insight that there is no single factor, but rather a number of factors from internal as well as external categories that drive enterprise development and job creation. Clearly, depending on the local context, some factors may be more important than others. Regarding the determinants driving enterprise growth, employment growth and improved working conditions in MSEs, the following key insights arise:

- 1) In their attempt to improve their performance and add workers, MSEs generally face these most salient **growth constraints**:
  - *MSEs struggle with regulatory ambiguity and deficits in law enforcement*: Generally, for many MSEs complying with business regulations and labour laws is associated with costs and only very few benefits. Thus, the incentives to grow beyond a certain threshold do not generally outweigh the costs of formality. Formal MSEs struggle to cope with ambiguities in the scope, depth and application of laws and this leads to unfair competition with informal units and larger formal enterprises. Further, deficits in law enforcement create additional costs for MSEs that few are able to shoulder. Thus, while overregulation inhibits entrepreneurial dynamics and learning among MSEs, the withdrawal of state support and a rather minimalist approach to regulation tolerates the law of the most powerful, unfair competition<sup>1</sup>, and bad working conditions leading to an MSE 'growth trap' (Altenburg & von Drachenfels, 2006).

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1 These can be described as actions of a competitor that actively harm the position of others with respect to their ability to compete on equal and fair terms. This may include 'below-cost' selling, counterfeiting or imitation, dumping, misleading advertising, rumour mongering, trademark or trade secret infringement and other unethical commercial practices.

- *MSEs suffer from poor infrastructure:* The quality of infrastructure significantly determines how efficiently and effectively a business can offer products and services. With uncertainties about the availability of infrastructure services, entrepreneurs will make fewer complementary investments in technologies and new operating systems (e.g. machinery, digitalisation, etc.). Among dynamic and growing MSEs, deficits in the quality of transport and energy are reported most frequently.
  - *MSEs lack access to adequate finance:* Most MSEs report lack of access to finance as a major constraint to growth and business expansion. Most MSEs rely on their own financial resources or those of personal or other informal networks. However, access to micro-finance has not yet been shown to increase the returns and employment of MSEs. A possible explanation is that a number of demand and supply conditions in the financial markets of LMICs have not yet been well designed to serve small enterprises.
  - *MSEs lack access to markets:* Due to their size, MSEs tend to have a limited market outreach and are therefore rarely exposed to business networks that provide access to state-of-the-art technologies, information and business practices. This further lowers the incentives for MSEs to make crucial investments in innovation and learning that could eventually drive job creation and improvements in job quality.
  - *MSEs struggle to find trained and skilled workers:* A lack, or a shortage of, skilled labour negatively impacts MSEs, especially those that engage in labour-intensive activities. In the case of labour-intensive industries the word ‘skill’ is often associated with workers who are able to operate modern machinery, such as power-looms in the textile industry. Thus, without access to skilled labour, MSEs will hesitate to make the complementary investments in modern machinery and production methods.
  - *MSE owners tend to suffer from educational and management deficits:* Higher levels of education, practical training as well as work exposure are considered to impact strongly on the entrepreneur’s capability to seize market opportunities, cope with problems and increase a business’ growth performance and employment potential. However, a large number of MSE owners shows deficits in educational attainment, management training and work experience in a relevant field.
- 2) Studies have revealed several **success factors** and characteristics which are important determinants of MSEs that manage to grow, expand and improve working conditions. These job creators and/or job improvers have the following characteristics:
- *They tend to be privileged:* Growing MSEs are often run by male-owners who are better endowed with human capital (education, training and work experience), more motivated, more courageous and more willing to take risks. They are also more likely to have acquired some personal wealth before starting up and expanding their business. Though gender is not a success factor *per se*, being male is associated with a number of privileges that enhance the growth of a firm.
  - *They tend to be located in growing industries:* The sector and industry in which an enterprise operates also significantly impacts on its potential to grow and add

employees. MSEs are more likely to add employees if they operate in booming industries in which demand for products and services is increasing.

- *They invest in research & development (R&D)<sup>2</sup> market research and workers:* The level of R&D and market research spending as well as investments in human resource development (HRD) are reported to significantly influence the ability to add more skilled workers and become more productive.
- *They do not have to be formal, but they will likely formalise:* Informal, opportunity-driven entrepreneurs with viable business ideas and necessary capabilities often choose not to formalise due to the recurrent costs of being formal and the low perceived benefits of formalisation. Once perceived benefits (e.g. access to finance or contracts with buyers) outweigh the costs, MSEs tend to register.
- *They are embedded in affluent networks:* Supportive *private* as well as *professional networks* are a further characteristic of expanding MSEs. Family wealth and personal securities assist entrepreneurs during economic shocks, while professional ties with lead firms in clusters or global value chains provide MSEs with access to trade credit, information and markets. In particular, linkages with successful medium-sized enterprises have shown to provide a number of advantages (information, finance, market access) for MSEs.

In summary, empirical observations show that only a very small group of well-endowed, privileged entrepreneurs manage to overcome growth constraints by compensating structural and individual deficits (De Mel, McKenzie, & Woodruff, 2012a, 2012b; Gries & Naudé, 2010; Hampel-Milagrosa, Loewe, & Reeg, 2015). This is not to say that poor entrepreneurs are incapable of growth, but that these are less exposed to the factors, resources and networks driving an MSE's capacity to manage and overcome growth constraints.

#### *Policy instruments to assist MSEs*

Recent empirical observations have raised doubts on the question as to whether MSEs can promote jobs and decent work (World Bank, 2013). It is argued that while MSEs generally play an important role in creating employment, especially for the poor, it might be less feasible to support them with growth promotion policies, e.g. (financial) business development programmes aimed at scaling-up production, if few of them actually intend to grow (Gomez, 2008; Liedholm 2002; World Bank, 2013). The fact that only few micro- and small entrepreneurs succeed in expanding their enterprises has led to the somewhat disillusioned policy suggestion that one focus only on those entrepreneurs who, in contrast to the large majority of 'survivalist' MSEs, show a better track record in educational, training and work achievements.

This report argues however that the policy consequences resulting from this observation should neither be an approach targeted exclusively on 'gazelles' (that is, high-growth

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2 Here R&D are understood as systematic reflection on and structured experimentation with products and processes.

MSEs) nor a withdrawal of the extended enterprise promotion policies as set out in the recommendations of the Doing Business reports (World Bank, 2015). The author argues that the uneven distribution of financial, human and social capital inhibits productivity and employment gains amongst disadvantaged MSEs and further enhances structural inequalities in society.

In order to drive productivity growth, job creation and decent work amongst *all* MSEs, policymakers should therefore not forget to undertake more fundamental policy reforms and interventions aimed at creating an environment where equal opportunities among all private sector enterprises in general and MSEs in particular exist. A policy approach targeted exclusively on ‘winners’ is likely to enhance inequalities amongst MSEs even more, thereby limiting the overall potential for further job creation and improvements in working conditions. Also, the neoliberal model of state actions falls short in addressing mutually enforcing MSE growth constraints, such as deficits in education, finance and market access, and therefore offers little or no state measures to adjust structural inequalities.

The **central policy recommendations** are as follows:

When building an inclusive and employment-oriented MSE promotion strategy, governments, policymakers and donors should not only address the enterprise-specific, but, above all, structural growth constraints of MSEs. Having said that, the overall policy agenda arising from this observation is going to be highly context-dependent and nuanced. Accordingly, this report suggests that policymakers follow a two-pronged approach:

- I. *Universalist policy measures*: In order to increase the overall number of productive start-ups and existing MSEs, governments should adopt universalist policy measures to overcome structural growth constraints and create an environment where equal opportunities among all MSEs prevail. This, above all, involves the provision of quality education and training, access to adequate finance, access to market information for all, the design of industrial policies that are sensitive not only to the needs of medium-sized and large, but also to those of smaller enterprises, access to quality infrastructure as well as reforms in the design and enforcement of business and labour regulations.
- II. *Targeted policy measures*: However, in all cases universalist MSEs policies might not be sufficient and effective in addressing very specific constraints, such as access to particular markets, etc. Thus, in these cases, targeted policies may be cost-effective in alleviating the very specific constraints of particular groups of MSEs, for instance those MSEs operating in a particularly dynamic export market. However, the following three observations must also be considered:
  - *Policy interventions are most successful if combined with others and integrated into a broader MSE promotion strategy*: Interventions targeted at particular bottlenecks of any kind may help to overcome one growth barrier, yet fail to address another. MSEs often end up in so-called ‘growth traps’ as several constraints are interrelated and mutually enhancing, such as financial and knowledge constraints. As a result, combined interventions that tackle several growth constraints simultaneously or provide ‘double-benefits’ might enhance the developmental impact on MSEs. This is why these are most successful if combined

with others and integrated into a broader universalistic MSE promotion strategy.

- *The implementation of interventions targeted at particular MSEs, for example high-growth firms, needs to be precise, performance-based, transparent and issue-focused to prevent potentially adverse secondary effects:* As the business success of many growing MSEs is based on structural privileges, targeting these involves the substantial risk of spending public money on the growth promotion of an already advantaged and small group of entrepreneurs that may have experienced growth sooner or later anyways ('windfall effects'). It is therefore essential to develop a precise definition of growth-orientation that allows bureaucracies to identify beneficiaries based on objective enterprise performance criteria, and not only on individual characteristics. Furthermore, the application process for public support schemes, subsidies or other benefits involved needs to be rendered transparent and open to all MSEs. This is of particular importance in the provision of publicly subsidised finance schemes (see Sub-section 4.3). Also, even if authorities manage to objectively identify growth-oriented but constrained MSEs, the question remains as to what happens to those that are not categorised as 'growth-oriented'. While targeted interventions may induce positive developments in beneficiaries, it is difficult to say what kind of indirect and unintended effects might occur elsewhere. At the present time, knowledge on the indirect effects of targeted interventions on other MSEs is very limited, for example as regards crowding-out effects. In other words, in terms of net employment creation it is hard to tell if by using targeted interventions new jobs were created or destroyed, or whether workers were pulled away from other, maybe more productive activities. This is, for example, the danger when adopting hiring incentives or wage subsidies (see Sub-section 4.5). In a 'worst case' scenario, targeted MSE policies could protect uncompetitive jobs for too long and inhibit the efficient allocation of capital and labour. Thus, in order to reduce the possibility of large, adverse effects, targeting programmes should be focused on particular issues and regularly revisited in their scope.
- *Few targeted MSE policy interventions are primarily aimed at employment creation or the job quality of workers:* The majority of policy instruments are not designed to induce employment creation in MSEs, but to increase their incomes, in other words: the job quality of MSE owners. As most MSEs are solely run by own-account workers, interventions primarily address constraints to profitability and productive investments (see Section 4). However, MSE interventions aimed at business performance do not necessarily lead to higher employment growth or better job quality for workers (see Sub-section 2.2). Inducing enterprise growth and employment creation in MSEs requires a substantial push of investments and, as a consequence, more concentrated and long-term-oriented policy measures. For example, in the majority of cases, hiring will only be induced if MSEs substantially increase production capacities (see also Sub-section 4.3). Also, quality improvements in work conditions for employees tend to take place slowly and gradually (see Sub-section 4.2). As a result, policymakers need to be very clear about their short-term and long-term policy goals when designing interventions. Policy support, however, should not be contingent on the creation of employment within MSEs but should primarily facilitate productivity gains. In addition, assistance and incentives for the enhancement of decent working conditions can be

introduced as accompanying measures, such as through the gradual phasing-in of labour laws, wage-incentives and raising awareness of HRD. Nonetheless in the long-term, the evidence suggests that the best long-term employment promotion policy for MSEs is the promotion of productivity growth amongst MSEs.

Reviewing the effectiveness of policy measures to drive enterprise growth, job creation and job quality among MSEs across six policy fields the following **sector-specific recommendations** can be made (see Sub-sections 4.1-.4.6):

- (1) *Access to physical infrastructure*: In order to assist MSEs, policymakers should focus on providing basic infrastructure to all, including those less affluent locations where the large groups of MSEs operate – mostly in traditional, commercial urban centres and rural areas as well as residential areas of the poor. Further, before adopting targeted infrastructure interventions, authorities should identify what enterprises – in particular MSEs in the area – actually need in order to survive or grow. Finally, before relocating MSE into areas where the infrastructure is better, policymakers should attempt to grasp the true value of an enterprise's current location and weigh up the costs and benefits of the measure not only from an urban planning, but also from an economic livelihood perspective.
- (2) *Business regulations, labour laws and law enforcement*: Evidence suggests that in order to boost job creation and job quality in informal enterprises it is not enough just to cover short-term expenditures of MSE registrations, that is, formalisations. In the first place, formalisation incentives are unlikely to work if the benefits of being formal do not outweigh the costs. If the benefits of becoming and remaining formal are to substantially increase for all MSEs, more fundamental reforms in the regulatory environment are needed. This involves in particular the reform of labour regulations and law enforcement. Second, rigorous and complex labour regulations are not going to automatically create employment or ensure protection of workers' rights: As the influence of labour regulations on the job-creation potential of MSEs is mostly dependent on the extent of their applicability and the quality of their enforcement, their design must be simple, applicable and enforceable. Third, strengthening regulatory compliance among MSEs is a two-way road requiring law enforcement and MSEs to work together. This involves policy measures that allow for the gradual phasing-in of regulations and standards, effective political representation and inclusion of small firms, improvements in public support services such as legal counselling available to MSEs, as well as access to public procurement contracts.
- (3) *Access to finance*: Evidence suggests that access to finance is only going to improve MSE business performance and lead to long-term job and job quality gains if governments improve more general demand-side and supply-side conditions (see Hampel-Milagrosa et al., 2015, World Bank, 2008). This involves raising the financial literacy of the general population by adopting more fundamental training measures at schools and by running educational and consumer-protection campaigns which offer information on the advantages and disadvantages of various private finance products and financial institutions (Hampel-Milagrosa et al., 2015). Second, many micro-finance schemes are used to smoothen consumption rather than for business growth (Berner, Gomez & Knorrninga, 2008). This will require that more in-

depth revision processes within banks take place when MSEs apply for ‘business’ funding as well as more structural efforts within the financial sector, in particular among micro-lending institutions, to re-consider some of their financial products aimed at poorer households. Thirdly, access to finance is only likely to result in employment gains via an increase in production capacities and long-term investments, which, in turn, requires a long-term focus on MSEs financing schemes (Banerjee, Duflo, Glennerster, & Kinnan, 2013; De Mel et al., 2013b). Finally, micro-finance schemes are usually not adequately designed to support growth within MSEs, leaving MSEs either ‘under-’ or inadequately served with financial products. Thus, there is need for other growth-oriented financial products.

- (4) *Markets, information and technology*: In order to drive learning, technology deployment and better market access, business development services (BDS) offer a viable policy option. However, in order to stimulate learning, job creation and better jobs among MSEs, BDS is only effective if the services offered manage to provide industry-specific information on current market developments and technologies as well as opportunities for strategic and financial cooperation with lead firms and other relevant intermediaries such as associations, research institutes, trade agents or successfully integrated medium-sized enterprises. BDS targeted at MSEs should also incorporate a payment component to ensure the recipients’ ownership. Third, BDS measures will have a limited impact on more and better jobs in small firms if the latter are isolated from, and not integrated into, a medium-to-long-term industrial development strategy (see also Altenburg & Stamm, 2004).
- (5) *Access to skilled and trained labour*: Often MSE employees lack the necessary education, skills and work experience to stimulate innovation, enterprise growth and expansion of their firm. In order to address this human capital trap, policymakers can first adopt private-sector incentives for higher wages, for instance, wage subsidies, and job-training measures amongst MSEs; second, introduce human resource development (HRD) awareness-raising campaigns and training; and third, adopt a national and regional training and skill-development framework, including technical vocational education and training (TVET) measures, and sectorally targeted human capital initiatives. Evidence suggests that with targeted hiring and training incentives such as wage subsidies, there exists a considerable danger of inducing substitution, ‘windfall’ and ‘crowding-out’ effects. Also, wage subsidies often cater exclusively to the formal sector and constitute a very costly intervention, which is why they may not be the best option to drive more and skilled jobs at MSEs. Policymakers, as well as private sector associations, are advised to incentivise MSEs to introduce HRD measures by raising awareness and providing information and training courses as many MSEs are not aware or trained in these measures. But finally these incentives will only work if governments adopt more fundamental and concentrated policy efforts to develop education and training frameworks that respond to the needs of the private sector.
- (6) *Access of MSE owners to education and training*: While the educational and managerial deficits of MSE owners inhibit a firm’s potential to innovate, grow and expand, entrepreneurship trainings are unlikely to compensate for a lack of basic education and skills amongst the large majority of less privileged micro- and small entrepreneurs. In order to increase the growth and job-creation potential of all MSEs,

governments would therefore be advised to improve the overall quality of basic national education systems and to incorporate entrepreneurial competences into the curricula of schools and other training institutions. Modern curricula should go beyond top-down knowledge transfers by also encouraging creativity, reflective and analytical thinking as well as explorative curiosity among young learners. Authorities should further incentivise higher educational institutions, such as universities and polytechnics, to run business competitions and start-up centres or business incubators as well as offering complementary industrial internships in support of the entrepreneurial projects of current under- and postgraduate students. Second, the targeted entrepreneurship training programmes that currently exist are seldom sensitive to their beneficiaries' needs: they may be too general to help already better educated MSE and SME owners who are searching for more substantial counselling, managerial skills and advice on strategic business development in order to expand their business (see Loewe et al., 2013; Reeg, 2013b). Targeting dynamic 'job-creators', that is, 'gazelles', requires entrepreneurship trainings to be more substantial and sensitive to the needs of the private sector. Thus, authorities are advised to pass over the implementation of these trainings to private industry organisations or other dedicated training providers who have the relevant know-how on recent trends in business management, accounting, legal aspects and other strategic business development matters (Loewe et al., 2013).

## 1 Introduction

In the coming years, hundreds of millions of new jobs need to be created to keep up with demographic changes and population growth in low and middle income countries (LMICs) just in order to keep unemployment and underemployment rates at their current levels – let alone to substantially improve the employment situation. The World Development Report 2013 on ‘Jobs’ estimates that this will require an additional 600 million jobs by 2020 if the ratio of employment to working-age population is to be kept constant (World Bank, 2013, p. 51). Further, evidence suggests that the majority of current jobs in LMICs does not lift people out of poverty. According to estimates from the International Labour Organization (ILO) nearly half of all workers worldwide still live below the USD 2 a day poverty line (ILO-IMF, 2010). Thus, in order to reduce poverty, we do not just need more jobs but also, and more importantly, better paid jobs and decent working conditions. The ILO concept of ‘decent work’ refers to conditions such as the absence of coercion, equity at work, security at work, dignity of work, and decent working hours.

Numerous discussions on how to create more and better jobs have taken place. Against the background of tight public budgets, suggesting that new jobs may be created by publicly sponsored works programmes is a rather unhelpful proposal to many governments in LMICs. What’s more, the idea that larger enterprises in the formal sector could spur sufficient job creation in order to absorb current and future labour surpluses has been put to rest by a recent study on size of individual firms and job creation (Ayyagari et al., 2014). This shows that, compared to other size classes, small formal enterprises showed higher job-creation rates, suggesting that formalised, smaller firms grow into larger small and medium enterprises (SMEs) in LMICs (ibid., pp. 83ff). As a result, policymakers and development practitioners have become highly interested in the job-creation potential of small enterprises (De Kok et al., 2013; ILO, 2015).

Across high-, middle- and low-income countries, micro and small enterprises (MSEs), including the self-employed, constitute the largest share of the private-sector enterprises and account for the bulk of employment at least in LMICs (Ayyagari et al., 2011, 2014; Maloney, 2004). In fact, over 35% of workers in developing economies, and the majority of workers in low-income countries, are self-employed (Gindling & Newhouse, 2014). Even though a large share of these MSEs are informal, they are also accountable for the greater part of employment creation in middle- and low-income countries (Ayyagari et al., 2014; Jütting & De Laiglesia, 2009). However, data suggest that in high-income countries large firms have the highest share of employment, followed by medium-sized firms and small firms (International Finance Corporation [IFC], 2013). Thus, as countries become richer, large firms show higher relative employment shares. Yet, even in high-income countries, it is mainly small firms that eventually grow bigger into larger enterprises (ibid.). Thus, for any job-creation strategy to be successful, micro- and small entrepreneurship in the formal and informal sector must be given central importance.

While MSEs can play a crucial role in contributing to job creation and decent working conditions, it should be noted that only looking at a certain size group of firms may lead to a biased picture when addressing job-creation challenges within national production systems. MSEs are part of a larger ecosystem of micro, small, medium-sized and large firms that together should produce sufficient numbers of good quality jobs, each according to their competitive advantage. In this healthy firm ecosystem, the growth of MSEs is

ideally led by dynamics of innovation, specialisation, complementarity and (national or even global) value chain integration (Altenburg & Eckhardt, 2006). However, the roles that MSEs as job contributors can play vary: While MSEs can act as specialised suppliers of products and services, they may also act as a job ‘net’ for surplus labour that lacks the necessary qualifications and skills to work in larger (formal) enterprises. Empirical evidence suggests that the latter case is the norm (Altenburg & Eckhardt, 2006; Banerjee & Duflo, 2007; Liedholm, 2002; Mead & Liedholm, 1998).

As a result, controversy remains over the underlying growth assumptions, the job creation potential and the net contribution of MSEs to national employment (Ayyagari et al., 2014; Banerjee & Duflo, 2007; Fields, 2014). Here, job creation within MSEs is defined as the creation of new employment in existing MSEs as well as the job contributions that arise from new MSEs, such as through start-ups and the self-employed. On the one hand, it is known that the majority of small-scale entrepreneurs in LMICs are hardly pursuing a growth strategy (Banerjee & Duflo, 2007); rather, many MSEs have been established out of necessity because their owners have been unable to find employment elsewhere (De Mel et al., 2010; Grimm, Knorringa, & Lay, 2012; Liedholm, 2002; Mead & Liedholm, 1998). In consequence, much of the employment created at MSEs is short-term, low productivity, low income and low quality (Altenburg & Eckhardt, 2006). On the other hand, the sheer magnitude of persons engaged in micro and small economic activities implies that, even if only a fraction of firms survive and grow, the employment implications could be substantial. In fact, evidence suggests that there is a group of innovative MSEs and start-ups that survive and develop into high-growth firms: these MSEs, which are termed ‘gazelles’, make important contributions to job creation and decent working conditions (Grimm et al., 2012).

However, while a firm’s innovative activities may result in the expansion of market shares, growth of productivity, turnover and sales, they may not necessarily translate into employment. Innovation may, for instance, bring about technological advancements and thereby increase labour productivity in such a way that the firm requires fewer employees to produce the same amount of, or even more, goods. Innovation would thus destroy rather than create employment. Hence it appears that up to now there has been little systematic knowledge concerning under what conditions MSE do or do not create jobs and decent working conditions. In addition, little is known about what kinds of regulation and types of policy instruments are in fact appropriate and effective in contributing to job creation and increasing job quality within MSEs in LMICs (see Grimm & Paffhausen, 2014).

Finally, a major *caveat* in estimating the potential of MSEs to create jobs is that it is difficult to nail down whether employment growth within the MSE segment results in a net increase or net loss in national employment. Even if an MSE creates employment, it is all but clear whether this may result in indirect effects for other enterprises, such as through the crowding-out of competitors: The innovative firm gains market shares at the expense of other MSEs which have to reduce their number of employees, pay lower wages or even close down completely. While the net effect on national employment may still be positive, that cannot be taken for granted. And even if the quality of employment improves while the net effect on the quantity of employment is negative, it is hard to judge whether the overall change is desirable or not.

While knowledge deficits definitely remain, this study offers guidance for policymakers and development practitioners who wish to leverage the potential of MSEs for job creation and decent work. Undertaking a review of the recent evidence, the focus is on MSEs – including the self-employed – in off-farm activities and includes formal as well as informal firms. In order to define the role and investigate the potential of micro and small enterprises in creating more and better jobs, this study addresses the following three questions in particular:

- (1) Employment creation: Under which conditions do MSEs create employment, that is, when do they create employment due to increases in sales or productivity? What are the factors driving productivity and employment growth within the MSE segment, and what constraints to their growth exist?
- (2) Job quality: Under which conditions does employment growth not only benefit company owners but also workers: Does enterprise growth (including informal sector MSEs) also translate into additional jobs, an increase of workers' wages and an improvement of their working conditions (for instance, shorter working hours, better working space, more safety at work, basic social security, non-wage benefits such as child-care at work, transportation to work etc.)? What does it take to improve working conditions within a firm?
- (3) Policy support: What type of policy instruments are available to policymakers and development practitioners in assisting formal and informal MSEs to create more and better jobs?

The study shows that MSEs can only serve the purpose of being (quality) job creators under certain conditions, namely only if they increase their productivity and follow employment-friendly growth trajectories (see Figure 2). However, only a very small group of affluent micro- and small entrepreneurs have shown that they have the potential to drive job creation and improvements in job quality. In Section 3 it is argued that various factors play a role in driving their enterprise growth and employment: (i) human capital (education, training and work experience) and private wealth; (ii) sector/industry focus; (iii) R&D and market research; (iv) workforce training and incentives; and (v) supportive networks. As the majority of MSEs lack access to these enabling growth factors (such as human, social and financial capital), few manage to overcome growth constraints, expand in employment and improve working conditions. Consequently policymakers must not forget to undertake more fundamental policy reforms and universalist interventions aimed at creating an environment where equal opportunities among all MSEs exist. While there is no single policy approach applicable to all LMICs, this report shows that a variety of policy measures are available to assist MSEs in productivity-enhancing and labour-friendly investments.

The remainder of the report is organised as follows: Section 2 introduces the relevance of MSEs for job creation in LMICs. It also defines MSEs and provides a short snapshot of these along with their growth dynamics in LMICs. Further, this section lays out a conceptual framework with which to investigate employment potentials in MSEs across low- and middle income countries. The determinants of MSE growth and the main constraints in creating more and better jobs are discussed in Section 3. Section 4 critically examines conventional policy approaches and discusses several policy measures aimed at assisting MSEs in driving growth, employment creation and job quality. This also involves policy recommendations. The paper ends with a short synthesis and an outlook in Section 5.

## 2 Micro & small enterprises: drivers for job creation?

Working in micro, small and medium enterprises (MSMEs) is the most prevalent way to make a living in low- and middle-income countries (ILO, 2015; World Bank, 2013). Formal MSMEs employ more than one-third of the world's labour force (Kushnir et al., 2010). The International Monetary Fund (IMF) estimates that across the 132 economies covered, there are about 125 million formal MSMEs of which 89 million operate in LMICs and of which the overwhelming majority, about 83%, are micro enterprises, including the self-employed (ibid.).

However, these estimates are probably only the tip of the iceberg as data on MSMEs, in particular on micro enterprises and the informal sector, is scarce and often not comparable across countries due to differences in definitions and methods of estimation. Most statistical MSME definitions and subsequent research are predominantly concerned with businesses that have formalised or registered in some manner and have reached a critical number of employees, thereby excluding micro and informal family enterprises and the self-employed, as in, for instance, the World Bank Enterprise Survey (WBES). As a consequence, the importance that micro and small enterprises (MSEs) have in providing employment is often underestimated and we know little about their potential in creating jobs.

Understandably, a central question for many policymakers and researchers revolves around the potential that may lie with formal and informal MSEs in creating jobs and improving working conditions. The literature provides three major perspectives:

- (1) *The optimists*: It is argued that most micro-entrepreneurs, even if informal, have growth and employment potential, but are held back by regulation, corruption or other bottlenecks to growth. They argue that large MSE sectors are a sign of a vibrant, innovative economy. Being an entrepreneur is an individual and voluntary decision to maximise returns from work, flexibility in working hours, as well as increasing financial independence.
- (2) *The pessimists* interpret the large number of MSEs as a sign of hidden unemployment and regard almost all (informal) micro business owners as 'necessity entrepreneurs'. The prevalence of subsistence activities, the low level of formal education as well as the low quality working conditions among MSEs support that notion. From this viewpoint (informal) MSEs have no intention of expanding and therefore little scope for creating employment; hence one should base one's hope on medium- and large-sized enterprises.
- (3) *The nuanced perspective*: While optimists fail to recognise the heterogeneity in growth motivations among MSE owners, pessimists tend to underestimate the challenges involved in starting to run a business. A clear-cut distinction, however, does not capture the actual gradation of MSE performance and managerial capacity between subsistence activities and growth-oriented entrepreneurs found on-the-ground. From a nuanced viewpoint, not all MSEs have the potential to create jobs but some do. Thus, a major challenge is to identify firms with potential and to assist them to overcome growth constraints.

The aim of this section is to clarify the role played by MSEs in LMICs in the context of recent discussions on job creation and decent work. In order to do this, the following sub-

sections will provide a snapshot of MSEs, that is, they will define them, characterise them and provide some insights into their dynamics. Lastly, this section will offer a conceptual framework that will help us to understand how and when MSEs may contribute to the creation of more and better jobs within the context of LMICs. Eventually, this framework will also function as a structural outline for the sections to come.

## 2.1 Definition, profile and dynamics of MSEs

There is no uniform definition of micro and small enterprises (MSEs), however, this report refers to MSEs as enterprises with up to 19 regular employees (Kushnir et al., 2010). The majority of MSEs in LMICs are informal, driven by necessity and micro in size; in other words, they are one-person undertakings and have few or no hired workers. Overall, in the micro and small enterprise segment in LMICs, entry and exit of firms are more common than the actual growth of an MSE into a higher size class. Only very few innovative and privileged MSEs have the potential to grow and expand into higher employment categories (Berner et al., 2008; De Mel et al., 2010, 2012a, 2012b; Goedhuys & Sleuwaegen, 2010; Hsieh & Klenow, 2009, 2011). As a result, what is important for the expansion of productive jobs and decent work among MSEs is the identification and support of opportunity-driven and growth-oriented entrepreneurs.

The following sections will present a more detailed profile of MSEs in LMICs and sketch out some of the driving dynamics in the MSE segment. Finally, a conceptual framework of how MSEs contribute to job creation and decent working conditions will be laid out.

### 2.1.1 Definition

Definitions of micro and small enterprises (MSEs) vary across countries as well as across sectors and industries. Although there is no universal definition of what constitutes an MSE, the most commonly referred criterion is its number of (regular or permanent) employees. Depending on data availability and the economic character of the host country, other additional criteria, such as a business turnover or a firm's capital investments, are made use of. In LMICs, the primary parameter is the number of regular employees, as this figure can be more easily observed and accounted for compared to other size-indicators such as turnover, capital investments, etc. Clearly, size categories provide little information on the ownership profile, type of legal entity or general provenance of the company. Though many might think of a local and privately-held company when reflecting on MSEs, other organisational and legal forms are possible. They may be locally- or foreign-owned, and privately held or state-owned enterprises. Also, start-ups may have their origin in a state-owned mother company; or alternatively they may be a spin-off from an internationally operating corporate firm.

Although enterprise size classes are defined in dependence on economic country profiles or based on relative measures of particular distributions within an industry, these thresholds across sectors and industries can generally be quite arbitrary. The World Bank Enterprise Survey (WBES) classifies enterprises with 5-19 employees as small and those with 20-99 as medium, while The World Bank Group in-house definition considers enterprises with 0-9 as micro-enterprises, 10-49 employees as small and 50-299 as

medium-sized (Kushnir et al., 2010). The existence of different threshold lines suggests that these should not be understood as strict concepts. Rather, it implies that the qualitative nature of the firm and its operations do not change substantially between the micro and small size segment. While some countries make a distinction between a micro and a small enterprise, in many cases countries include micro enterprises within the small-enterprise definition. This is the case when small enterprises are lumped into wider umbrella terms, for instance in categories of micro and small-sized enterprises (MSEs) and micro, small and medium-sized enterprises (MSMEs). Also, in some cases, countries opt to categorise micro-entrepreneurs with no additional registered employees as self-employed or as own-account workers.

However, in terms of quality, there seems to be a stark difference as to whether a firm is on the one hand micro and small, or on the other medium in size. While traditional and simple forms of enterprise organisation and structure might be sufficient for running an MSE, evidence in LMICs shows that starting from a threshold of 20 or more employees enterprises requires a more complex and systematically organised enterprise structure (Altenburg & Eckhardt, 2006; Liedholm, 2002; Mead & Liedholm, 1998). It is this threshold that for many firms constitutes a rough qualitative cut-off point into a more advanced level of organisation – the medium-size bracket (see also the reference to the WBES in Kushnir et al., 2010). In consequence, for the purpose of this paper, it is expedient to define MSEs as formal and informal enterprises with up to 19 regular employees and, medium-sized enterprises as those having 20 regular employees or more.

### 2.1.2 Profile

MSEs are a very heterogeneous group. The following paragraphs aim to provide a rough snapshot of MSEs with regards to their *main characteristics*:

*Size distribution and employment contribution:* Taken together, MSEs comprise the majority of all enterprises and create the bulk of employment in LMICs (see also De Kok et al., 2013). Especially, micro enterprises – that is, enterprises with 9 or less employees – are the main constituents of MSEs (World Bank, 2013). According to the World Development Report on Jobs, shares in formal and informal micro enterprises range from 80% in Latin American countries, such as Argentina, El Salvador and Mexico, to more than 90% in Asian countries, such as China, India, Indonesia and the Philippines (ibid., pp. 11ff). Even in more advanced economies such as Chile, micro enterprises provide employment to nearly 40% of the population (ibid., p. 11). A former ILO study (2003) examining firms with fewer than 10 workers found that they generated 58% of total employment in Paraguay, 54% in Mexico and 53% in Bolivia. Household and labour force surveys in Ethiopia show that micro and small enterprises together account for 97% of employment (World Bank 2013, p. 105). Similarly, the seminal study of Mead and Liedholm (1998) found that in the five African countries under study<sup>3</sup>, the number of people engaged in micro and small enterprises was twice the level of those employed in the formal large-scale and public sectors. Moreover, they show that most of those enterprises were only one-person businesses. Hired workers,

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3 The survey was conducted between 1990 and 1995 in Botswana, Kenya, Lesotho, Swaziland, Zimbabwe, South Africa and the Dominican Republic.

excluding unpaid family workers, were a rare case, and in most countries the percentage of hired workers constituted only around 20% of the MSE labour force (Mead & Liedholm, 1998). Hence, the MSE segment is characterised by ‘working owners’, that is, high rates of self-employment.

*Informality:* MSEs can be registered (formal) or unregistered (informal). Informal MSEs make up the vast majority of businesses in most LMICs. Unfortunately, the sampling frames of most cross-country and national statistical surveys exclude informal enterprises. Unfortunately, this is also the case for the World Business Environment Survey (WBES) which not only excludes formal enterprises with less than 5 employees, but also informal enterprises. Very few reliable estimates on the employment share of the informal economy, particularly informal MSEs, exist. However, it is widely acknowledged that informal MSEs often outnumber formal MSMEs many times over. For example, in the case of India, 1.6 million registered MSMEs are matched with an estimated number of 26 million unregistered MSMEs, of which the majority is in the micro or small-size category (Kushnir et al., 2010). Similarly, looking at household data in thirteen sub-Saharan countries, Fox and Sohnesen (2012) found that only 9% of employment is generated by formal enterprises. Comparatively, subsistence family farming (70%) and informal MSEs (15%) create most of the employment (ibid.). While informal enterprises are responsible for a large number of jobs, workers in the informal sector tend to have no formal social protection. Thus, job quality within informal enterprises tends to be lower than in formal enterprises (Jütting & De Laiglesia, 2009). Nevertheless, it should be stated that informal employment also exists in formal and larger enterprises (ibid.).

*Labour force characteristics:* As the vast majority of MSEs are operated as a one-person business, it is only logical that entrepreneurs themselves formally constitute the largest category of ‘labour’. However, many owner-operated MSEs also employ unpaid family members. In their survey on sub-Saharan Africa (SSA), Mead and Liedholm (1998) found that together with the owners themselves, unpaid family members constitute up to 75% of the total labour force in MSEs. Only one-fifth of workers in MSEs are hired employees (20%) and only another tenth of workers are apprentices (10%) (ibid.). Thus, as in the case of many SSA countries, most MSEs are in fact family enterprises. Similar evidence has come up in other LMICs (De Mel et al., 2008; Hampel-Milagrosa et al., 2015; Gindling & Newhouse, 2014; Reeg, 2013b ).

*Gender:* In LMICs, about half of the micro enterprises are operated by women (Gomez, 2008; Mead & Liedholm, 1998). Even so, micro-entrepreneurship among women is often part of a multiple-livelihood strategy that involves several other activities such as additional (informal) employment, for instance as a domestic worker, and agricultural work, such as subsistence farming. As a result, female-headed enterprises are often found in activities that can be operated from home, such as retail activities, knitting, sewing, cooking, brewing and other food processing as well as repair services (Maloney, 2004). Because of home-based operations and a high degree of informality in female entrepreneurship, the latter is often ‘hidden’ and underreported in official statistical nets (International Labour Organization [ILO] & Women in Informal Employment: Globalising and Organising [WIEGO], 2013). Compared to male-headed businesses, women also tend to have less workers and pay them less. This is because women prefer a business with stable returns and income to take care of their families, rather than investing in risky business that may have higher returns and better growth prospects. This comes as no surprise, as most female self-employed are poor and highly risk-averse, and in turn are most likely to be necessity entrepreneurs. According to

the international network “Women in Informal Employment: Globalising and Organising” (WIEGO), the female self-employed are concentrated in high-poverty-risk, low-average-earnings categories (ibid.). However, Maloney (2004) argues that, given the challenges that poor women face in balancing salaried work with child-bearing and -rearing, elderly care, and household work, informal self-employment may be a relatively desirable alternative to formal jobs.

*Geographical and sectoral composition:* MSEs are distributed across various sectors and industries, such as agriculture, modern services as well as the traditional manufacturing sectors. The largest group, however, engage in petty trade and street vending (about 27%), but a substantial number operate in light-manufacturing sectors (16%) with the most common being textiles and apparel, food and beverages, and wood and forest products (World Bank 2013, pp. 110ff). In the SSA context, Mead and Liedholm (1998) show that these three categories make up about 75% of manufacturing MSEs in urban and about 90% of manufacturing MSEs in rural areas. More than half of all micro enterprises in SSA are found in rural areas and roughly 30-46% are located in urban or semi-urban areas (World Bank 2013, p. 110).

*Efficiency:* Most small enterprises, particular informal ones, focus on activities in highly saturated markets that are characterised by low entry barriers, inefficient scales of operation and low labour productivity (Altenburg & Eckhardt, 2006; La Porta & Shleifer, 2008; Little, 1987). Instead of using their competitive advantage in scope economies and in complement to larger firms, many MSEs tend to compete with various large-scale productions in mass markets (such as textiles) (see also Altenburg & Eckhardt, 2006). Micro units with no further workers generate the lowest net returns and already a small increase in size is associated with significant increases in economic efficiency (Mead & Liedholm, 1998). According to Liedholm (2002) MSEs which already involve a few more family members show significant increases in economic returns. Also, Page and Söderbom (2012) find labour productivity in medium-sized firms – measured as value added divided by employment – to be twice as high as in micro enterprises. Obviously, this relates to low capital investments and inefficient scales of operations. Moreover, as MSEs often operate as family enterprises they follow a socially harmonising rather than a profit- and efficiency-maximising logic. Consequently, many MSEs absorb additional workers – often family members – and provide them with employment even if there is no work for them; the existing work (and income) is simply distributed over a larger number of employees, thereby lowering the yield and earnings per worker and ultimately the productivity of the firm (Hampel-Milagrosa et al., 2015; Mead & Liedholm, 1998).

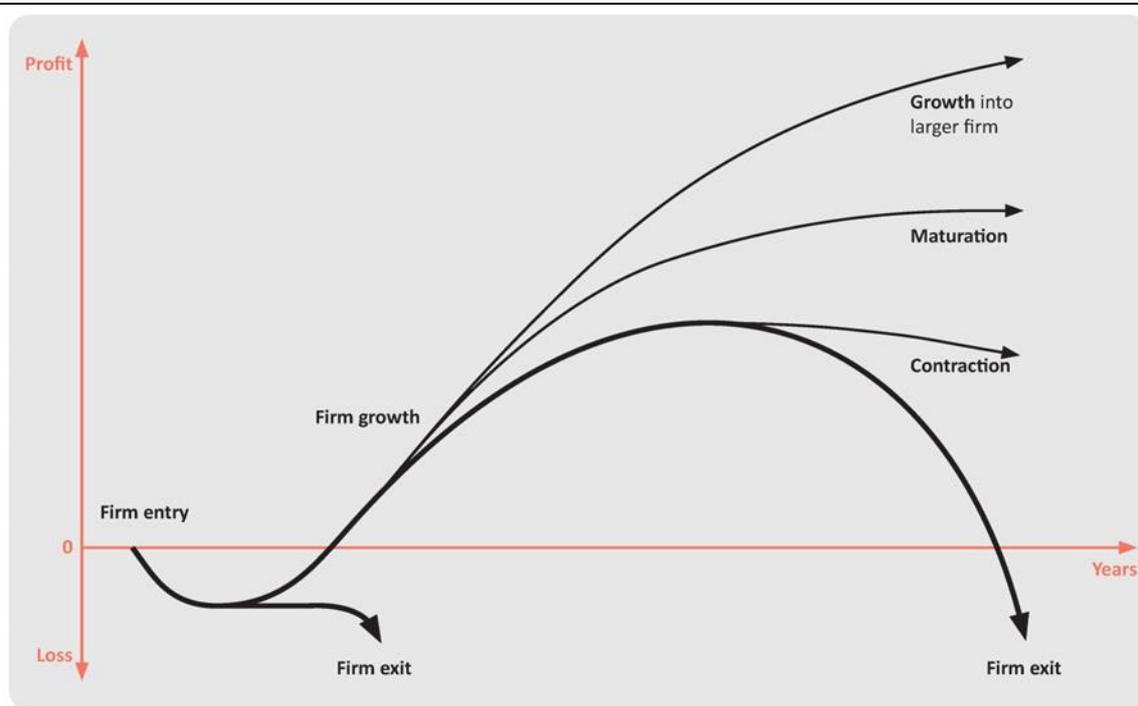
*Markets and firm linkages:* The majority of MSEs sell their products or services directly to the final consumer. Liedholm and Mead (1998) found that over 96% of MSEs surveyed in Africa sold primarily to individuals. Similarly, up to 87% of MSEs focused on final consumers in the Latin American context (ibid.). Market linkages to other firms are fairly limited. Plausibly, with the bulk of MSEs engaging in petty trading, little interaction with other businesses is required. Also, the lack of quality standards with regard to MSE produce and services might prevent institutional arrangements such as sub-contracting by larger enterprises or traders. Moreover, although clustering among MSEs, especially among manufacturing enterprises, is found in various geographical contexts, few of these clusters produce extensive inter-linkages between firms (ibid.). Several cluster studies have indicated that this might be due to low levels of trust (Knorringa, 1999; Loewe et al., 2013; Schmitz, 1995).

### 2.1.3 Dynamics

The MSE segment is predisposed to so-called ‘churning’: Especially in the small-size segment, firms are constantly being created or closed down and expanding or contracting in size at a high rate. Individual enterprises can go through stages similar to organic organisms: birth (start-up), growth (firm expansion), contraction (firms shrinking in size), and death (firms exiting) (see Figure 1). A majority of MSEs, however, never undergo a substantial growth phase, but stay micro in size before eventually exiting the market. By combining individual enterprise dynamics at the aggregate level, one arrives at the net firm creation and net firm expansion. While net firm creation accounts for new firm ‘births’ minus firm ‘deaths’ (market exits); net firm expansion accounts for firm expansion minus firm contraction. Unfortunately, as these dynamics often occur simultaneously and in opposite directions, aggregate data on MSE activity actually masks these churning dynamics.

Ideally, enterprise churning initiates a process of ‘creative destruction’, in other words a process by which new, more productive firms drive uncompetitive ones out of the market or by which more competitive firms grow and others contract (Schumpeter, 1943, 1949). According to Schumpeter, the constant change in the composition of enterprises through entry, exit, expansion and contraction is essential in developing and creating new processes, products and markets (Baumol, 2010; Schumpeter, 1943). At the aggregate level, this reallocation within and across sectors and countries eventually drives productivity growth and structural transformation in LMICs (Bartelsmann, Haltiwanger, & Scarpetta, 2004; Gries & Naudé, 2010). Enterprise development is thus at the root of transforming rural, agricultural-based societies to modern manufacturing- and service-based economies. As an essential part of this process, employment opportunities will also be reallocated from low- to higher-productivity jobs.

**Figure 1: Stylised phases of an enterprise life cycle**



Source: Author

There is only little that we know about the different life cycle phases of MSEs in LMICs. The few bits and pieces data we have suggests that a vibrant enterprise life cycle in LMICs is largely absent, that is, the churning among MSEs rarely leads to the reallocation of factors from unproductive to more productive enterprises (Hsieh & Klenow, 2009, 2011; McPherson, 1996; Mead & Liedholm, 1998). The inability to advance productivity-enhancing ‘structural transformations’ is often attributed to various market failures and institutional constraints, such as a lack of finance or a viable business strategy, holding back the entry and growth of potentially successful firms and leading to high failure rates among small firms. As a result, the entries of new firms are often as unproductive and uncompetitive as incumbent firms or firms exiting, leading to high rates of firm entries and firm exits. Mead and Liedholm (1998) find that, in the African and Latin American countries they studied, about 20% of MSEs – often one-person enterprises – entered and exited the market in the same year. This is not surprising as MSEs are most vulnerable when their owners are still learning how to operate and effectively run the business. Similar results were found in Egypt, India and the Philippines (Hampel-Milagrosa et al., 2015) and in Vietnam (World Bank, 2013) where firms tend to close down after two to three years (see also World Bank, 2013).

Likewise, limited data on closure rates makes it difficult to understand why firms close. The research by Mead and Liedholm (1998) suggests, however, that conventional assumptions about business failure may be overestimated. Only about one-third of respondents closed their businesses due to the lack of economic and financial viability. More common were reports relating to reasons such as the shortage of working capital, the prevalence of government forced-closures, personal reasons (such as illness), or the emergence of alternative earning opportunities (*ibid.*). Firms that survive are often those that grow in the initial phases extending to 2-3 years after market entry (Liedholm, 2002). This supports the notion that for new MSEs, such as start-ups, time is of the essence. Additionally, MSEs in the real estate, wood processing, wholesale trading, and non-metallic metal sectors showed higher survival rates than similar enterprises in trading, transport and chemicals (*ibid.*).

Overall, micro and small firm entry and exits are more common than the actual growth of MSEs in LMICs (see also Figure 1). Evidence suggests that only very few MSEs grow into higher size categories (Berner et al., 2008; De Mel et al., 2010, 2012a, 2012b; Goedhuys & Sleuwaegen, 2010; Hsieh & Klenow, 2009, 2011). According to Mead and Liedholm (1998) only 1% of those enterprises that are initially micro or small will expand beyond 10 employees, in other words, most MSEs are ‘non-growers’. In sub-Saharan Africa, few household enterprises hire more employees beyond the household, as revealed by research in Ethiopia, Tanzania, and Madagascar (Grimm, Krüger, & Lay, 2011; Grimm, Lange, & Lay 2011; Grimm et al., 2012; Kinda & Loening, 2008; Loening & Imru, 2009). In Mexico, the businesses of individuals setting up micro-enterprises are also more likely to remain a one-enterprise business than to expand vis-à-vis employment (Fajnzylber, Maloney, & Rojas, 2006).

The literature on MSEs distinguishes two quite different reasons for setting up a business or for becoming self-employed: necessity-driven and opportunity-driven entrepreneurship (Gries & Naudé, 2010; Berner et al., 2008). The idea is that those who start up a business or turn to self-employment simply because they have no other option are more interested in mere survival and maintaining their businesses on a small scale, while those entrepreneurs who

**Box 1: The Global Entrepreneurship Monitor (GEM)**

The Global Entrepreneurship Monitor (GEM) is a multinational research project aimed at measuring entrepreneurial aspirations and individual involvement in new business creation across the globe. A key goal of GEM is to help understand how entrepreneurship relates to economic growth and economic development. Unlike other enterprise surveys, the GEM aims to gather data on very new and smaller firms. In 2013, more than 197,000 individuals were surveyed while approximately 3,800 national experts on entrepreneurship participated in the study across 70 economies.

The GEM explores early stage entrepreneurial activity (formal and informal) by using two complementary survey components: (1) The Adult Population Survey (APS), and (2) the National Expert Survey (NES). The intent of the first survey is to systematically assess two things: the level of start-up activity or the prevalence of nascent firms; and the prevalence of new or young firms that have survived the start-up phase. First, start-up activity (the 'nascent' rate) is measured by the proportion of the adult population (18–64 years of age) in each country that is currently engaged in the process of creating a nascent business. Second, the proportion of adults in each country who are involved in operating a business that is less than 42 months old is a measure of the presence of new firms (the 'baby' rate). The second survey – the expert survey – measures perceptions of nine defined Entrepreneurial Framework Conditions (EFCs) by national experts in a respective field, e.g. finance, government policies, entrepreneurial education and training, etc.

The GEM has been criticised because it cannot effectively compare entrepreneurship in different developmental country settings. For example, in low-income countries such as Ecuador, Peru and Uganda, entrepreneurial activity and potentials are higher than in high-income countries such as Germany or Sweden. In order to be able to interpret entrepreneurial data in a more meaningful way, GEM researchers started to collect and label data according to two major categories: (a) opportunity entrepreneurship, that is, starting up a business to exploit a perceived business opportunity; and (b) necessity entrepreneurship, namely starting up a business because one has no other chance of finding employment elsewhere.

Source: GEM Homepage; Acs, Desai, & Hessels (2008); Acs, Desai, & Klapper (2008)

seize an economic opportunity or an innovative idea when starting up their firm are high-productivity entrepreneurs whose firms are likely to grow fast. Only the latter type of MSEs is regarded as being crucial for enterprise growth, employment and economic development. A major research and data-collection effort to document the 'ups and downs' as well as the different 'typologies' of entrepreneurship is the Global Entrepreneurship Monitor (GEM) (see Box 1). The GEM aims to provide a database on different stages of entrepreneurship across widely varying sets of economies and regions. GEM research on the relation between entrepreneurship and economic growth has shown that new entries of firms in LMICs tend to increase when the overall economy is weak (Ayyagari et al., 2014; Naudé, 2010). This observation supports the notion of a high prevalence of necessity- rather than opportunity-driven entrepreneurship in LMICs (see also Box 2).

This said, the conceptual differentiation of necessity vs. opportunity entrepreneurs is only helpful in a conceptual sense; as empirical experiences show, there are a large number of informal entrepreneurs who may have started their business out of necessity but who are now by all means in a position to identify and take on business opportunities (Grimm et al., 2012; Hampel-Milagrosa, 2015). De Mel et al., (2008) in Sri Lanka and Grimm et al. (2012) in West Africa have shown that MSEs can indeed be very productive and innovative. It is argued that even if only a few of these 'growth gazelles' got a chance to unleash their potential, it could have substantial implications for job creation in LMICs

(see World Bank, 2013). Similarly a three-country study of Egypt, India and the Philippines has shown that there are indeed successful medium-sized enterprises that have grown out of the (informal) micro and small enterprise segment creating a substantial number of jobs (see Hampel-Milagrosa et al., 2015).

**Box 2: Entrepreneurship, MSE dynamics and economic development**

Entrepreneurs, start-ups and micro and small enterprises play different roles in different economic contexts. Acs, Desai, and Hessels (2008) distinguish the role played by entrepreneurship according to the three stages of economic development identified by Porter et al. (2002): (1) The first stage is marked by competition through low-cost efficiencies and high rates of self-employment. At this stage MSE expansion is characterised by high levels of ‘churning’ and net firm creation. (2) In the second stage, countries (such as the BRICs group – Brazil, Russia, India, China) compete by increasing their production efficiency and educated workforce, and hence this stage is marked by a decreasing level of entrepreneurial activity because the returns for working are greater than for managing. Consequently net firm expansion is prevalent, that is, rewarding the enterprise’s growth rather than firm creation. (3) Most of the developed countries are at the third stage, referred to as the innovation stage, which is again characterised by increased entrepreneurship. According to Acs, Desai, and Hessels (2008) these economies have transformed themselves into service economies with great advances in information and communication technology that provide more opportunity and greater returns for entrepreneurship.

Source: Acs, Desai, & Hessels (2008); Porter et al. (2002)

In summary, while many MSEs are indeed initiated out of necessity, this does not mean that there is no potential for enterprise growth and expansion. What is important for governments and development agencies is the identification and support of growth-motivated and innovative MSEs (e.g. Autio, 2008; Goedhuys & Sleuwaegen, 2010). The following section will investigate the job-creation potentials of MSEs as well as job quality within MSEs.

## 2.2 MSEs, job creation and job quality: a conceptual framework

Recent cross-sectional evidence across LMICs points to the importance of small enterprises in job creation. Ayyagari et al. (2014)<sup>4</sup> found that in the formal sector small firms generate on average more jobs than larger and older enterprises – excluding informal and micro enterprises. However, at the same time, small enterprises are criticised for being not very innovative and productive. Indeed, most studies on MSMEs are not able to capture the survival rates of firms and, when they do, job creation rates do not seem to differ from those of larger enterprises (Page & Söderbom, 2012). In fact, observations based on panel data show that only a few MSEs engage in productive activities, grow and create jobs in the long-term (see Liedholm, 2002). As a consequence, some confusion exists as to how, and how much, MSEs actually contribute to the creation of jobs. The following paragraphs aim to clarify what a job is and how MSEs in developing countries contribute to job creation and the improvement of working conditions.

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4 Their sample consists of 49,370 firms in 104 countries, surveyed over the period 2006–2010. The caveats associated with this study are: enterprise surveys cover only the formal sector and exclude informal firms; there is no data on microenterprises (less than 5 employees) in the sample; Ayyagari et al. have data only on surviving firms. Given the high failure rates of small firms, the latter caveat may lead to an overestimation of the growth rates for very new firms.

What can be defined as a job is a matter of international discussion and it is difficult to reach a consensus for a large group of highly heterogeneous countries. This paper will use the broad definition set by the World Bank (2013, p. 66) that describes a job as “*activities that generate actual income, monetary or in kind, and do not violate fundamental rights and principles at work*” (see also Box 3). Using this definition allows the inclusion of informal and formal activities of the self-employed and MSEs. However, it provides a very modest account of perceptions of job quality, although this might be adequate in the challenging economic and social settings in LMICs.

**Box 3: Definitions: jobs and employment**

Across countries, the International Conference of Labour Statisticians (ICLS) sets standards in defining terms for official employment statistics. According to the ICLS, a ‘job’ is “*a set of tasks and duties performed, or meant to be performed, by one person, including for an employer or in self-employment*” (World Bank, 2013, p. 63). Further, according to the ICLS, a ‘job’ is differentiated from the term ‘employment’. While the former describes the activities that need to be done, the latter relates to the people performing them: one person can have a multiple number of jobs but be either employed or self-employed.

Obviously, clear-cut classifications are difficult to set for the majority of low- and middle- income countries (LMICs) as jobs are much more diverse and working hours and the characteristics of jobs vary substantially. For example, jobs containing a stable employer-employee relation are rare in LMICs. Self-employment and subsistence farming are dominant. Sometimes those few wage employees might also be self-employed and hire (unpaid) family labours to increase their income, as in the case of household enterprises. What is also problematic is the fact that the ICLS excludes household work, elderly care, childrearing and other non-monetary activities from its definition. Correspondingly, informal activities or informal jobs are not accounted for. Finally, statistical definitions are not subject to international norms of basic human rights as defined by the United Nations Universal Declaration of Human Rights (1948) and the International Labour Organization Declaration on Fundamental Principles and Rights at Work (1998).

For this reason, the World Development Report provided a merged definition of jobs as “*activities that generate actual income, monetary or in kind, and do not violate fundamental rights and principles at work*” (World Bank, 2013, p. 66). This definition includes categories, such as wage or salary employment, employers, members of cooperatives, family workers (including unpaid family members), and the self-employed.

Source: World Bank (2013)

Generally, MSEs can contribute to job creation in two ways: (1) Employment creation as the emergence of new jobs in existing MSEs (*enterprise growth*), and (2) job contributions that arise by the creation of new MSEs, such as through start-ups and the self-employed (*enterprise creation*).

Macroeconomic evidence suggests that the stage of economic development as well as the current state of the economy have an impact on the patterns as to how MSEs grow and create jobs (Bartelsmann et al., 2004; see also Box 2). If an economy is competitive and strong, MSEs tend to grow and add additional workers to their businesses. In this case, in the MSE segment more jobs might be created from net firm expansion (*enterprise growth*) than from net firm creation (*enterprise creation*). The latter form of MSE growth, that is, an increase in the total number of MSEs entering the market, tends to occur when the economy is weak and provides only a few opportunities for wage employment. In this case there is enormous pressure on individuals to start their own jobs as ‘necessity’ business, even if these yield only marginal returns.

As a consequence, not all jobs created by MSEs are productive and conducive to economic development and poverty reduction. Increased employment opportunities in less productive job sectors, such as necessity self-employment, may not be enough to alleviate poverty. As work in this segment is characterised by low earnings and poor working conditions, a simple reproduction of similar job opportunities will lead to an increase of underemployment and/or exploitation. Similarly, an unprofitable enterprise that hires additional workers lowers its productivity, returns and investments for growth. Thus, to be able to contribute to poverty reduction, it is not only important whether MSEs generate new jobs, but also whether these jobs are stable enough to prevail during economic shocks and whether they offer decent working conditions. Hence, in order to make MSEs drivers of productive job creation and decent working conditions three conditions have to be met with regard to: a) productivity growth; b) employment growth; and c) job quality (see also Figure 2).

#### a) Productivity growth

In theory, low-productivity jobs disappear if high-productivity jobs are created by innovative MSEs or new firm entrants. However, for many middle- and low-income economies – and even in high-income economies – it has been found that productive jobs never completely substitute jobs in low-productivity segments; in other words, the latter are often found to co-exist in the informal sector, especially in the services sector, where entry barriers are low (Altenburg & Eckhardt, 2006; Chen, 2005; Jütting & Laiglesia, 2009; La Porta & Shleifer, 2008; McMillan & Rodrik, 2011). Micro and small businesses themselves need to become more productive and profitable in order to contribute to the expansion of high-productivity jobs. Research suggests that across high-, middle- and low-income countries increased returns, productivity growth and improved competitiveness among MSEs is strongly associated with the implementation of innovative activities (Dutz et al., 2011; Schumpeter, 1943, 1949; Szirmai et al., 2011). Innovative activities in LMICs can be defined as relative practices of a firm doing business differently in a way that allows higher-than-average returns ('innovation rents') compared to competitors (Porter, 1998; Schumpeter, 1943, 1949). These innovative practices can refer to various activities such as the introduction of new products, new production or marketing methods or tapping into new markets (Dutz et al. 2011). For developing economies, it can be argued that productivity growth among small businesses is largely due to efficiency gains – how to do things better and faster (World Bank, 2013, p. 102; Acs, Desai & Hessels, 2008; see also Box 2). This suggests that among high-potential MSEs the introduction of new products, production methods, technologies and organisational renewal will be most prevalent (Dutz et al., 2011).

#### b) Employment growth

Though the association between innovation and productivity is quite pronounced, the relationship between productivity growth and employment growth is mixed. Statistically speaking, the relationship between growth and employment varies substantially over time, across countries, and across sectors showing that a given rate of enterprise growth will not automatically lead to a given level of employment growth. In fact, concerned scholars have observed the phenomenon of 'jobless growth' in Latin America, Africa and India (Aryeetey & Baah-Boateng, 2007; Jemio & Del Carmen Choqu, 2006; Mehta, Shepherd, Bide, Shah, & Kumar, 2011). Theoretically, after an increase in enterprise growth has occurred, three employment scenarios are possible: innovations within a firm can lead to firms expanding (1), stagnating (2) or decreasing (3) in employment (see Figure 2).

*Firm expansion (1):* MSEs may experience increases in productivity growth and employment growth simultaneously (Baily, Bartelsman, & Haltiwanger, 1996). This job-creation scenario is probably the one most wished for by policymakers and development practitioners. The World Development Report 2013 on jobs highlights experiences of these ‘upsizers’ achieving both productivity and employment growth in manufacturing firms in Chile, Romania and Ethiopia (World Bank 2013, pp. 101ff). Over the period 2001-2006, the Report finds that one-fourth of manufacturing plants in Chile are successful ‘upsizers’ (ibid.). Within a time span of 5 years, similar percentage shares were found in Romania and Ethiopia. Further, using the World Bank Enterprise Survey (WBES), Dutz et al., (2011)<sup>5</sup> provide evidence that firms that innovate in products or processes, or that have attained higher total factor productivity, exhibit higher employment growth than non-innovative firms. Also, this effect is most profound for MSMEs. Moreover, in contrast to dominant beliefs that innovative firms create jobs only for the highly educated, qualified and privileged, Dutz et al. (2011) find that in many cases innovation-driven employment growth is significantly positively associated with the share of the firms’ workforce that is unskilled. Thus, innovation at the firm-level can, in fact, lead to inclusive enterprise growth. This suggests, that the preferred job creation scenario of ‘inclusive’ firm expansion is probably not as uncommon as conventional pessimism on job-creation prospects for the poor would let us to believe. However, one might still assume that the impact on the unskilled workforce is likely to vary according to the level of technological sophistication applied in a firm. For example, a firm starting at a very low level of technology usage might notice stronger immediate impacts on the creation of jobs compared to a firm that already started with a high level of technological sophistication.

*Firm stagnation (2) and firm contraction (3):* The most common viewpoint is that increased productivity at the firm level goes hand in hand with the downsizing of numbers of employees or a reluctance of firms to hire additional workers (Bartelsman et al., 2004; Tybout, 1996). Thus, a firm’s innovative activities may result in the growth of turnover and sales but not employment. This is the case if a firm produces the same level of output with fewer inputs (*firm contraction*), or more output with the same inputs (*firm stagnation*). These labour-saving displacement effects are most likely driven by process innovations and increased efficiency. This said, while the immediate effect of employment contraction might persist over time, cost reductions within the firm could spur further demand and incentivise firms to create more output, for which they in time might need additional workers. Such a counterbalancing dynamic could have a compensating effect, and eventually lead to firm expansion. In fact, Liedholm (2002) has already pointed at the lumpy nature and time inconsistency of employment growth within firms. While labour-saving effects might dominate in the short-term, one could argue that, with a lag after a sizeable growth in real sales, compensation effects will prevail in the medium- and long-term. Thus, for most cases of productive and innovative MSEs, their growth is only jobless in very few cases.

Finally, a major *caveat* to decipher MSEs contribution to net job creation is that, regardless of the nature of the shift in jobs, almost inevitably jobs are created in some firms and destroyed in others. While the growth or the start of a productive MSE is a precondition for

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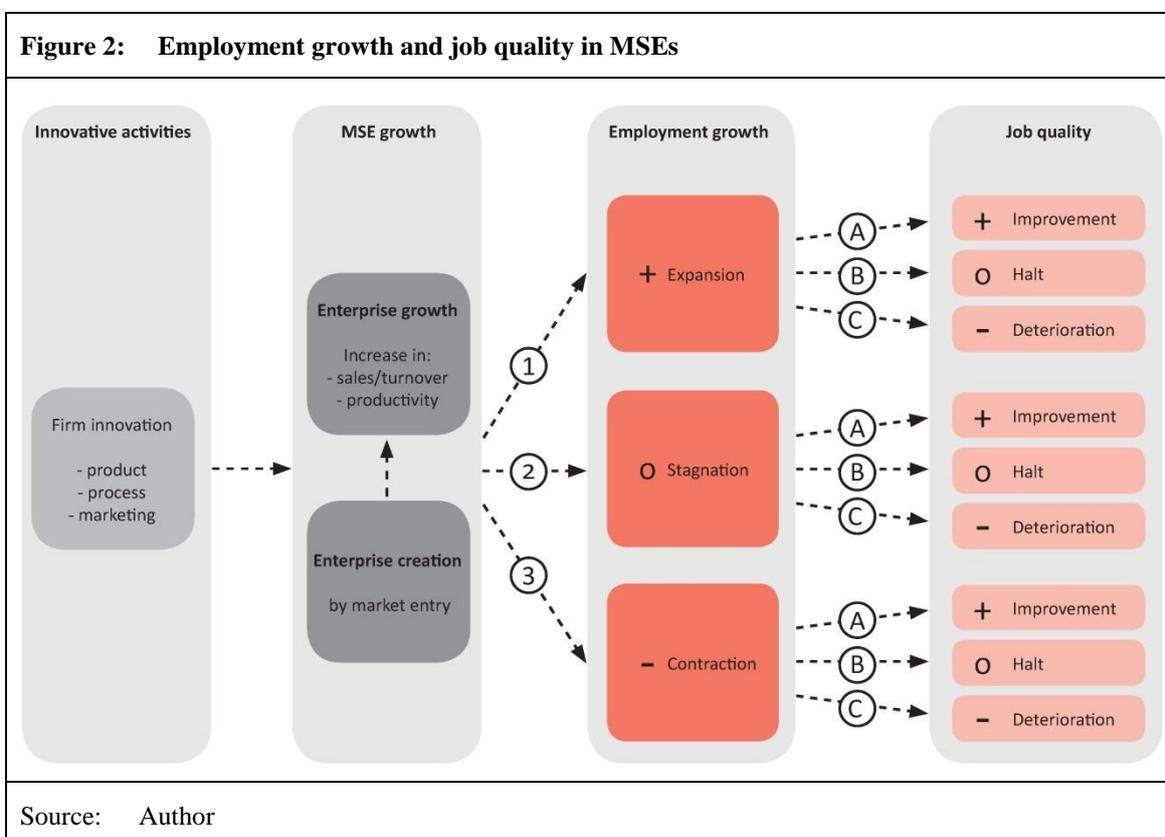
5 Dutz et al. (2011) base their research on a sample of more than 26,000 manufacturing establishments across 71 countries (both OECD and developing).

the creation of jobs within the MSE segment, it is all but clear whether this also results in a net increase of national employment. Even if an MSE's innovation creates employment, this may result in the crowding-out of competitors: The innovative firm conquers market shares at the expense of other MSEs which have to reduce the number of their employees, pay lower wages or even close down completely. The net effect on national employment may still be positive, but that should not be taken for granted.

And, even if the quality of employment improves while the net effect on the quantity of employment is negative, it is hard to judge whether the overall change is desirable or not. For example, there might be cases where job creation and quality improvements in working conditions are to the benefit of the already privileged, educated and better qualified, making MSE growth less inclusive for larger segments of the poor. Or, in other cases, the growth of a particular sort of MSE might encourage the development and employment growth of other MSEs making their development interdependent. Accordingly, it is important to keep in mind that, so far, there is no reliable means by which one could decipher or anticipate the indirect effects that the growth and expansion of a particular MSE might have on its environment.

c) Job quality

Another central element is the quality of jobs generated by MSEs (see Box 4). Following the ILO (2009) definition of productive employment, a productive job has to offer sufficient returns to permit the self-employed, workers and their dependents a level of consumption above the poverty line. Thus the first crucial aspect of a quality job is a sufficient level of income as well as income security. However, in 2013 the ILO estimated that around 839 million workers worldwide – that is about 27% of total employment – lived on USD 2 a day



or less (ILO, 2014a). In addition, worldwide 48% of the global population work under vulnerable employment conditions, that is, they are self-employed or work as contributing family workers with low and unreliable income (ibid.; ILO, 2009).

The quality of a job is further defined by its working conditions. The concept of ‘decent work’ refers to these conditions by adding quality dimensions such as the absence of coercion (no slavery, no child labour), equity at work (equity of conditions and opportunities for all workers), security at work (health, pensions, security against job loss), dignity of work, and decent working hours, that is, working not more than 48 hours per week (Szirmai, Gebreyesus, Guadagno, & Verspagen, 2013). While the need for these additional non-wage qualifiers is widely recognised, most of these rights remain unfulfilled. For example, the ILO estimates that in 2013 only 27% of those working have access to social security systems while the rest is only partially covered or not at all (ILO, 2014b).

**Box 4: Job quality, quality of employment and decent work**

Policy actors and researchers have recognised that not only the number, but also the quality of jobs matters to poverty alleviation and economic development (ILO, 2014d). Yet, though it is easy to reach a consensus on its relevance, there is no universal agreement on what constitutes a good job. There have been various attempts by researchers as well as institutions, such as the International Labour Organisation (ILO) and the European Union (EU), to develop a theoretical concept of quality of employment. However, it is because of the multiple facets of jobs that the existing conceptual terminology is rather confusing: Job-related terms range from ‘quality of working life’, ‘job quality’ or ‘quality of work’, to ‘quality of employment’ or ‘decent work’. While the first term deals with worker’s perceptions of their jobs, the second group of terms relates to aspects of the work environment and the job content, including skill variety, task significance, and autonomy. ‘Quality of employment’ and ‘decent work’ on the other hand cover most of the preceding job aspects, but also extend their analytical focus beyond particular work environments to more aggregated measures of labour market relations and systems.

As a consequence, most of the academic literature has combined theoretical conceptualisations on job quality with direct methodological considerations on how to operationalise and measure them. There are generally two kinds of indicators to measure job quality: subjective and objective indicators. The first refer to indicators such as job satisfaction and other measures of perceived wellbeing, which, however, tend to suffer from self-report bias and are not as popular due to the lack of comparability. Objective indicators focus on the characteristics of jobs, such as income, working hours, job security and non-wage benefits, for instance, contributions to basic social protection, health plans and training. In some cases, research has also used sets of mixed indicators; however, what appears to be striking is that work on overly comprehensive job quality concepts and wide-ranging indicators of job and employment quality are rather limited. Instead, the most prominent works are those with fairly simplistic concepts and narrowly-defined indicators.

This stands in contrast to institutional efforts – most prominently ILO’s Decent Work agenda launched in 1999. Since the beginning, the conceptual underpinnings of decent work have been criticised by researchers and policymakers as being too vague and too broad to be used as a tool driving research and policy insights. Set up as a mission statement of universal values, decent work encompasses all levels and aspects of job quality ranging from characteristics of individual workers to aspects of their work environments and labour markets, including social protection and labour regulations. As decent work has remained vague, the ILO has still not produced a universally applicable methodology for its measurement. Furthermore, the paucity of reliable and internationally comparable data as well as the political influence of employers’ organisations, trade unions and governments over the ILO’s research agenda have led to a stalemate. For the sake of promoting the topic of employment quality, generating internationally comparative data on working conditions becomes crucial in moving forward. As long as there is no political will to commit to the implementation of standardised labour force surveys there will be no further insights on job and employment conditions in the near future.

Source: Burchell, Sehnbruch, Piasna, & Agloni (2014)

In regard to these two aspects of job quality, MSE owners and workers tend to be disadvantaged. Job quality within the formal MSE segment is found to be lower than for formal medium- and large-sized enterprises (Ayyagari et al., 2014). Large firms show higher productivity growth, and are therefore more likely to offer more high-quality jobs (ibid.). In contrast, MSEs tend to be less productive and therefore tend to provide less quality jobs with lower incomes and less job security to their owners and workers. An example would be when workers work very long hours (reaching 55 hours per week) and receive payments at a piece rate rather than in weeks or months (Goedhuys, 2002). Besides, MSEs hire workers with fewer skills and less experience, which in turn leads to low productivity and explains why the wage gap between smaller and larger enterprises prevails (ILO, 2014c).

What's more, MSE owner's and worker's rights as well as their social security are more limited than in larger firms. This is partially a phenomenon of informality among MSEs. For example, unionisation is absent or exists only at a very low level (ILO, 2004). Also, informal MSE owners and workers have no access to benefits such as unemployment insurance, sick leave, education, and health insurance (Goedhuys, 2002).

Thus, a *good quality job* as defined by the combined dimension of productive employment and decent work is a rare case within an MSE. Against this background and for the purpose of this paper, I will define a good quality job more simply as one that does not violate basic human rights and that provides an income or wage above the poverty line of USD 2 a day (see also Gindling & Newhouse, 2014).

Referring to Figure 2 there are three potential trajectories of how MSE growth can impact job quality: job quality can (a) improve, (b) come to a halt, or (c) deteriorate. Following these three scenarios, job improvement can essentially be understood as an increase in the income and wages of the employed or self-employed, holding working hours constant. Similarly, a reduction of working hours, while holding income and wage constant, can be interpreted as an improvement. Further, an increase of benefits and the introduction or extension of rights to MSE workers can be defined as a clear improvement. For example the introduction of social security and health care contributions, free transportation or free meals can be seen as a significant improvement in working conditions. A halt in job quality takes place if there is no substantial change in any of the mentioned job qualities. A deterioration is associated with a decrease in income, income security and the dismantling of previously gained job benefits, e.g. free meals, work hour autonomy, free transport, and so on.

Along with the transformation of MSEs into a more productive enterprise segment there might be trade-offs between the number and the quality of jobs generated. While improvements in job quality might always offset reductions in the number of jobs, deteriorations or a halt in job quality might fall under the category of 'jobless growth' – given that the MSE did in fact grow in productivity, sales or turnover. This said, in some cases reductions of job quality might be a necessary measure if companies wish to stay competitive, particularly in high-income countries where non-wage benefits are quite extensive (for instance, holiday pay and Christmas bonus). However in most low- and middle-income countries a halt or the deterioration of working conditions often has far-reaching implications for the health and wellbeing of the self-employed and workers and thus signifies a clear step backwards.

### 3 Enterprise growth and job creation: what matters to MSEs?

Only very few MSEs in LMICs manage to grow and expand in employment. However, those few formal MSEs that do manage to grow into higher-size categories can, in fact, be held responsible for the bulk of job creation among MSEs (see Ayyagari et al., 2014).<sup>6</sup> This hints at the potential that some MSEs hold in creating considerable productivity and employment gains (De Mel et al., 2012a; Grimm et al., 2012). However, the fact that only a very small group of micro and small entrepreneurs survives and grows also suggests that several growth barriers and constraints exist which impede the productive reallocation of jobs. Researchers and policymakers have therefore been interested in identifying the factors that constrain and drive enterprise growth. Moreover, there is a keen interest in understanding what it takes for MSE growth to also translate into additional productive jobs, and into an increase in workers' wages or an improvement of their working conditions.

Different strands of literature propose a number of factors determining whether an enterprise can grow, expand in employment and increase job quality: Some highlight the internal qualities of the firm while others focus on the external conditions that enterprises face in a country or a region. These two groups of internal and external factors can be assigned to four broad categories: (1) entrepreneur characteristics (such as education, age, gender); (2) enterprise characteristics (informality, location, R&D); (3) networks (both personal and professional) and the (4) business environment (regulation, infrastructure, access to finance) (see the 'Onion Model' displayed in Figure 3).

In order to assess the employment intensity and employment quality of MSE output growth it is essential to identify what factors drive enterprise growth in output and returns. In terms of assessing the performance of a firm, empirical research prefers to investigate financial ratios such as profits, revenues, returns on investment (ROI), and returns on sales or equity. However, because of confidentiality, completeness, accuracy and inaccessibility, the majority of studies on enterprise growth in LMICs choose the change in the number of employees as a non-financial measure and proxy indicator to measure the magnitude of growth in output (see also Mead & Liedholm, 1998). Thus, in many cases, studies on MSE growth are, in fact, already measuring employment growth rather than the actual growth in output. Liedholm (2002) points out that this practice might lead to systematic underestimation of micro and small enterprise growth. For example, in Kenya, Parker (1994) found that the real sales growth of the MSEs studied was almost double the growth in employment. This observation supports the idea that the employment effects only translate after a substantial lag in time of MSE growth in sales and output, and that a substantial increase in returns is required to sustain productive employment growth.

Unfortunately, despite the insight that the job quality within MSEs matters for poverty reduction, there is insufficient empirical research in this area. While there is a broad consensus that the link between enterprise growth and job quality is not automatic, there have been relatively few attempts to systematically unpack the relationship and the drivers

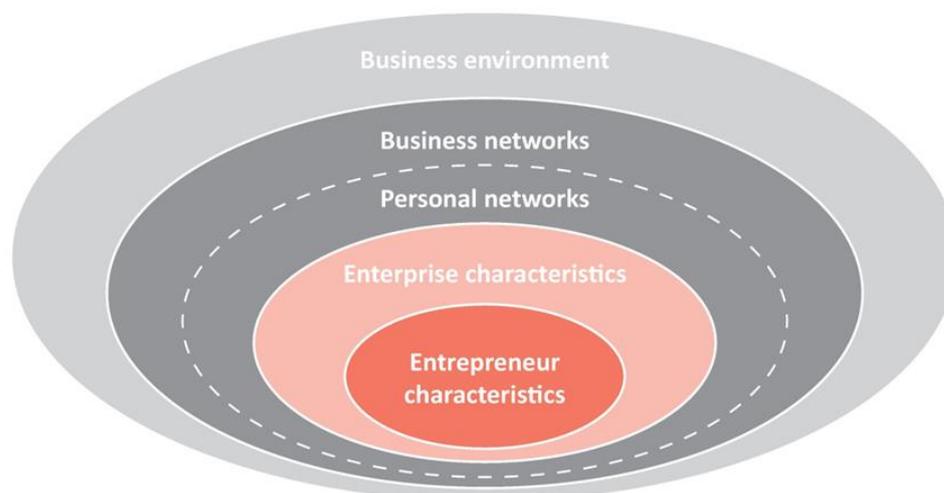
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6 The study's sample consists of 49,370 firms in 104 countries (largely LMICs), surveyed over the period 2006–2010. The caveats associated with this study are: enterprise surveys cover only the formal sector, excluding informal firms; there is no data on microenterprises (less than five employees) in the sample; Ayyagari et al. have data only on surviving firms. Given the high failure rates of small firms, the latter caveat may lead to an overestimation of the growth rates for very young firms.

between MSE growth, MSE employment growth, and job quality. Though in special cases the measurement of more wide-ranging job characteristics might be possible, no internationally comparable data sets on such comprehensive concepts as the ILO's Decent Work agenda exist (see Box 4).

The fact that in low- and middle-income countries wage work in the formal economy is the exception to the rule and an estimated 60% of those working in the informal sector are in fact self-employed microentrepreneurs with help from unpaid family labour but no wage workers, calls into question how the concept of decent work could be usefully operationalised in these contexts (Jütting & Laiglesia, 2009; Maloney, 2004; see also Box 4). Thus, deficiencies in data on MSEs and their working conditions as well as conceptual challenges may each explain why so many questions are unresolved to date. As a result, the few empirical research efforts on job quality in MSEs have preferred to use more restrictive notions of job quality by measuring the level of income of owners or workers or other selected criteria, such as job security (see also Gindling & Newhouse, 2014; Goedhuys, 2002).

**Figure 3: The onion model**



Source: Reeg (2013)

When one reviews the evidence on the growth of MSEs into larger size categories, it is partly necessary to fall back on SME evidence. There are three reasons for this: in order to find out what drives growth in MSEs, one must first analyse the growth trajectories of those large and medium-sized firms that started as micro and small in size; second, due to lack of data on MSEs and especially informal firms, it is partly necessary to analyse dynamics within slightly larger enterprises such as small and medium enterprises that could be applied to smaller firms; and thirdly, a large part of the literature refers to the umbrella term 'MSMEs' (micro, small and medium enterprises), rather than to specific size brackets within this group.

Studying MSE dynamics has led to the insight that there is no single factor but rather a number of factors from internal as well as external categories that drive enterprise development and job creation (see also Figure 4). Clearly, depending on the local context, some factors might play a more or less pronounced role. With regard to the driving

determinants of enterprise growth, employment growth and improved working conditions in MSEs, the following key insights arise:

- 1) In their attempt to improve their performance and add workers, MSEs generally face these most salient growth constraints:
  - *MSEs struggle with regulatory ambiguity and deficits in law enforcement:* Generally speaking, for many MSEs, complying with business regulations and labour laws is associated with costs and only very few benefits. Thus, the incentives to grow beyond a certain threshold do not generally outweigh the costs of being formal. Formal MSEs struggle to cope with ambiguities in the scope, depth and application of laws leading to unfair competition with informal units and larger formal enterprises. Additionally, deficits in law enforcement create additional costs for MSEs that few are able to shoulder. Thus, while overregulation inhibits entrepreneurial dynamics and learning among MSEs, the withdrawal of state support and a rather minimalist approach to regulation tolerates the law of the most powerful, unfair competition<sup>7</sup>, and bad working conditions leading to an MSE 'growth trap' (Altenburg & Von Drachenfels, 2006).
  - *MSEs suffer from unreliable infrastructure:* The quality of infrastructure significantly determines how efficiently and effectively a business can offer products and services. With uncertainties about the availability of infrastructure services, entrepreneurs will make fewer complementary investments in technologies and new operating systems (such as machinery and digitalisation). Among dynamic and growing MSEs, deficits in the quality of transport and energy are reported most frequently.
  - *MSEs lack access to adequate finance:* Access to finance has not yet been shown to increase MSE's returns and employment but helps entrepreneurs to sustain and secure existing jobs. However, a possible explanation is that financial systems in LMICs are leaned towards a dual system with traditional commercial finance providers, and a smaller group of alternative financial institutions that are specialised in pro-poor- and micro-credit loans. Both fail to address the needs of job creators, which is why the latter are likely to use their own financial resources or that of informal networks. Targeting young, and growing MSEs with more adequate financial services might however unleash a stronger growth and employment impact.
  - *MSEs lack access to markets:* Due to their size, MSEs tend to have limited market outreach and are therefore rarely exposed to business networks that provide access to state-of-the art technologies, information and business practices. Larger, and globally operating firms rarely source directly from small firms due to high transaction costs and a lack of economies of scale and quality standards, as well as concerns over flexibility, timely delivery and other service capabilities. This further lowers the incentives for MSEs to make crucial investments in innovation and learning that could eventually drive job creation and improvements in job quality.

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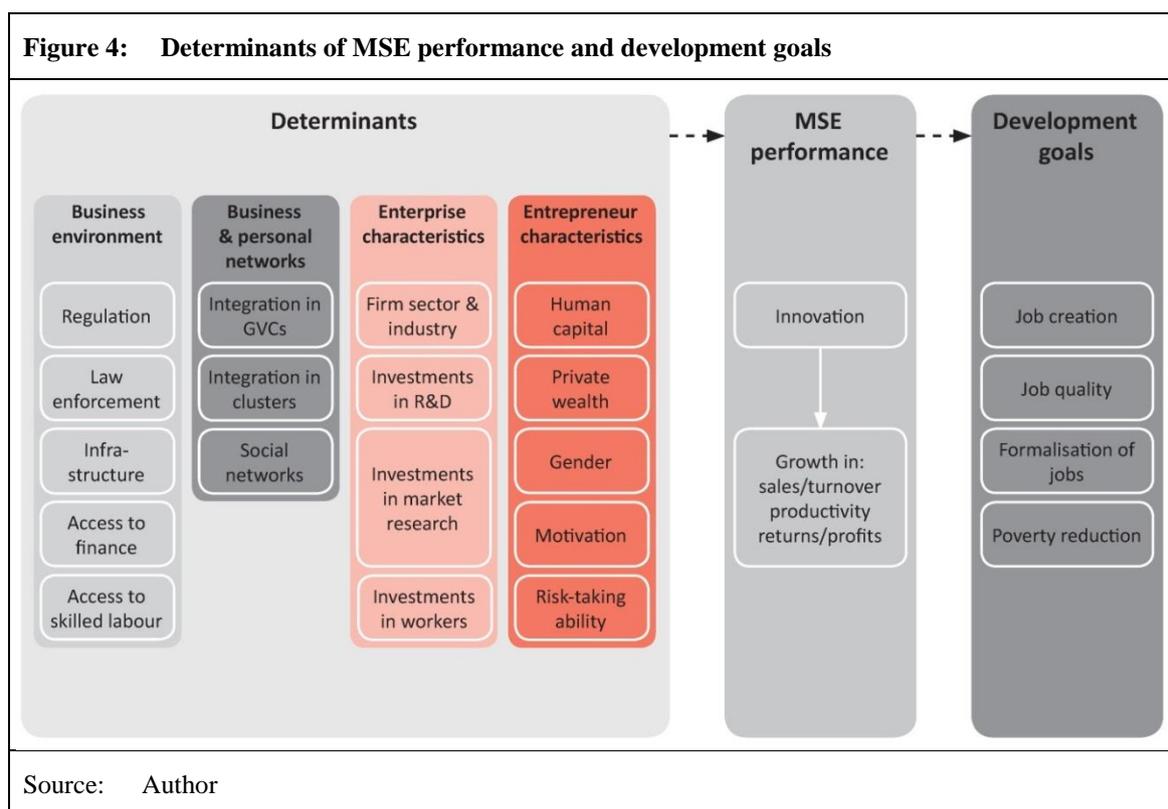
7 This can be described as actions of a competitor that actively harm the position of others with respect to their ability to compete on equal and fair terms. This may include 'below-cost' selling, counterfeiting or imitation, dumping, misleading advertising, rumour mongering, trademark or trade secret infringement, and other unethical commercial practices.

- *MSEs struggle to find trained and skilled workers:* A lack or a shortage of skilled labour negatively impacts MSEs, especially those that engage in labour-intensive activities. In the case of labour-intensive industries, the word ‘skill’ is often associated with workers who are able to operate modern machinery, such as power-looms in the textile industry. Thus, without access to skilled labour, MSEs will hesitate to make the complementary investments in modern machinery and production methods.
  - *MSE owners tend to suffer from educational and management deficits:* Higher levels of education, practical training as well as work exposure are considered to impact strongly on the entrepreneur’s capability to seize market opportunities, cope with problems and increase a business’ growth performance and employment potential. However, a large number of MSE owners have deficits in educational attainment, management training and work experience in a relevant field.
- 2) Studies have revealed several key characteristics as important determinants of MSEs that manage to grow, expand and improve working conditions. These job creators and/or job improvers have the following characteristics:
- *They tend to be privileged:* Growing MSEs are often run by male-owners who are better endowed with human capital (education, training and work experience), more motivated, more courageous and more willing to take risks. They are also more likely to have acquired some personal wealth before starting and expanding their business. Thus, job creators are not poor, but have more privileged backgrounds.
  - *They tend to be located in growing industries:* The sector and industry in which an enterprise operates also significantly impacts on its potential to grow and increase its number of employees. MSEs are more likely to add employees if they operate in booming industries in which demand for products and services is increasing.
  - *They invest in R&D, market research and workers:* The level of R&D and market research spending as well as investments in human resource development (HRD) are reported to significantly influence the ability to add more skilled workers and become more productive.
  - *They do not have to be formal, but they will likely formalise:* Informal opportunity-driven entrepreneurs with viable business ideas and necessary capabilities often choose not to formalise due to the recurrent costs of being formal and the low perceived benefits of formalisation. Once perceived benefits, for instance access to finance or contracts with buyers, outweigh the costs, MSEs tend to register.
  - *They are embedded in affluent networks:* Supportive *private* as well as *professional networks* are a further characteristic of expanding MSEs. Family wealth and personal securities assist entrepreneurs through economic shocks, while professional ties with lead firms in clusters or global value chains provide MSEs with access to trade credit, information and markets. In particular, linkages with successful medium-sized enterprises have been shown to provide a number of advantages (information, finance, market access) to MSEs.

In summary, empirical observations indicate that only a very small group of well-endowed, privileged entrepreneurs manage to overcome growth constraints by compensating structural and individual deficits (De Mel et al., 2012a, 2012b; Gries & Naudé, 2010; Hampel-Milagrosa et. al., 2015). This is not to say that poor entrepreneurs are incapable of growth

but only that these are less exposed to the factors, resources and networks driving an MSE’s capacity to manage and overcome growth constraints. Based on experiences in LMICs, a simplified overview of the most salient factors influencing MSE growth and employment outcomes can be seen in Figure 4.

The rich number of determinants requires a structured review of the four onion layers conceptualised in Figure 3: entrepreneur characteristics (1), enterprise characteristics (2), personal and business networks (3) and the business environment (4). In accordance with these four layers, the subsequent sub-sections will present insights from the empirical literature in more detail. Whenever specified, the literature quoted will refer to either enterprise growth, employment growth or aspects of job quality.



### 3.1 Entrepreneur characteristics

Most MSEs are one-person businesses that are supported by unpaid family members and have little or no hired staff (De Mel et al., 2008; Gindling & Newhouse, 2014; Hampel-Milagrosa et al., 2015; Liedholm, 2002; Reeg, 2013b; World Bank, 2013). This suggests that micro- and small entrepreneurs hold a high degree of control and oversight of business activities and performance. For that reason it is intuitive that the characteristics of the entrepreneur should have a strong impact on enterprise growth, the decision to hire additional workers, and the improvement of working conditions. The most important entrepreneur characteristics quoted by the literature are human capital (including work experience and training) (Eifert, Gelb, & Ramachandran, 2005; Mead & Liedholm, 1998), entrepreneur age (Cortes, Berry, & Ishaq, 1987), gender (McKenzie, 2009a; McPherson & Liedholm, 1996) as well as motivation (De Mel et al., 2008) and risk-taking ability (Szirmai et al., 2011).

## a) Human capital

Higher levels of education, practical training as well as work exposure are considered to impact strongly on an entrepreneur's capability to seize market opportunities, cope with problems and increase a business' growth performance and employment potential. An entrepreneur's motivation to grow, skill set (namely: financial literacy, managerial and communication know-how, etc.), self-confidence and other creative capacities are expected to go hand-in-hand with better educational performance as well as with years of training and work experience. Studies suggest that entrepreneurs who are successful in running a profitable business and employ hired staff tend to be better educated and trained (De Mel et al., 2008; Fafchamps & Woodruff, 2012; Gindling & Newhouse, 2012; Grimm, Krüger, & Lay, 2011; Grimm, Lange, & Lay, 2011; Hampel-Milagrosa et al., 2015; Mead & Liedholm, 1998). In contrast, businesses that perform badly tend to be associated with owners who have little or no formal education or training. These survivalist entrepreneurs are therefore more likely to show characteristics similar to those of wage workers (De Mel et al., 2008). Beyond formal schooling, the literature suggests that learning how to apply knowledge and skills within a relevant work and training environment is nearly as important. Parker (1994) found that the businesses of entrepreneurs in Kenya who had worked at least 7 years prior to the small business start-up did indeed grow faster than those of entrepreneurs without prior work experience. In sub-Saharan Africa, McPherson (1996) and Parker (1994) found that entrepreneurs with vocational training and those who gained experience working in another business owned firms that grew much faster than those owned by proprietors without previous work experience. Also a study in Ethiopia shows that successful entrepreneurs managing medium to large-sized manufacturing enterprises started their careers in trading companies which exposed them to market information and business practices (Ostuka & Sonobe, 2011). Similar patterns are found in Russia, China and India implying that former work exposure and training is a crucial source of knowledge-transfer and informal learning opportunities (Djankov, Edward, Qian, Roland, & Zhuravskaya, 2005, 2006; Reeg, 2013b). In addition, work experience has been found to enhance professional and social networks, which are helpful in accessing financial resources, management advice and identifying business opportunities as well as accessing skilled workers (Eifert et al., 2005; Hampel-Milagrosa et al., 2015).

## b) Age

Some scholars suggest a positive or negative association of an entrepreneur's age and a firm's propensity to grow and expand in employment. Data so far is inconclusive. In Colombia, Cortes et al. (1987) find that older entrepreneurs are unable or unwilling to expand their businesses. They argue that younger individuals may be more willing to assume risks and expand their business in contrast to firms that are run by more mature business owners. This is also supported by a recent study in Sri Lanka where the firms of older business owners are found less likely to grow (De Mel et al., 2008). However, while younger individuals may have more motivation to expand their businesses, they may also have fewer financial resources, less experience and fewer networks. McPherson (1996) tested data collected from five sub-Saharan African countries and found that the effect of the entrepreneur's age on enterprise growth was inconsistent. However, with regard to the age of the enterprise itself, young firms seem to be more dynamic than older ones (see Sub-section 3.2).

c) Gender

The literature on MSEs and self-employment often argues that women entrepreneurs in LMICs are less likely than their male counterparts to be in favour of growth of their firm due to their reproductive roles as well as their responsibilities as the main carers for children, the elderly and other family members with special needs (Berner et al., 2008; De Mel, 2008; Grimm, Krüger & Lay, 2011). Most female-led micro enterprise activities are found to be part of a multiple livelihood strategy that involves income from several sources such as formal employment, farming, outsourced home-work, and plantation labour (Berner et al., 2008). In contrast, male-led enterprises are less likely to be part of a multiple livelihood strategy (ibid.). Indeed, most studies find gender to be significantly associated with firm growth (Fafchamps, McKenzie, Quinn, & Woodruff, 2011; Fajnzylber et al., 2006; Liedholm, 2002; Maloney, 2004; McKenzie, 2009a; McPherson, 1996). In Sri Lanka De Mel et al. (2008) find female-led enterprises are less likely to add employees and are more risk averse. The average female self-employed are also often found to have fewer characteristics similar to growth-oriented entrepreneurs: they have lower levels of education, training and relevant work experience (De Mel et al., 2012a; Liedholm, 2002; Olomi, Nilsson, & Jaensson, 2001).

However, while the association between gender and the growth of a firm is strong, several researchers highlight that the relationship is not causal and that growth-oriented women-led enterprises also exist (Minniti & Naudé, 2010). In fact, Loewe et al. 2013 find that growth-oriented female entrepreneurs in Egypt do not face any more difficulties than male entrepreneurs in expanding their companies. Thus, while it surely cannot be generalised across all LMICs, qualitative evidence suggest that gender *per se* is not a constraint to enterprise growth. Nonetheless, structural constraints in the social and business environment may create uneven opportunities for male and female entrepreneurs to start up growth-oriented enterprises that have a greater potential to create jobs (Berner et al., 2008; Hampel-Milagrosa et al., 2015; Loewe et al., 2013; Maloney, 2004; Olomi et al., 2001; Reeg, 2013b).

d) Psychological traits

Successful entrepreneurship is associated with certain psychological traits such as growth-motivation, risk-taking ability, need for achievement, self-confidence and optimism. Having said that, these are difficult to observe and measure. In the context of LMICs, the most prominent empirical work on this subject has been done by De Mel et al. (2008) testing the relative risk aversion of SME owners, wage workers and the self-employed in Sri Lanka. Unexpectedly, using experiments they find that successful SME owners are more risk averse than the two other groups. Yet, when asking the persons about their willingness to take financial risks and risks in life, SME owners show themselves to be the most willing and wage workers to be the least willing to take risks. De Mel et al. (2008) also show that successful entrepreneurs tend to be more tenacious and work-motivated than own-account workers and wage workers, indicating that the motivation to grow as well as the need for achievement is more pronounced. Successful SME owners also tend to be more comfortable with multi-tasking and the exposure to new situations as well as more optimistic about business outcomes (ibid.). However, it is important to bear in mind that the evidence so far is limited and it is reasonable to believe that an entrepreneur's psychological characteristics change over time.

### 3.2 Enterprise characteristics

Whether an MSE grows and creates employment also depends on a number of factors that result from the nature of a particular business as well as from other enterprise-level attributes and characteristics. Within this category, the most commonly mentioned enterprise characteristics are the age of the firm (Jovanovic, 1982), sector or industry focus (Mead & Liedholm, 1998), location of the firm (Pyke & Sengenberger, 1992), research and development (R&D) and market research activities (Cohen & Levinthal, 1990), worker's human capital and human resource development, as well as informality (Jütting & Laiglesia, 2009).

#### a) Age of the enterprise

Whether a company is young or old is expected to impact on its structure, behaviour and growth propensity (Evans, 1987a, 1987b). In his 'learning model', Jovanovic (1982) offers the explanation that older enterprises grow more slowly because managers have learnt their efficient size of operation over time. Younger and smaller enterprises face efficiency and financing constraints at the beginning of their operations, which result in slower growth at the beginning; yet, these constraints are said to decrease once the business achieves minimum efficiency scales and gains better access to financing. The general viewpoint is that, with increasing age, enterprises go through intense processes of organisational learning, bureaucratisation and structural change that eventually lead to an optimisation of their productive performances and their number of employees. This implies that, as firms become older, the level of managerial sophistication increases, indicating that – although older firms may not grow in size – they likely grow with regard to turnover, profits and other indicators of firm performance. That means that younger firms tend to grow via an expansion in employment more than older enterprises. This notion is supported by empirical evidence in LMICs where scholars found that employment growth rates of enterprises decreased with age of the firm (Evans, 1987a; Liedholm, 2002; McPherson & Liedholm, 1996; Mead & Liedholm, 1998; Parker, 1994). Furthermore, most recently, Ayyagari et al. (2014) estimated the role of the age of a firm was conditional on size, total employment and job creation rates across 104 countries. Controlling for the fixed effects of enterprise size, country, industry and year, they found that job creation rates are highest amongst young and small firms (less than 5 years old and with less than 20 employees) while older firms had lower employment growth (ibid.). All the same, given the high failure rate among young enterprises they contest that the growth rates might actually be overestimated since the dataset provides only information on surviving firms.

#### b) Enterprise location

A business's location – whether it is located in a rural or urban area, or whether it operates from a shop, a plant, or home – affects an MSE's growth in output and employees. Agglomeration externalities and the associated benefits that come with them imply that urban-based firms will grow faster than those located in rural areas (Pyke & Sengenberger, 1992). Strong supplier and buyer relations, economies of scale and scope, better infrastructure and access to markets, and more effective demand are benefits that MSEs typically have when they are close to population centres. Indeed, so far, empirical observations have shown that urban enterprises are more likely to grow and expand in

employment than enterprises located in rural areas (Mead & Liedholm, 1998; Sabel & Priore, 1984; World Bank, 2013). Liedholm (2002) also found that rural-based enterprises grow more slowly than their urban-based or semi-urban-based counterparts due to a number of infrastructure bottlenecks. Further, McPherson (1996) adds that enterprises located in business districts are also more likely to expand than home-based businesses.

c) Enterprise sector & industry

The sector or industry in which an enterprise operates also significantly impacts on its potential to grow and add employees. Firms face diverse conditions that stem from differences on the cost side (in other words, inputs are more or less costly to obtain), technological intensity and sophistication, levels of competition as well as varying market demand in certain sectors and industries. At the firm-level, empirical evidence suggests that MSEs involved in trading or retailing, which are classical service sectors, are less likely to grow in wage employment as compared to businesses involved in manufacturing and modern service sectors (De Mel, 2008; Mead & Liedholm, 1998). For example, economic booms and increases in aggregated demand in the information technology (IT) service industry in India have allowed many young MSEs to seize opportunities to grow and hire more employees (Reeg, 2013b). Further, in the automobile and consumer electronics sector, the outsourcing of light manufacturing activities from high-income countries to middle- and low-income economies, such as in East, South-East and South Asia, allowed many small component-suppliers to grow in both turnover and employees (Hobday & Perini, 2005; Sturgeon, Memedovic, Van Biesebeck, & Gereffi, 2009).

Whether a sector or industry is conducive to the entry and growth of MSEs depends on the economic opportunities that a firm has against wider structural changes within and between sectors and industries. Structural changes can alter the demand for certain goods and services and thereby affect the development of MSEs positively or negatively. As the economy modernises, secondary and tertiary sectors gain importance; these two latter sectors are generally associated with higher productivity as compared to the primary sector. A global study by Kapsos (2005) examined the employment elasticities of all three sectors in the formal economy. He found that during 1991-2003 employment in absolute numbers was generated in the service sector at a considerably faster rate than in the other sectors, though this was not associated with a net loss in jobs in manufacturing or agriculture (*ibid.*). Also, he provided data that, in agriculture and especially in the industrial sector in LMICs, value-added growth was driven more by gains in productivity than by gains in employment (*ibid.*). Indeed, against the current rate of population growth, the total number of jobs created in manufacturing is disappointing, however, in the past, jobs in manufacturing were better paid and also offered more indirect benefits (Kapos, 2005; Lavopa & Szirmai, 2012; Szirmai et al., 2013). Loayza & Raddatz, (2006) have shown that growth in unskilled intensive manufacturing sectors contributed to poverty reduction.

Notwithstanding, uncertainty remains as to whether increasing labour-intensive manufacturing jobs is always the best way to reduce poverty. Depending on where local pockets of poverty exist, agriculture and service sectors have equally shown that they offer other effective poverty-reducing job opportunities (Loayza & Raddatz, 2010). As the growth dynamics of sectors and industries shift between one another, a major challenge to governments will be to support the movements of business and labour from one to the other.

d) Research & development (R&D)<sup>8</sup>

Knowledge-driven approaches highlight the role of learning, experimentation and technology in contributing to innovations, firm productivity and enterprise growth (Cohen & Levinthal, 1990; Zahra & George, 2002). Enterprises that spend more on research and development (R&D) exhibit higher rates of survival and economic success (Dutz et al., 2011; Hampel-Milagrosa et al., 2015). The incentive to innovate as well as the R&D expenditure level increases with firm size, which is why bigger firms are generally more active in R&D (Dutz et al., 2011). Nonetheless, MSEs are also involved in basic forms of experimentation, testing and technology adoption. These basic R&D efforts can make a significant difference in an MSE's propensity to grow (Hampel-Milagrosa et al., 2015). In fact, the literature highlights the role of technology adoption as a central factor in increasing the efficiency and productivity of MSEs and the industrial sector in LMICs in general (Bell & Albu, 1999; Bell & Pavitt, 1997). For example, Dutz et al. (2011) found that the use of the internet among small firms is a dramatically important enterprise characteristic that boosts ideas and the likelihood for employment growth.

However, what is less clear is whether knowledge and technology diffusion among MSEs always positively affects employment growth. For most people, an intuitive concern is that the introduction of technologies, such as automation and intelligent software, will substitute jobs. Yet, data at the micro-level suggests that this is actually not the case. In the labour-intensive sectors in India, Das and Kalita (2009) indicate that for every extra machine that the firms under study invested in and put into operation, there was also an increase in the workforce needed to operate the machine. Hence, technological advancement may not necessarily be labour-displacing. Evidence suggests that the employment impact of technologies also depends on the skill intensity of the adopted technologies as well as the absorptive capacity of the recipient firm and its workforce (Cohen & Levinthal, 1990). Accordingly, the benefits of innovation are traditionally perceived to flow disproportionately to the enterprise owner, managers and the highly skilled; from this perspective, innovation-driven growth is not inclusive to the larger share of unskilled workers. Counter-intuitively, Dutz et al. (2011) show, however, that innovative firms introducing new products and process technologies are in fact hiring more (unskilled) employees than non-innovative firms. They reveal that the output expansion of firms, especially smaller ones, creates job growth that is not biased towards the already privileged but generally includes the unskilled (*ibid.*).

While these insights refer to short-term and medium-term perspectives in the relationship between technology adoption and firm expansion at the micro-level, at the macro-level Das, Wadhwa, & Kalita (2009) find a constant aggregate decline of labour-intensity within highly labour-intensive industries, such as textiles and apparel (see also Das & Kalita, 2009). There are various possible explanations for an aggregate decline in the labour-intensity of manufacturing, namely increased levels of productivity and efficiency, but also higher demand for flexibility and outsourcing in a globalised economy. Partial outsourcing might even take place into the informal economy where labour costs tend to be lower. However, the limited availability of data as well as methodological challenges in

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8 Here R&D is understood as systematic reflection on and structured experimentation with products and processes.

connecting the heterogeneous performance of firms to outcomes at the macro-level have created challenges in providing solid explanations.

e) Active market research

Beyond the adoption and diffusion of technologies, many MSEs benefit from market research. Obviously, market research within smaller business operations tends to use simple methods which are often taken up by the entrepreneur himself, a manager, or a highly-skilled worker. However, even in their simplest forms, thinking ahead and researching for new market opportunities, market changes and consumer preferences enable entrepreneurs to adapt quickly and preserve or even increase current scales of business operations. The efforts of individual firms to gain feedback on products as well as services are of particular importance in economic settings where market information is limited or non-available. Research on MSEs in three LMICs showed that successful entrepreneurs were actively seeking for information on new markets by using their own private exposure in other countries or by visiting fairs and exhibitions, even when they were not presenting products themselves (see Hampel-Milagrosa, 2014; Hampel-Milagrosa et al., 2015; Loewe et al., 2013; Reeg, 2013a). Further, they relied on qualitative feedback discussions with clients, the continual monitoring of sales figures as well as active field testing (ibid.). There is also some explorative evidence implying that social networks and ties are crucial disseminators for the active marketing of products and services making those entrepreneurs with access to privileged socio-economic groups especially successful in their advertisements and sales (see Reeg, 2013b).

f) Workforce training and incentives

Empirical evidence indicates that the education and training of employees strongly impacts on a firm's potential to innovate and grow (Ayyagari et al., 2011). Clearly, introducing new products or services requires that employees are able to adopt new production procedures, standards and technologies. Thus, basic educational attainments as well as a high absorptive capacity amongst employees ease the process of internal reorganisation and technology adjustments.

However, the large majority of workers in MSEs are unskilled: in other words, the majority of workers have not passed through formal schooling or any vocational training and have thus learned most of their work literally 'on the job' (World Bank, 2013). As a consequence, it is not surprising that micro-, small and medium entrepreneurs in Egypt, India and the Philippines reported a lack of skilled workers as one of the most challenging bottlenecks in sustaining and improving business operations (see Hampel-Milagrosa et al., 2015). Amongst the MSEs studied it is those that invested in in-house training and other forms of human resource development that also showed an increase in output growth, quality and employees (ibid). Das and Kalita (2009) also infer from their analysis of labour-intensive industries that a major problem for employment generation is in fact the shortage of skilled labour. In order to grow, MSEs need labour that is able to operate machines and take on more sophisticated tasks. Accordingly, it must also be recognised that low-skilled labour, low wages and bad working conditions can limit the productivity and the further growth of MSEs. Incentives for labour, such as higher wages, better working conditions, and job training and management programmes can therefore be part of a broad strategy to enhance a small firms productivity and employment growth (Dutz et al., 2011).

Unfortunately, only very few MSEs adopt job-training measures and management programmes. In fact, many risks and disincentives exist for MSEs when it comes to investing in the training and further development of their workforces. In-house training of unskilled workers requires time and resources, both of which are limited in mostly undercapitalised MSEs. Further, MSEs are generally reluctant to take on the tasks of in-house training as they fear the subsequent loss of capable employees to competitors offering slightly higher wages or other additional benefits once the training has come to an end (Hampel-Milagrosa, 2014; Loewe et al., 2013; Reeg, 2013b).

As MSEs tend to exhibit highly personalised and mostly informal management styles, employee relations strategies often follow the characteristics, personalities and preferences of the business owner or manager: there is little or no formalisation of a ‘code of conduct’ between employer and employees. If at all adopted, recruitment and training practices often take place on a case-by-case basis, for instance, depending on the ‘value’ of the worker. Generally, it is privileged MSEs with access to a number of resources and a medium- to long-term growth perspective that are found to develop a human resource development (HRD) strategy. Often, this HRD strategy is exclusive as it aims only at the satisfaction, motivation and loyalty of strategically important employees such as managers, machine operators, highly-skilled workers (such as master tailors) and/or permanent workers (Reeg, 2013b). Yet, with increasing size, cases of small and growing firms have been found where more elaborate training and incentive measures aimed at ‘shop-floor’ workers have been adopted to strengthen recruitment and the production base (Hampel-Milagrosa et al., 2015; Loewe et al., 2013; Reeg, 2013b). In order to attract and retain workers, these measures included above-average pay, an overtime premium, a monthly premium for no days of absenteeism and punctual arrival, free meals and transport, a safe and clean working environment with access to sanitary facilities, as well as – in some cases – basic childcare facilities.

#### g) Informality

Empirical observations support the view that informal firms differ structurally from formal firms in far more aspects than just in registratory status (La Porta & Shleifer, 2008). MSEs that are informal, namely those that are not formally registered, are often found to be less efficient than their formal counterparts (De Paula & Scheinkman, 2008; Jütting & Laiglesia, 2009; La Porta & Shleifer, 2008; Sleuwaegen & Goedhuys, 2002). Not only is informality in itself connected to low levels of productivity, but it is also associated with several other characteristics that make enterprise growth difficult (Mead & Liedholm, 1998; La Porta & Shleifer, 2008). Low levels of human capital, limited access to market information as well as financial constraints often reduce the number of economic opportunities of informal micro-entrepreneurs to low-return activities, such as street vending and simple repair activities (Liedholm, 2002). Apart from these individual vulnerabilities, many public and financial services are generally segmented along formal-informal lines leading to structural disadvantages of being informal. For example, informal enterprises face greater difficulties in accessing formal credit and assistance from government agencies and courts. Further, business opportunities with international buyers or government bodies often cannot be taken up due to the lack of legal certificates and other formal requirements.

As a result, the informal sector is often perceived as a free-entry sector of last resort; yet this idea has been contested by Maloney (2004) who argues that informality is not a binding

constraint to enterprise growth *per se*: though the majority of informal MSEs are in fact survivalist businesses, there are a minority of opportunity-driven entrepreneurs with viable business ideas and necessary capabilities choosing not to formalise due to the recurrent costs of being formal and the low perceived benefits of formalisation (De Mel et al., 2008; Hampel-Milagrosa et al., 2015; Nelson & De Bruijn, 2005). In his case study on Mexico, Maloney shows that some workers prefer entrepreneurship in the informal sector over formal job activities as the former provides better income and benefits (Maloney 2004). For example, entrepreneurs might use the informal sector to test a business idea and bypass cumbersome regulations and taxes in order to increase their income and that of their wage employees (Bennett, 2010). Kelley (1994) points out that while formal firms were two to four times more productive than informal ones, being an informal entrepreneur paid as well as or even better than being employed in a formal firm. Thus, informal work arrangements may provide a relatively desirable and productive alternative to formal-sector wage employment. This is especially relevant in the context of low-skilled female workers where childcare, care of the elderly and other services (such as cooking and cleaning) are not available or more cost-intensive than the formal wage actually paid (Gomez, 2008). Thus, one should be cautious with generalisations depicting informal (self-) employment as involuntary. That said, Maloney (2004) also reveals that changing from formal employment to informal employment results in a 15% income decrease.

### 3.3 Personal and business networks

Lorem ipsum dolor sits amet, A number of studies suggest that personal and professional networks play an important role in the process of MSE creation, growth and employment expansion (Granovetter, 1982; Grimm, Krüger & Lay, 2011; Kaplinsky & Morris, 2001; Meagher, 2010; Sonobe, Higuchi, & Otsuka, 2012). Social capital can be a means of raising resources that are required in starting and expanding a business, such as finance, knowledge and emotional support. Depending on the strength and the quality of networks these can accelerate the start-up of new enterprises, spur their growth and increase their innovative capacity. On the other hand, however, networks may also hinder enterprises from reaching their full potential (Grimm, Krüger, & Lay, 2011). Networks can be roughly categorised in two ways: personal networks, such as those personal ties of firm owners with family members, friends and extended social circles; and professional networks, namely an MSE's relations with suppliers, buyers and competitors.

#### a) Personal networks

The large majority of MSEs, and even SMEs, in LMICs are family-run businesses and therefore rely heavily on social or interpersonal networks. In cases where states are unable to provide basic services and social protection, social capital based on family relations and kinship provides a cushion against hard times but also allows entrepreneurs to access financial capital and knowledge. MSEs benefit from unpaid family labour. Moreover, support from spouses, parents, friends and other extended acquaintances can help entrepreneurs to access financial capital, markets and knowledge.

Demonstrating the role of family and social ties for MSEs in francophone West Africa, Grimm et al. (2012) find that the highest *capita* returns, and thereby the highest growth potential, lies with micro- and small entrepreneurs who show substantial family wealth

and also have better management skills than survivalist businesses. In Sri Lanka, De Mel et al. (2008) find that the parents of successful SME owners were more likely to have been self-employed themselves. This indicates that, growing up in an environment in which at least one parent was or still is successfully self-employed, may provide the incentive and access to relevant knowledge in order to grow and expand a business. Similarly, Djankov et al. (2005) and Djankov et al. (2006a) find that Russian and Chinese business owners have more entrepreneurs in their families and extended social circles than similarly educated and trained persons, suggesting that not only education but the upbringing within particular social networks matters for business success.

In this line of thinking, more qualitative evidence exists showing that many entrepreneurs of successfully expanding businesses come from traditional trading or business communities (Deshpande & Sharma, 2013 for India; Chan, 2001 for China). Taeube (2004) finds that the information and technology centres in Bangalore, Hyderabad, and Chennai are largely controlled by Brahmins, traditionally the privileged, priestly and knowledgeable caste group in India. Especially in cases where formal institutions like courts and regulatory bodies are absent or weak, tight social relations can help to regulate business transactions (Reeg, 2013a). This can be facilitated through informal institutions and social capital, such as trust (which reduces transactions costs), or reputation (which ensures contract enforcement) (Banerjee & Duflo, 2000; Hobday & Perini, 2005). Also, when it comes to hiring staff for strategic positions, entrepreneurial communities rely on their social networks to recruit adequate personnel (Reeg, 2013b).

But while some see social ties as crucial alternatives when market information is lacking and labour and capital markets do not function properly, others depict tight and exclusive personal networks as an obstacle to MSE growth and employment expansion. Evidence on the informal sector in Africa illustrates that social and ethnic ties can, in fact, be dysfunctional for economic progress and growth by nourishing clientelistic practices and increasing fragmentation (Castells, 1996; Collier, 2007; Meagher, 2010). Research in Kenya, Zimbabwe and Nigeria reveals how the entrepreneur's embeddedness in tight social and political production networks can either limit or promote entrepreneurial innovation by limiting or expanding the exchange of information, services and goods (Meagher, 2010; Sverrisson, 1993). Thus, social networks can produce a sub-optimal environment for inclusive economic development by reproducing inequalities along communal, ethnic or political lines. Furthermore, within the entrepreneur's household there may exist pressures to use a businesses' profits for consumption at the cost of more productive capital investments, such as in new technologies or training. This common barrier to growth for small-scale businesses is often found in cases where there are no other substantial sources of family income and entrepreneurs tend to be embedded in 'networks of the poor' (Banerjee & Duflo, 2011).

#### b) Professional networks

A number of studies demonstrate that successfully expanding businesses appear to be tightly interlinked with other firms (Bair, 2005; Bell & Albu, 1999; Kaplinsky & Morris, 2001; Humphrey & Schmitz, 1996, 2000; Sonobe et al., 2012). Individual firms are found to foster horizontal as well as vertical linkages with other firms. Horizontal linkages describe the relations between firms offering similar goods and services (often competitors within the same industry), while vertical linkages describe a firm's forward and backward ties with buyers and suppliers. Both types of linkages are found to influence a small enterprise's

likelihood of growing and increasing the number of its employees. The notion that an entrepreneur's professional ties and business networks are a highly relevant source of information, knowledge, learning, finance and market access is most prominently advocated by the literature on industrial clusters and value chains (Gereffi, Humphrey, & Sturgeon, 2005; Guiliani, Pietrobelli, & Rabellotti, 2005; Nadvi, 1995; Sonobe et al., 2012).

*Clustering:* Most empirical research on horizontal inter-firm linkages and their advantages to MSEs is related to the analysis of industrial clusters. A cluster is defined as a group of firms specialised by sector, located in close geographic proximity, and comprised of enterprises mostly micro, small and medium in size. Also – in many cases – clusters likewise accommodate other private or public agencies and research centres. As the performance of clusters varies in productivity, output growth, employment size and wage levels, clustering *per se* hardly drives enterprise success. Still, localisation offers various benefits to firms: it saves on the costs of accessing electricity and building infrastructure; it attracts (international) buyers as well as suppliers; it enhances access to finance, trade credit and skilled labour; it reduces transaction costs and promotes specialisation. Besides, with several firms operating within a connected industry, spill-overs of information, knowledge, and skills occur (Bair & Gereffi, 2001; Bazan & Navas-Alemán, 2004; Giuliani et al., 2005). Various case studies are available documenting the advantages of clusters in Brazil (Schmitz, 1999), Mexico (Rabelotti, 1999), Pakistan (Nadvi, 1995) and India (Knorringa, 1999). Collecting data from industrial clusters in Ghana, Ethiopia, Tanzania, Bangladesh, Vietnam, and China, Sonobe et al. (2012) find that those clusters that have experienced firm-level innovations have grown rapidly both in output and employment.

Equally, disadvantages also exist: For innovators and those that invest in R&D knowledge, spill-overs can be problematic, if not destructive for further expansion of the firm. It is thus important to set in place an institutional framework that not only protects innovators but also supports technology diffusion: The reason is that, if firms within clusters do not make progress in inventing new production methods, in creating new profitable products and in accessing new markets, clustering will not encourage MSE growth and expansion (Sonobe et al., 2012). Learning among clustered firms is also largely driven by the differentiation and complementarity of skills and know-how of individual enterprises within the cluster (Altenburg & Stamm, 2004; Weijland, 1999). Thus, it is not only individual, innovating firms that make a cluster dynamic, but the strong intertwined and co-dependent networks of suppliers and buyers trading and exchanging know-how with each other. In LMICs in particular, many clusters in fact accommodate stagnating survivalist-type businesses that often produce low-quality, standardised goods and services to (saturated) local markets (Altenburg & Meyer-Stamer, 1999). In her study on Indonesia, Weijland (1999) shows that, because of their weak integration in effective trading networks, clustered MSEs in rural areas tend to have limited market outreach and therefore little incentive to invest in innovation. In contrast, other more privileged entrepreneurs are able to circumvent these market limitations by using middlemen to market their products and get exposure to new and more demanding networks. Traders and other middlemen can therefore function as decisive catalysts for learning and technology-diffusion by bringing in new production incentives (Knorringa, 1999). As a consequence, in the absence of innovation efforts and individual and collective learning processes, clustering *per se* does not encourage successful entrepreneurship.

*(Global) value chain (GVC) integration:* Vertical integration into (global and/or national) value chains is argued to open up opportunities for MSEs to expand their output and number

of employees (Kaplinsky & Morris, 2001). Value chains are vertical linkages that connect economic actors, buyers and suppliers along a specific product or service chain reaching from the input stage to manufacturing, via branding and marketing, and finally to the stage of consumption and disposal (ibid, p. 4). In LMICs, national value chains are the major access point through which small firms may tap into larger domestic or even international markets and expand in size (Altenburg, 2006a). Linkages with buyers<sup>9</sup> are found to expand an enterprise's capabilities and learning possibilities, which in turn increases business and growth opportunities (Schmitz & Knorrinda, 2000). In order to receive products and services of good quality and on time, lead firms may offer access to trade credit, information, training and other forms of assistance to their suppliers (Guiliani et al., 2005; Navas-Alemán, 2011). Moreover, in the case of global value chains, international exposure and the effects of export competition on small firms are significant correlates of labour-intensive growth and increasing wages (Dutz et al., 2011).

However, for MSEs the possibilities to engage in such nurturing business relations is limited (Altenburg, 2006a): Large, global operating firms rarely source directly from small firms due to high transaction costs, a lack of economies of scale and of quality standards, as well as concerns over flexibility, timely delivery and other service capabilities (Tewari, 1999). Thus, for MSEs to be successfully integrated into GVCs it often requires an intermediary, such as a national medium-sized enterprise, cooperative organisation or an agency. Yet, enterprise growth and employment expansion are not automatic within GVCs (Altenburg, 2006a). Research on power relations within GVCs have shown that the potential for small and medium enterprise development and upgrading largely depends on the strategic interests of lead firms (Humphrey & Schmitz, 2000). In cases where lead firms aim to defend their market shares or pursue other strategic interests (such as pushing prices down) integration may, in fact, not be beneficial to smaller suppliers which have far less negotiation power (Altenburg, 2006b).

### 3.4 The business environment

Lastly, it is widely argued that the quality of the business environment has an impact on a firm's innovation, output growth and job creation potential (Acemoglu & Johnson, 2005; Acs, Desai & Klapper 2008; Aterido, Hallward-Driemeier, & Pages, 2007; Aterido & Hallward-Driemeier, 2010; Eifert et al., 2005; Rahman, 2014). The business environment is composed and shaped by a system of various institutional, policy and market conditions that govern and direct private sector activities (Klein & Hadjimichael, 2003). Clearly, these conditions have an influence on the development of the private sector, MSEs and overall job creation potential. Market failures and institutional distortions can create fixed costs for businesses and this disproportionately disadvantages smaller enterprises. Moreover, larger firms may have more resources and political influence to shape the business environment according to their interests. Thus, a poor business environment may provide fewer growth opportunities for small-scale entrepreneurship, create a number of entry barriers to vulnerable and less-privileged entrepreneurs and thereby have a disproportionately negative effect on job creation and poverty reduction. Indeed, among MSEs, the large majority suffer from constraints that are associated with the structural

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9 These can be national or international lead firms.

disadvantages within their business environment (Aterido et al., 2007; Klein & Hadjimichael, 2003; Hampel-Milagrosa et al., 2015; World Bank, 2013).

Manifold research on the business environment has emerged. The most salient factors impacting MSE growth and job-creation potential include: the macroeconomic performance, political stability, the degree of competition, business regulations and law enforcement, the level of corruption, as well as access to infrastructure, finance, business development services and labour.

a) Macroeconomic policies and political stability

A stable macro-economic and political environment has been shown to positively affect private-sector development. Economic and/or political instability increases the number of risks that entrepreneurs face in their daily operations. Especially for micro and small enterprises, high-risk environments render planning nearly impossible and prevent important investments in productivity-enhancing and job-creating activities from being undertaken. To sustain macro-economic stability there exists a wide agreement that stable growth, a stable inflation rate and healthy public balance sheets are essential (Ocampo, 2005). A survey in Ghana covering around 500 MSEs found that inflation, high interest rates for credits and the price volatility of the local currency had severe impacts on their performance (Robson & Obeng, 2008). Similar observations were made in other sub-Saharan African and Latin American countries (Tybout, 2000). Generally, smaller firms are affected more by inflation and price volatility as they have worse access to financial markets than larger firms (Beck et al., 2008). Similarly, political instability and turmoil have been found to deter investments in the use of new technologies (Collier & Duponchel, 2010). Thus, both political and macro-economic instability are regarded as obstacles to the creation of productive jobs within MSEs.

b) Business regulations and labour laws

The regulation of businesses by laws, policies and incentives influences economic activity in manifold ways. It is now widely acknowledged that there is no 'optimal approach' to regulation, meaning that the intensity or the scope of regulating business-to-business and state-to-business relations is largely dependent upon local conditions, private-sector needs and the interests of national policymakers. With regard to the regulation of MSEs, governments find themselves in a position where they have to reconcile three conflicting goals: they have to foster enterprise growth and employment growth; they have to increase or ensure job quality; and they have to encourage formalisation. These goals may conflict with one another as regulation has both positive and negative implications for enterprises.

Business regulations impact on whether a firm registers itself, may enhance a firm's investments in human or physical capital, and can deter or stimulate the adoption of new technologies. Regulations and policies are set in place to protect (intellectual) property rights, enforce contracts, settle disputes and ensure that private companies uphold certain standards and contribute to common goods such as public education, health and the environment (Klein & Hadjimichael, 2003). The clear formulation and transparent enforcement of regulations reduces uncertainty in markets and thereby helps small entrepreneurs to adapt to adequate practices. That said, regulations may also have the potential to increase the costs of doing business: this includes the direct costs associated with registration and taxation, the time and money that is involved when applying for

licences, permissions, and land titles, as well as the costs of complying with labour laws and further social and environmental standards (Djankov, La Porta, Lopez-de-Silanes, & Shleifer, 2002). In this line of thinking the annual Doing Business report argues that regulatory costs are simply too high thereby discouraging MSEs from formalising and growing (De Soto, 1989; World Bank, 2015).

Indeed, for many MSEs, complying with labour laws is associated with costs. Not wanting to impose these costs on already poor entrepreneurs and family businesses, many LMICs follow an approach whereby they completely or partially exclude MSEs below a certain threshold (often less than 5 or 10 employees) from regulations. Partial regulatory exclusion of MSEs typically refers to taxes and labour laws. For example, state governments apply lower health and safety standards, tolerate collective dismissals, reduce or drop mandatory social security contributions and do not apply the right to trade union representation. Yet, exclusion – even if only partial – means that MSEs have no incentive to grow beyond a certain threshold and reap the benefits of formalisation. Dynamic and growing MSEs that decide to formalise might find themselves in an unfair competition with informal units, especially as recent research on value chains has shown how formal firms out-contract work to informal enterprises (Drechsler, Jütting, & Xenogiani, 2008). Similar observations have been made by Das and Kalita (2009) in labour-intensive sectors in India where the outsourcing of jobs and the splitting of one enterprise into two or more businesses is a highly prevalent practice to circumvent regulatory thresholds.

Although excessive regulation is certainly costly for MSEs, the existence of no or very little regulative guidelines neglects the fact that creating a business-enabling environment involves more than just the simplification of procedures or the lowering of corporate taxes and exemption from labour laws. What is important is that regulations also need to be set up in a way to provide businesses of all sizes with the benefits of formalisation (Altenburg & Von Drachenfels, 2006). However, MSEs have often little to gain when formalising. This is because MSEs tend to be politically underrepresented. MSEs have a weaker political voice and often struggle to find a united front against local politicians and the interests of larger businesses (which they might supply to).

In addition to the doubts about the benefits of formalisation, MSEs and state governments are both concerned about the enforcement capacities of local authorities (Hampel Milagrosa et al., 2015; Loewe et al., 2013), as legislations are sometimes difficult to apply or not formally applicable to smaller firms. As a result, MSEs struggle to predict appropriate business practices and regulative outcomes, even if they are well informed about the content of the law. In some cases inspections may not take place for practical reasons (such as geographical dispersion), and in other cases regular inspections are used to extract bribes (Reeg, 2013b). Arbitrariness and unpredictability of law enforcement are thus additional costs that MSEs with limited financial assets and time constraints are often not able to shoulder.

As a consequence, and in meeting conflicting policy goals, governments have to adopt a nuanced ‘carrot-and-stick’ method in MSE regulation by which, on the one hand, they do not allow the informal economy to dictate the rules and conditions of work but, on the other, encourage MSEs to formalise and grow, providing them with the benefits and applying a gradual – rather than an ‘all-at-once’ – approach to law enforcement.

c) Competition policy

Depending on the level of economic development, competition is found to have different effects on MSE growth and employment expansion. Theoretically, it is widely agreed that in perfect markets competition among firms can function as a selection mechanism driving uncompetitive firms out of the market and spurring growth in those that invest in innovations (Porter, 1998; Tybout, 2000). However, in LMICs, the existence of a number of market failures, entry barriers and institutional insufficiencies hinder the emergence of a fair competitive environment (Singh, 2002). Above all, the segmented market structure and diversity of firms operating at different levels of productivity in LMICs makes it difficult to draw up general statements. Still, as MSE development largely depends on the imitation and catching-up of existing technologies, competition policy in LMICs should set in place adequate incentives for smaller and often informal enterprises to invest in learning. In this line of reasoning, high levels of competition and stringent intellectual property rights to protect innovators (often larger firms) may actually hamper rather than facilitate technological diffusion, innovation and job-creation among MSEs (Acemoglu, Aghion, & Zilibotti, 2003). This said, while using a development-conscious approach in formulating and enforcing competition policy, it is of vital importance for MSEs that policymakers effectively regulate unfair competition<sup>10</sup> and the competitive practices of market-dominating firms. The latter are often larger in size and already operate at the technological frontier (Singh, 2002). Thus, for market competition to have a positive effect on micro and small enterprise innovation, policymakers in LMICs need to find a middle-ground between developmental and innovation objectives.

d) Corruption

Theoretically, corruption may have positive as well as negative impacts on MSE growth and employment expansion. On the one hand, it is argued that bribes function as an efficiency-enhancing instrument to reduce costs by obtaining licences or other public services faster (Huntington, 1968). On the other hand, corruption creates unfair competition by allocating private and public resources towards entrepreneurs who have the means to distort the provision of common goods and services (Shleifer & Vishny, 1993). Corruption thus negatively affects growth of asset-poor and microentrepreneurs. Due to the secretive nature of corruption, only little empirical evidence exists; however, a cross-country study found that corruption hampers employment growth across small, medium and large firms (Aterido et al., 2007). Studies in Mozambique (Sequeira & Djankov, 2009) and in Uganda (Fisman & Svensson, 2007) found that corruption has significant economic consequences indicating that a firm's growth is substantially hampered. Also, qualitative evidence in Egypt, India and the Philippines suggests that rich and privileged entrepreneurs perceive corruption mainly as an inconvenience, whereas for poor and politically-not-connected entrepreneurs it may become an insurmountable barrier to enterprise growth (Hampel-Milagrosa et al., 2015).

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10 This can be described as actions of a competitor that actively harm the position of others with respect to their ability to compete on equal and fair terms. This may include 'below-cost' selling, counterfeiting or imitation, dumping, misleading advertising, rumour mongering, trademark or trade secret infringement and other unethical commercial practices.

## e) Physical infrastructure

The availability of transport, land, clean water, reliable energy grids and access to information and communication technology has a strong impact on the performance of the private sector and smaller enterprises in particular (Hausman, Rodrik, & Velasco, 2008). The state of the infrastructure, as well as an enterprise's access to it, determines how efficiently and effectively a business can be run. In Asia, Hallward-Driemeier, Wallsten, and Xu (2006) discovered that the quality of infrastructure is a decisive determinant of growth in profits and productivity. Further, with uncertainties about the availability of infrastructure services, few entrepreneurs will make complementary investments – for example investments in machinery that requires high voltage power lines (Aterido et al., 2007; Reeg, 2013b). This is because MSEs have few options when it comes to compensating for frequent power cuts, impassable roads, contaminated water and a lack of telecommunication and internet grids (Reeg, 2013b). Accordingly, firms that have their own means of transporting manufactured goods were shown to grow faster in eleven African countries (Goedhuys & Sleuwagen, 2010). In terms of employment, a recent study by Aterido and Hallward-Driemeier (2010) across 31 sub-Saharan countries has shown that, though unreliable infrastructure services generally hamper growth for most enterprises, they are actually associated with higher employment growth rates among micro enterprises. However, in this context, the majority of expanded employment has been in low-productivity and labour-intensive segments, raising concerns over the allocated efficiency of labour towards productive and more rewarding economic activities.

## f) Financial services

It is often argued that access to financial services is crucial for MSEs in overcoming capital constraints and managing risks (World Bank, 2008). Indeed, many MSEs lack the financial capital to engage in more productive and rewarding activities. As a consequence, the provision of micro-loans and other financial services such as micro-insurance schemes and saving accounts aimed at poorer entrepreneurs have increased substantially over the last decade (ibid.). Evaluation of these financial services has focused mainly on micro-credit schemes, (in-kind) grants and cash-transfers (De Mel, 2013b). As a result, one should be cautious to extrapolate the results on microfinance to other financial services such as commercial loans or particular targeted SME growth funds or bank loans. So far, there has been no evaluation of the employment effects of micro-insurance (see also Grimm & Paffhausen, 2014). Though access to micro-finance is commonly believed to lead to enterprise growth and development, empirical evidence on the evaluated interventions collected so far shows rather weak or no effects on profits and employment (Arraíz, Meléndez, & Stucchi, 2012; De Mel, 2013b; Karlan & Zinmann, 2011).

However, access to micro-finance has been shown to enhance investments in working capital, inventories, machines, fixed capital investments and buildings (Arraíz et al., 2012; De Mel et al., 2013b). Impacts on employment have been found to be generally small and insignificant, especially for existing MSEs. This is also true of finance interventions addressing female-entrepreneurs. The most positive but still weak effects were observed for young MSEs and slightly larger SMEs, though it must be said that the latter receive a different finance package including larger credit volumes and maturities (see Grimm & Paffhausen, 2014).

There are several explanations of why the impact of micro-finance might have had such a weak or no impact on returns and employment. One explanation is connected to the research design of impact evaluations: these might suffer from selection bias or fail to capture the long-term effects. Another explanation could be that interventions were never designed to support employment creation. Generally, entrepreneurs access micro-credit loans without the objective of hiring new staff but with an aim to increase their income, become more profitable and invest in better materials, machines or other fixed capital. Moreover, many micro-credit organisations target poor entrepreneurs who struggle with their own and family needs. As a result, micro-credits are also used to smoothen consumption. Finally, financial services might not be optimally designed to unleash entrepreneurial dynamics, as they withhold long-term, growth-oriented investments (Banerjee & Duflo, 2011). In other words, micro-credits have too high interest rates and too short repayment cycles and therefore do not incentivise structural changes in business operations. Indeed, Sonne (2011) argues that the dual system of organisations offering either micro-finance or larger industrial development loans fails to address the needs of the somewhat more dynamic, growing MSEs.

In sum, though access to micro-finance has not yet been shown to increase MSE's returns and employment, it must however be said that micro-finance has helped entrepreneurs to sustain and secure the existence of the jobs in already operating businesses. Targeting young, and growing, MSEs with more adequate financial services might indeed unleash a stronger growth and employment impact.

g) Business development services (BDS)

In addition to financial services, many argue that access to BDS has a positive impact on MSE growth and employment. BDS involve services connected with business planning, marketing, legal advice and the provision of premises and training for audits. It seems intuitive that detailed business planning, monitoring and advisory services should increase investments and lead to higher growth, although unfortunately few rigorous empirical studies have actually tested its impact on MSEs. Those few studies that do analyse the effect of BDS programmes on MSMEs observed positive impacts on growth and employment; yet, due to weaknesses in the methodological set-up of evaluations, doubts remain (Eshetu, Ketema, & Kassa, 2013; Lopez-Acevedo & Tinajero-Bravo, 2010).

h) Availability of skilled labour

A lack or a shortage of skilled labour is expected to impact negatively on enterprises, especially on MSEs that tend to engage in labour-intensive activities. In the case of labour-intensive industries, the word 'skill' is often associated with workers who are able to operate modern machinery, such as power-looms in the textile industry. Thus, without access to skilled labour, MSEs will hesitate to make the complementary investments in modern machinery and production methods (Lall, 1997). Empirical evidence in LMICs suggests that the lack of skilled and adequately educated labour in a region or country is, in fact, inhibiting employment generation (Das & Kalita, 2009; Hampel-Milagrosa et al., 2015; see also Sub-section 3.2).

#### 4 Assisting MSEs in driving growth, job creation and job quality

Decades of research on private-sector development have made it clear that the overwhelming majority of MSEs in high-, middle- and low-income countries do not grow (De Mel et al., 2012a, 2012b; Kushnir et al., 2010). Even so, recent work has emphasised that a small group of fast-growing and opportunity-driven MSEs – so-called ‘gazelles’ – exist, which, in contrast to the majority of MSEs, hold substantial job-creating potential (see De Mel et al., 2012a, 2012b; Gries & Naudé, 2010; Grimm et al., 2012; World Bank, 2013).

Based on these empirical observations, recent policy debates have focused on the identification and targeting of gazelles in order to achieve higher productivity and employment gains among MSEs (see also Grimm & Paffhausen, 2014). The idea has emerged of adopting special enterprise support schemes that are explicitly targeted at ‘growing’ and ‘job-creating’ MSEs rather than at the large heterogeneous group of mostly ‘survivalist’ MSEs (World Bank, 2013). This neo-structuralist turn in private-sector development is based on the rather pessimistic view that only very few MSE entrepreneurs reflect the ‘Schumpeterian’ ideal and that not many are likely to induce innovation, growth and job creation in the near future (see Table 1). This school of thinking stands in stark contrast to the neo-liberal ‘minimalist’ notion of private sector development as represented by the World Bank’s Doing Business reports, where a withdrawal of state interventions, that is, via deregulation and the simplification of business and labour laws, is expected to unleash entrepreneurial dynamism and growth (see Table 1; Altenburg & Von Drachenfels, 2006; World Bank, 2015). The underlying understanding is that informal MSEs are not very different from those operating in formal markets.

In terms of policy formulation, the fundamental difference between both schools of thought lies in their assumptions about market and government failure: While structuralists argue that market failure is pervasive and governments have a more active, correcting role to play, the neoliberal approach underscores the failures of governments and bureaucrats when intervening in markets, such as the lack of market information or political capture of rents, (Klein & Hadjimichael, 2003). In the former model, the state does too little to help overcome structural growth constraints while the latter model raises concerns over the limited administrative and financial capacities of state bureaucracies.

Certainly, MSEs in LMICs that succeed in growing differ significantly from the average pool of their MSE peers. Productivity growth, job creation and good working conditions in MSEs tend to be associated with entrepreneurs who are better endowed with human capital, are more highly motivated, have the ability to take risks, are willing to invest in human resource development, run R&D efforts and market research, are integrated in global value chains and have personal savings at the disposal or access to family finance (De Mel et al., 2012a, 2012b; Hampel-Milagrosa et al., 2015). In this sense, it is true that the entrepreneur – that is, his or her abilities, human capital and personal outreach to social and professional networks – matters a lot in determining the likelihood of business success, job creation and improvements in working conditions (Hampel-Milagrosa et al., 2015).

Despite this, not all of the characteristics of successful MSEs can, in fact, be observed: for example in the case of psychological qualities of entrepreneurs. The danger exists that promoters of targeted interventions overestimate the capacity of bureaucrats and planners in identifying and picking winners (see World Bank, 2013). This proves to be particularly difficult as the distinction between ‘growth-oriented’ and ‘survivalist’ entrepreneurs as shown in Table 1 might not always be clear-cut.

**Table 1: Policy implications of neoliberal and structuralist views of informal MSEs**

	View on MSEs and informality	Policy implications
<b>Neo-liberalism</b>	<ul style="list-style-type: none"> <li>• Differs from formal MSEs only in registratory status</li> <li>• Mostly growth-oriented and opportunity-driven</li> <li>• High job-creation potential</li> </ul>	<ul style="list-style-type: none"> <li>• Deregulation/reduce regulatory barriers</li> <li>• Simplify/streamline registration procedures</li> <li>• Adopt formalisation incentives</li> </ul>
<b>Neo-structuralism</b>	<ul style="list-style-type: none"> <li>• Differs from formal MSEs in productivity; this involves deficiencies in know-how, skills and capital</li> <li>• Mostly survivalist and necessity-driven (hidden unemployment)</li> <li>• Low job-creation potential</li> </ul>	<ul style="list-style-type: none"> <li>• Adopt targeted interventions addressing most binding constraints (e.g. training, access to finance, market linkage programmes, etc.)</li> </ul>

Source: Author

Further, while some ‘success’ characteristics of entrepreneurs such as entrepreneurial courage, the personal urge to be financially independent, the need for achievement and strong internal growth motivations can be traced back to psychological and behavioural qualities, other characteristics, such as quality education, work experience and personal wealth, tend to be strongly based on societal privileges. As a result, the growth and job-creation performance of MSEs should be seen as an outcome driven not *only* by entrepreneurial talent and motivation but *also* as one driven by underlying inequalities in the structure of opportunities as well as by the resources that entrepreneurs have to overcome growth constraints. In fact, the World Development Report (2013, p. 114) on jobs clearly states that *“a successful entrepreneur is defined as someone who employs others and is not living in poverty”*. As a research project of the German Development Institute/Deutsches Institut für Entwicklungspolitik (DIE) in Egypt, India and the Philippines also reveals, the majority of entrepreneurs whose firms grew out of the micro level *did not live* in poverty before they started their business endeavours; on the contrary, privileged social backgrounds enabled entrepreneurs-to-be to make crucial up-front investments in quality education, informal training and quality work placements (Hampel-Milagrosa et al., 2015). Thus, while MSE growth is often associated with entrepreneurs who have outstanding personal qualities, competences and characteristics, their entrepreneurial success is also based on structural inequalities amongst MSEs. As the majority of MSEs lack the access to ‘enabling’ growth factors such as human, social and financial capital, few entrepreneurs manage to overcome growth constraints.

The fact that only a few micro and small entrepreneurs succeed in expanding their enterprises has led to a somewhat disillusioned policy suggestion namely focusing on only those entrepreneurs that, in contrast to the large majority of ‘survivalist’ MSEs, show a

better track record in educational, training and work achievements. Yet the policy consequence resulting from the above observations should neither be an exclusively targeted approach on gazelles nor a withdrawal of extended enterprise promotion policies as set out in the recommendations of the Doing Business reports (World Bank, 2015).

In order to drive productivity growth, job creation and decent work amongst MSEs, policymakers should undertake more fundamental policy reforms and interventions that aim at creating an environment where equal opportunities amongst private sector enterprises in general and MSEs in particular exist (see also ILO, 2015). It is argued that the uneven distribution of financial, human and social capital inhibits productivity and employment gains amongst disadvantaged MSEs. Accordingly, a universalistic approach to MSE promotion is needed in order to provide quality education, quality training, access to adequate finance, infrastructure and market information for all. Extending these services to all MSEs is necessary because a policy approach targeted exclusively on 'winners' is likely to enhance inequalities amongst MSEs even more, thereby limiting the overall potential for further job creation and improvements in working conditions.

To review the effectiveness of various different MSE promotion policies to increase the competitiveness, job creation potential and job quality of MSEs, the following sections are organised along six central policy areas:

- (1) Access to physical infrastructure,
- (2) Business regulations, labour laws and law enforcement,
- (3) Access to finance,
- (4) Access to markets, information and technology,
- (5) Access to skilled and trained labour, and
- (6) Access of MSE owners to education and training

These address the most salient MSE growth constraints and their impacts on employment as identified in Section 3, and will subsequently be analysed in more detail.

#### 4.1 Access to physical infrastructure

Investments and improvements in physical infrastructure are crucial not only for the development of MSEs, but for the private sector as a whole (Hallward-Driemeier, Wallsten & Xu, 2006; Hausmann, Rodrik, & Velasco, 2008; see also Sub-section 3.4). The state of the physical infrastructure, (the availability of quality roads, affordable land and real estate, clean water, reliable energy grids and access to digital and telecommunication networks, etc.) is a crucial framework condition that determines not simply how efficiently a business can be run but also how effectively a business can fulfil production or service standards and demands (Hallward-Driemeier, Wallsten, & Xu 2006; Hausmann, Rodrik, & Velasco, 2008).

While it is clear that MSEs require access to basic physical infrastructure if they are to grow, expand in employment and improve working conditions, efforts to improve such access have been limited or show mixed results for three main reasons:

Firstly, policy efforts in improving access to basic infrastructure in areas where most MSEs can be found are limited, that is, in traditional, urban commercial sites, in residential areas of the poor and in rural regions (World Bank, 2008). Typically MSEs have operated for decades with insufficient infrastructure, yet rarely do policy expectations and demands take into account structural inequalities in the inequality of opportunity among small enterprises and actually change their physical environment (World Bank, 2008). With limited access to common public goods and little means to compensate these constraints with complementary investments such as power generators, own means of transport or water-filtering technologies, the majority of MSEs find themselves in low-productivity and labour-intensive segments (Reeg, 2013b). Access to clean air, sanitary facilities, and even more so, improved access to basic infrastructure is needed if small enterprise investments are to move towards productivity-enhancing technologies and better working conditions including clean and safe working spaces. As a result, large-scale infrastructural programmes to improve road networks, energy grids and water pipelines, for instance, should not only take place in more affluent boroughs and neighbourhoods but should also reach those less affluent locations where the large groups of MSEs operate – mostly in traditional, commercial urban centres and rural areas as well as residential areas of the poor. This involves the basic provision of reliable energy grids, water and wastewater supply, public waste disposal, and safe roads.

Second, beyond the provision of basic infrastructure, authorities rarely consult MSEs when introducing targeted measures to improve urban or rural infrastructure of commercial or semi-industrialised areas (United Nations Economic and Social Commission for Asia and the Pacific [ESCAP], 2012). This supply-driven approach to infrastructure provision might be expedient to improve the quality of residential life where demands for basic access to water, energy and transport is standardised; however, for the large group of heterogeneous (small) enterprises, infrastructural needs differ and constraints to growth can vary substantially. For example, although many MSEs operate in crowded urban areas and do have reliable access to transport services, they face constraints in accessing affordable larger plants or real estate (Reeg, 2013b). What is more, in order to deploy more sophisticated machinery, urban MSEs require more stable and higher voltage energy access, yet this is not accessible in traditional MSE clusters (*ibid.*). Further, rural MSEs have abundant possibilities to rent or buy production sites, yet they suffer from deficits in the road network as well as from poor access to water and energy. In order to provide better infrastructure services, a needs-driven investigation of enterprise clusters is therefore necessary to identify what enterprises – in particular MSEs in the area – actually need in order to survive or grow.

Third, within the context of infrastructure development a primary responsibility of policymakers is also urban planning and management. As enterprises operating within cities can become a major source of environmental degradation, many local authorities have set up industrial estates, technology parks and economic special zones in order to relocate traditional MSE clusters. However, programmes to ‘re-plant’ MSE clusters from urban centres to semi-urban or even rural industrial production zones with better infrastructure have a poor history (Reeg, 2013b; United Nations Industrial Development Organization [UNIDO], 2010), for instance due to the lack of semi-skilled workers, access to markets and business networks as well as the substantial rise in production costs that comes with the formalisation of former informally operating MSEs (Reeg, 2013b). Thus, before relocating firms, policymakers need to understand the true value of an enterprise’s

current location. Many MSEs locate their shops or plants in close proximity to their living places as this is the only way to run the business in a time-efficient manner (this particularly applies to women entrepreneurs) and to regularly access workers (for instance in the case of daily or temporary labourers) (Berner et al., 2008). Additionally, most MSEs have developed a localised market base of suppliers and clients which might disappear if they were to move to another location (Reeg, 2013b).

#### 4.2 Business regulations, labour laws and law enforcement

LMICs are characterised by large informal sectors. As a consequence, there exists a strong belief that employment growth and job quality in MSEs will improve once the latter have formalised (Bruhn & McKenzie, 2013). The idea is that, once registered with the authorities, enterprises are liable to comply with business regulations and labour laws that have often been adopted on the basis of recognition of international rules and standards, such as the ILO's core labour standards. Formalised MSEs would therefore abolish unacceptable working conditions, such as child labour, and ensure workers' rights. However the evidence shows that the impact of formalisation, as well as formalisation incentives, is limited.

Firstly, evidence suggests that in order to boost job creation and job quality in informal enterprises it is not sufficient only to cover the cost of MSE registration. As long as the benefits of being formal do not outweigh the costs, the majority of MSEs will still remain informal despite the provision of substantial economic incentives (Bruhn & McKenzie, 2013; De Mel et al., 2013a). Most of the policies and economic measures to incentivise formalisation were introduced in Latin America. This involved (a) positive incentives to formalise, such as reduction of registration fees and procedures, entitlements to health services as well as the gradual introduction of health and social security legislation, corporate tax holidays and allowances, or (b) economic disincentives for staying informal, such as conditional access to public procurement, subsidised credit schemes and other public services (Bruhn, 2011; De Mel, 2013a; Fajnzylber, Maloney, & Montes-Rojas, 2011; Kaplan et al., 2011). The most effective measure to formalise MSEs was by using inspections; however, this did not result in any employment gains (Bruhn & McKenzie, 2013; De Andrade, Bruhn, & McKenzie, 2013). Those informal enterprises that became registered showed only modest or no effects on performance and employment (Bruhn, 2011; Bruhn & McKenzie, 2013; De Mel et al., 2013a). Nevertheless, modest positive effects on performance and employment were detected among a small group of already growing and slightly bigger MSEs (*ibid*). Thus, evidence suggests that formalisation incentives are most effective if targeted at high-growth and already well-performing entrepreneurs. Yet, identifying these informal gazelles is likely to be difficult and not practical. Also, it is debatable whether these MSEs would sooner or later have formalised in any case. From a policy perspective, it might therefore be more important to assist MSEs in driving productivity and profitability, rather than in urging formalisation. In this line of thinking, a growing enterprise becomes formal because it has reached substantial gains in returns and productivity, rather than the other way around. While the latter depicts a dual-economy model, the former recognises the fact that becoming formal is more of a continuous transition (see Chen, 2005; Jütting & Laiglesia, 2009). This transitional notion of informality is supported by the observation in LMICs that informal work is highly prevalent among formal firms (see Chen, 2005). The latter case is a reminder that MSE formalisation does not necessarily warrant an increase in the number as well as the quality of jobs.

Second, several empirical cases suggest that rigorous and complex labour regulations are not going to create employment nor ensure protection of workers' rights. Though increased registration rates might be promising for employment protection within MSEs, it is much harder for MSEs to stay formal and sustain enterprise growth (Hampel-Milagrosa et al., 2015; Liedholm, 2002). Once operating in formal markets, MSEs face a number of new regulatory demands. Often, capital-poor MSEs tend to build their competitive advantage on labour-intensive activities, which is why they are strongly affected by the rigorous application of complex labour laws. Not wanting to increase the costs for MSE activities, many governments practice a soft-law approach by either partially or completely excluding MSEs from regulations if they stay below a certain size threshold. This seems reasonable as many of those operating under the threshold are, in fact, own-account workers. Hence, there is no employer-employee relationship that needs to be governed. However, once MSEs come close to that threshold or formalise, the policies and regulations that were intended to ensure job quality might actually deter the development of more and better jobs (see Morris, Basant, Das, Ramachandran, & Koshy, 2001 for India). Heckman and Pages (2004) find that increases in job security lead to lower hiring prospects for young, female and unskilled workers in Latin America and the Caribbean. In some countries, many growing MSEs are observed to either stop hiring or to split in two or into several other businesses in order to stay just below regulatory labour thresholds (Morris et al., 2001). Minimal wage legislations in China and Indonesia resulted in negative effects on employment growth of SMEs (Alatas & Cameron, 2008; Huang, Loungani, & Wang, 2014). Indeed, enterprise surveys have pointed out that MSEs exempted from the labour law did not see the labour law as an impediment to their growth, yet, those MSEs that were growing and were covered under labour regulations found themselves in a disadvantageous position (Hampel-Milagrosa et al., 2015; ILO, 2007; Reeg, 2013b).

At the same time, these surveys would also seem to imply that labour law and regulation in itself may not be the source of the problem, but rather labour administration and law enforcement. MSE entrepreneurs covered by the law ranked labour inspection second to tax inspection as a source of harassment (see ILO, 2007). Complex labour regulations such as the legal patchwork of antiquated, new, applicable and non-applicable legislation, often lead to (a) an inability of entrepreneurs to anticipate outcomes, and (b) inefficient labour administration (ibid.). In many cases, the lack of clarity is further exploited by bureaucracies or auditors asking for bribes (Loewe et al., 2013; Hampel-Milagrosa et al., 2015). As a consequence, the influence of labour regulations on the job-creation potential of MSEs is mostly dependent on the extent of their applicability and the quality of their enforcement. Unfortunately, on the policy front, little thinking and experimentation goes into policy measures to help more fragile 'gazelles' stay formal and comply with labour laws and regulations. Recommendations to establish an MSE-friendly regulatory framework without giving up on decent work conditions point at a regulatory design that is simple, applicable, enforceable and compliant. Evidence suggests that tough and complex laws are not going to ensure protection of the workers' rights (ILO, 2007). In fact, a simpler law with a more efficient labour administration might be more effective in bringing MSEs to comply to labour standards.

In third place, strengthening regulatory compliance among MSEs requires that law enforcement authorities and MSEs work together on regulations and policies. What we know suggests that this is best achieved through the gradual phasing in of regulations and standards (ILO, 2007). A gradual introduction helps MSEs to get a clear picture of the

regulatory demands and necessary investments in their businesses (ibid.). Labour administration should also think of ways to make it cheaper for MSEs to comply with health and safety standards as many operate in an environment where the quality of energy, water and sanitary infrastructure has major deficits (Reeg, 2013b). Also, compliance with labour regulations depends on the quality of interactions between labour administration and MSE owners. Involving MSEs in the drafting of legislation as well as in the design of tailored sanctions in the case of labour law infringements might lead to higher levels of ‘ownership’ and subsequent compliance (ILO, 2007). This should also involve effective and accessible complaint mechanisms by which MSEs can collectively bargain for rights and promote their freedom from inappropriate law enforcement. In order to allow a continuous dialogue on the design and anticipated impacts of legislation, informal or formal tripartite mechanisms (meaning the involvement of government, workers’ unions, and employers’ organisations) have shown to be promising in a number of LMICs (ibid). A prerequisite for the effective representation of MSEs is, however, the existence of effective (informal) MSE employer’s associations (Bekko & Muchai, 2002). Many (informal) employers’ associations and alliances suffer from inadequate administrative and institutional capacities and a lack of sustainable funding.

These observations suggest that, for most MSEs, formalisation – that is, operating under business regulations and stringent labour laws – is not beneficial but rather an experience linked with costs. Even when authorities ease entry and assume a large part of the costs, MSEs only rarely take advantage of formalisation. This might have less to do with MSEs being informal but rather more with MDEs being too small to reap formalisation benefits. In fact, to qualify for institutional support, to enter into public procurement contracts and to have access to good-quality public services and subsidised government-led industrial development programmes, certain size thresholds for enterprises apply; the latter often function as entry barriers and lead to the systematic exclusion, not only of informal and formal MSEs but also of medium-sized enterprises.

### 4.3 Access to finance

Micro and small businesses face significant constraints in obtaining financial resources. The lack of finance limits opportunities for the growth of operational capacities, technological upgrading and employment creation. Accordingly, access to finance is expected to increase business performance and job-creation potential among MSEs. Yet, across countries, empirical evidence implies that the uptake as well as the impact of microfinance products on growth and employment creation is modest and insignificant (Arraíz et al., 2012; Banerjee et al., 2013; De Mel, 2013b; Karlan & Zinmann, 2011; see also Sub-section 3.4). With the exception of some young start-ups and slightly larger SMEs, access to finance shows only weak effects on MSE profits and employment (ibid.). Researchers have forwarded several reasons for why access to financial services has not shown to provoke any substantial change in business performance and employment.

The first reason is that that access to finance is not going to improve MSE business performance and lead to long-term job and job-quality gains if governments do not improve more general demand-side and supply-side conditions (see Hampel-Milagrosa et al., 2015; World Bank, 2008). While microfinance products have become increasingly available in LMICs, demand-driven explanations point to the fact that the majority of

MSEs still do not have the necessary financial literacy to understand, apply for and make effective use of micro credit schemes (see Hampel-Milagrosa et al., 2015; World Bank, 2008). In order to increase the capacity of MSE owners to effectively apply for and make use of loans, they would first need to be made aware of and trained in adequate accounting and financial reporting tools and in strategic business-plan writing. Especially, the latter training measure is often embedded in entrepreneurship training programmes and has been shown to be most effective when combined with micro-lending schemes (see Grimm & Paffhausen, 2014). Additionally, in targeting MSEs, financial capacities might increase the actual uptake and effectiveness of loans; supply-sided-measures such as an increase in the quality of consulting services amongst micro-lending institutions is also necessary. This involves the provision of detailed and easily comprehensible information on credit modalities (interest rates, credit time-lines, etc.). However, there are clear boundaries as to the extent to which bank officials and financial institutions can compensate for the educational and knowledge constraints of MSE owners. As a result, it would be necessary to raise the financial literacy of the general population by adopting more fundamental training measures at schools and by running educational and consumer-protection campaigns that offer information on the advantages and disadvantages of various private finance products and financial institutions (Hampel-Milagrosa et al., 2015).

Second, there is evidence that micro-finance does not address growth-oriented entrepreneurs but rather those using credits to smoothen their consumption (Berner et al., 2008). Many microentrepreneurs take out micro-loans even though they do not intend to expand their business (ibid.). In other words, a majority of MSEs use micro-finance as a consumption-smoothening device, for instance in the form of private loans for food, health services and education (see also Banerjee et al., 2013; World Bank, 2008). In many cases there might be no demand for financing ‘business growth’ but for funding other productive investments such as an educational measure or a health treatment. While micro-credits have been primarily designed to allow poor entrepreneurs to access financial services, micro-finance institutions have to acknowledge the different financial needs of the poor. Consequently, when aiming at business expansion, micro-finance institutions as well as commercial banks will need to strengthen their capacities to screen their customer’s needs and investment plans more carefully. This will require more in-depth revision processes within the banks of MSEs applying for ‘business’ funding as well as more structural efforts within the financial sector, in particular among micro-lending institutions, to re-consider some of their financial products aimed at poorer households, for example, in developing more targeted products for educational investments, property finance, etc. Eventually, there is also the danger that poor households become indebted if their investments do not pay off. As a result, public policies should establish and strengthen existing credit and financial registries to include private households as well as businesses in order to prevent them from taking out several loans and accumulating an unsustainable debt burden.

Thirdly, access to finance is likely to result in employment gains only via an increase in production capacities and long-term investments; in contrast to this, most micro-finance is based on short-term lending models (Banerjee et al., 2013; De Mel, 2013b). MSEs have been shown to be more likely to use additional financial resources for capital- rather than labour-investments (Banerjee et al., 2013; De Mel et al., 2013b); in this case there is no demand for ‘labour-finance’. Indeed, since many MSEs tend to suffer from low market

demand, their labour and that of their workers is often underutilised (Barnes, 2001). In order to become more profitable and productive, it is economically reasonable for MSEs to aim at producing near capacity before hiring additional personnel. As a consequence, the short term job-creation effects of financial interventions are more likely to be modest, yet, via an increase in production capacities, employment potentials in MSEs could also increase in the long term (Banerjee et al., 2013; Karlan & Zinmann, 2011). This insight also implies that, for very small enterprises, it is advisable not to make credit access conditional on the achievement of employment goals, at least not in the short-term.

Fourth, evidence suggests that many growth-oriented, small-scale entrepreneurs are ‘under-’ or inadequately served by the current finance options available (Hampel-Milagrosa et al., 2015; McKenzie, 2009b; Sonne, 2011; Szirmai et al., 2013). Often, micro-finance provides financial packages that involve small loans, relatively high interest rates and short repayment cycles. This combination does not drive long-term investments in a business like investments in machinery, introduction of new production and process standards, etc. Growth-oriented MSEs will likely require other forms of financial assistance although this will involve the development of new financial products or even institutions. From a policy perspective angle, the financing gap is an already well-known problem in the context of enhancing the growth of medium-sized enterprises (Stein, Goland, & Schiff 2010). Most SMEs suffer from a lack of adequate financial options, as the dual financial system between traditional large-scale industrial finance and micro-credit finance fails to address their needs. Growth-oriented MSEs are likely to face similar, if not amplified, problems to access finance. While finding new financial instruments will involve a degree of experimentation and exploration, some financing instruments have shown themselves to be more and less helpful in providing more adequate finance to small enterprises. These are supply chain finance, trade credit or factoring, guarantee funds, leasing and venture capital (see also Malhotra, 2007; Stein et al., 2010; World Bank, 2008).

‘Supply chain finance’ refers to financial products and services that flow to or through any point in a value chain in order to increase the returns on investment, growth and competitiveness of that value chain and its participants (Stein et al., 2010). Value chain finance and trade credit by business partners have always existed as a form of informal finance mechanism along with formal financial services by banks and is therefore a major instrument in offering funds to informal firms (*ibid.*).

Value chain finance as a financial arrangement can offer solutions in the domain of microfinance; it can be adopted as part of a commercial arrangement between two or more chain partners, or it can be integrated into a multipartite arrangement including chain partners, public actors and financial institutions. What is most promising for growing MSEs is that buyers can help to access credit through value chain finance. This so-called ‘factoring’ involves a third party who receives a share of the invoice, while in return the supplier is paid a percentage in advance from this third party (Malhotra, 2007). Thus, factoring is a specific form of supplier finance by which enterprises sell their creditworthiness and in turn receive immediate cash. The underwriting policy of factoring is based on the risk of the accounts receivable and, therefore, depends on the assessment of the creditworthiness of the buyer in relation to that of the supplier. This makes it an important financing instrument for MSEs that, due to their informality or age, lack

collateral and credit histories. Moreover, as buyers commit to helping finance a supplier, they also enter a stable contract with MSEs. This form of ‘contract-embedded’ finance further allows MSEs to lower the risk of low and/or irregular demand. Another advantage of this sort of finance is the fact that credit modalities, such as credit volumes and time-lines, also grow with demands in value chains. This makes financial investments more sustainable and adequate in catering for long-term MSE development perspectives. Similarly, other business partners and governments can give guarantees and act as ‘factors’ to commercial banks to help growth-oriented MSEs access better and more extensive financial services.

Guarantee funds operate on the same principle of providing ‘guarantees’ for MSEs. However, in contrast to privately-run programmes, government-run guarantee schemes for slightly larger SMEs have proven to be less financially sustainable due to somewhat careless monitoring and missing linkages to markets and orders (ibid.).

Further, leasing instruments have been discussed as a viable medium-term financial option for small firms that mostly rely on their turnover and cash-flow to access funds, rather than on balance or credit history. Leasing involves a contract between two parties by which one party provides a specific asset such as equipment or machinery in exchange for specific payments. However, there seems to be not enough experience, even for SMEs, with this kind of financial instrument as leasing markets in LMICs are still underdeveloped (Stein et. al, 2010).

Furthermore, venture capital provided by ‘business angels’ is often mentioned in the context of MSEs; here the drawback is that equity markets in LMICs are not sufficiently developed for this sort of finance mechanism.

Overall, it appears that, apart from various forms of value chain finance such as factoring, only few viable financing options for expanding MSEs exist. Along with supporting and backing micro-finance schemes, governments are therefore advised to incentivise public development banks as well as commercial banks in order to increase the volume and supply of innovative finance products targeted at smaller, but growing, MSEs. These should be made accessible on the basis of clear, objective performance criteria and in-depth revisions of business plans, and should involve longer-term finance.

Lastly, a strong argument exists for the development of micro-insurance for micro and small entrepreneurs with a view to securing them against income loss and to increase private financial security in risky investments (Grimm, Lange & Lay, 2011). Micro-insurance programmes aim to offset the tendency of MSEs to under-invest in more concentrated assets in the presence of background risk. As basic social protection is still not available for most individuals in LMICs, other forms of safety net such as a tailored insurance, might induce more growth and employment investments in MSEs. However, in Egypt, Groh and McKenzie (2014) found that the uptake of insurance against macroeconomic and political risks by micro-entrepreneurs neither induced increases in loan uptake nor an increase in loan size or changes in investment behaviour. Hence, there are still a lot of open questions with regard to the impact of insurance on MSE’s business performance and/or employment.

#### 4.4 Access to markets, information and technology

MSEs suffer from a limited market outreach, irregular market demand as well as from a lack of viable market information and access to state-of-the-art technologies. Due to their low visibility they are rarely exposed to those quality, inter-firm and trading networks that nurture learning and innovation and eventually drive labour-intensive growth, increasing wages and better working conditions in small firms (Dutz et al., 2011; see also Sub-section 3.2). On the other hand, there are several ways in which policymakers can address deficiencies amongst MSEs in access to markets, information and technology.

Evidence suggests that BDS (namely the use of dedicated non-financial business development services (BDS)), have positive effects on MSEs performance and employment. Here BDS are defined as those non-financial business development services that aim to improve the competitiveness of firms and facilitate their access to new markets, market information and technology. In concrete terms, this involves measures such as supplier development programmes, the dedicated dissemination of technologies and market information, and market linkage programmes amongst MSEs. Small enterprises that make use of BDS often receive training<sup>11</sup> on new technologies and business practices, counselling, marketing or linkage services in exchange for a subsidised fee. While the empirical base on BDS effectiveness for MSEs might be still quite weak, most recent evaluations indicate significant positive effects on their ability to innovate as well as add jobs (Arraíz, Henríquez, & Stucchi, 2013; Eshetu et al., 2013; Lopez-Acevedo & Tinajero-Bravo, 2010). However, there are still a lot of open questions with regard to the methodological strength of BDSs impact evaluations. Often participating firms tend to select themselves into BDS programmes, especially if these are publicly or donor-funded (Arraíz et al., 2013); this makes it difficult to test whether BDS are functioning *per se* or whether BDS are attracting MSEs that are already successful.

Second, with regard to effective design, it appears that non-financial BDS have to be demand-driven, customised and concentrated in their efforts. However, few publicly-run BDS centres have the industrial knowledge, enterprise outreach, organisational capacities and financial resources to be demand-driven, customised and concentrated. As one of the main providers of embedded, donor-funded BDSs in clusters, UNIDO (the United Nations Industrial Development Organization) oversaw several independent evaluations of its programmes concerned with services such as BDS, cluster development and industrial upgrading (UNIDO, 2000, 2010, 2013). Very few business development centres are demand-driven. Rather, many business development centres appear to be characterised by centralisation, heavy bureaucracy, poor management and inadequately trained personnel (UNIDO, 2000, 2010). In consequence, many BDS centres follow a top-down, rather than a bottom-up logic, making services everything but effective in addressing the needs of MSEs. This is underlined by qualitative evidence from India and Egypt where entrepreneurs reported that public BDS were irrelevant, unattractive or not worthwhile paying for (Loewe et al., 2013; Reeg, 2013b). Thus, participation in supply-driven market-linkage programmes is likely to increase under the condition that the latter actually

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11 This involves quite specific training measures focusing on the dissemination of new technologies, market information, and policy briefs as well as educational events on new quality standards in production. Thus, BDS training measures tend to go beyond rather general entrepreneurship trainings.

provide viable business information and useful contacts – irrespective of whether the structure is top-down or bottom-up (Altenburg & Stamm, 2004; Loewe et al., 2013).

In addition, since many BDS programmes are based on government-led regional economic development strategies and offer a wide range of services to a very heterogeneous local clientele, few business development centres have the administrative and financial capacities to offer customised and concentrated services according to industry – or size-specific – challenges (UNIDO, 2000). This is especially the case for smaller MSEs where transaction costs tend to be high. Furthermore, the outreach to particular industrial actors, especially to lead firms, is often constrained, which limits a centre's capacity to effectively run market-linkage events and programmes (UNIDO, 2010).

Case studies suggest that the effectiveness of BDS can be dramatically improved if industry organisations, small enterprise associations and R&D organisations like universities or institutes of applied research are also actively engaged as implementing agents and as a member of a tripartite arrangement (UNIDO 2000, 2010, 2013). Together these actors can provide the required industry know-how as well as resources to design sustainable BDS that are, in fact, demand-driven, customised and concentrated in their efforts. While some BDS may be subsidised to reach out to MSEs, all services should have some payment component in order to ensure the involvement of service recipients and, more importantly, to mirror a true demand for the service. Ultimately, the level of client payment is the easiest and most effective measurement that BDS is demand-driven and effective.

Third, BDS measures will have a limited impact on more and better jobs in small firms if the latter are isolated from and not integrated into a medium-to-long-term industrial development strategy.

Fourthly, while targeted BDS can address some crucial growth and hiring bottlenecks, it is important for governments to address MSE challenges in a more fundamental way by integrating small enterprise promotion policies, including BDS, into a national and regional industrial policy strategy (Altenburg, 2011; Bair, 2005; Bell & Albu, 1999; Humphrey & Schmitz, 1996, 2000; Kaplinsky & Morris, 2001). This involves an enhanced integration of small enterprises into nationally promoted value chains, cluster policies, strategic trade policies as in export promotion programmes, as well as industry-wide technology transfer and innovation programmes. Within such efforts, policymakers may offer or fund the provision of free information about markets, recent market developments and possible support schemes to all MSEs (Hampel-Milagrosa et al., 2015). Governments should further consider the development of subsidised technology funds for all MSEs that wish to undertake investments in research and development as well as the provision of market-linkage services that support MSEs and MSE associations in their efforts to gain visibility in national or even international industrial exhibitions or trade fairs (Loewe et al., 2013; Reeg, 2013b). A potential source for funding such endeavours might be government-funded voucher schemes by which firms are free to select their BDS provider (Altenburg & Stamm, 2004).

#### 4.5 Access to skilled and trained labour

If MSE owners wish to become and remain competitive, their employees are a crucial resource. Indeed, empirical evidence in LMICs suggests that a lack or a shortage of skilled and adequately educated labour – or human capital – inhibits productivity and employment growth amongst MSEs (Das & Kalita, 2009; Hampel-Milagrosa et al., 2015; see also Figure 4). Without employees being adequately educated, trained and incentivised to constantly take on new and more sophisticated tasks, a firm's potential to innovate, grow and expand will remain limited. This has further implications for several dimensions of job quality, in particular wages and working conditions: wages will remain low thereby deterring skilled workers from coming to work at an MSE or from staying on. As a result, most MSEs find themselves stuck in a 'human capital trap' as they are major employers of uneducated, untrained and unskilled workers that need to undergo substantial on-the-job training. However, only a few MSEs make investments in the further quality training of employees as they fear that they may lose skilled workers to better paying and larger firms once the training has been completed.

In order to address this 'human capital trap', policymakers can adopt the following measures to assist MSEs in finding, keeping and supporting their employees.

First, governments can set economic incentives for MSEs to offer more on-the-job training and higher wages via wage subsidies. The idea is that wage subsidies for smaller units could induce additional hiring and training that would have not happened otherwise and thereby contribute to a beneficial increase in production turnover and general performance. Wage subsidies belong to the group of active labour market policies which are rarely used in LMICs due to the lack of fiscal space, the inadequate administrative and institutional capacity of labour ministries as well as inadequate labour market information systems resulting from large informal sectors (Almeida, Orr, & Robalino, 2014). Though evidence is scarce, there are some recent impact evaluations of wage subsidies in small enterprises in Sri Lanka and Turkey showing some promising results in increased employment levels (Betchermann, Meltem Daysal, & Pagés, 2010; De Mel et al., 2013b). Yet, since only few experiences have been made with wage subsidies, policymakers should be cautious with overly optimistic expectations.

In the context of high-income countries, wage subsidies are primarily aimed at increasing or preserving employment of certain, mostly vulnerable, target groups such as low-skilled, low-wage workers (Almeida et al., 2014). Besides functioning as a 'hiring incentive', wage subsidies also facilitate on-the-job training of unskilled, young workers ('learning effects'). The training component in wage subsidies appears to be of particular importance for long-term employment creation as employers only keep formerly subsidised workers if they have increased their skill level substantially and are, in fact, enhancing the productivity of processes at the firm (ibid.). The uptake as well as the effectiveness of wage subsidies in creating employment and in driving skill development also largely seemed to depend on the design of the subsidy giving employers the opportunity to take on those workers from whom they speculated to gain the most (see also Betchermann et al., 2010). However, Almeida et al. (2014) point out that wage subsidies in high-income countries may have been more effective in increasing the human capital and employability of vulnerable groups than in increasing employment levels. This is because of windfall effects, namely that workers are

hired that would have been hired anyway, and substitution effects, namely that non-subsidised workers are being replaced by subsidised workers.

Similarly, in a study on Sri Lanka, De Mel et al. (2012b) find indicative evidence of windfall effects in MSEs participating in a micro-finance programme. In terms of learning effects, it is debatable whether MSEs in LMICs always offer a learning environment as many MSE themselves lack access to new technologies, knowledge and best practices. It may be that wage subsidies are a more appropriate instrument to induce hiring and training in slightly larger and more dynamic SMEs. Above all, formality is often an eligibility criteria to participate in wage subsidy programs (Almeida et al., 2014). This in turn questions the policy goal of improving the competitiveness, job-creation potential and working conditions of disadvantaged, informal MSEs that might not be able to partake in such measures. On the contrary, supporting formal and slightly larger SMEs with wage subsidies might further enhance the incentives of skilled workers to leave their smaller and worse-paying employers, and thereby exacerbate the human capital trap of informal MSEs (crowding-out effects). Finally, it should also be acknowledged that wage subsidies are a very costly intervention in high- and middle-income countries, which is why their applicability in LMICs is severely constrained.

Second, as micro- and small entrepreneurs are only partially aware of the importance of human resource development (HRD) measures, including workforce training, employee incentives and decent working conditions, policymakers should introduce educational campaigns as well as information events on the relevance and the need to integrate HRD into traditional apprenticeships and informal on-the-job trainings (see also Hampel-Milagrosa et al., 2015). Apart from large-scale public campaigns, industry and enterprise associations could be incentivised to run events and dedicated HRD trainings and BDS counselling portfolios focusing on subjects such as human resource management, occupational safety and health, resolving complaints and disputes, productivity at the workplace, training materials and exchange among teaching personnel, for example among master tailors and craftsman, etc. A national and regional training and skill development framework, including technical vocational education and training (TVET) measures and sectorally targeted human capital initiatives, could be adopted.

Although MSEs already carry on most of the informal on-the-job-training, the existing mismatch between demand and supply on labour markets cannot be shouldered by them alone (Liedholm, 2002). The third point is therefore that eventually improvements in training activities at the enterprise level can only be effective if they are accompanied by national and regional policy efforts to develop education and training frameworks that are sensitive to private sector needs – in this particular case to those of MSEs in the informal sector. Such a national training and skill development framework may involve several policy efforts: One is that training institutions and authorities need to be made aware of and trained in assessing the training needs of informal sector firms, in particular MSEs. Second, governments should be encouraged to improve the institutional landscape for technical education and vocational training (TVET) which requires investments in regional facilities, such as polytechnic schools, as well as the introduction of mostly private-sector driven training curricula. A third effort needs to address the development of sectorally targeted human capital initiatives in growing economic sectors: the case of the software industry in India is, for example, another policy measure to address the short- to medium-term labour and knowledge constraints of local enterprises, in particular MSEs (see Reeg, 2013b). This

includes more short-term training courses as well as matching initiatives. Other examples are regular local job fairs or permanent exhibitions by hiring MSEs at TVET centres, polytechnics and other short-term skill development training centres.

Fourthly, the development and upgrading of technical skills is closely linked to the possession of basic formal education. Thus, in the long run, the most important policy measure to increase the long-term employability of the working population is to improve the quality of public education starting at the primary up to the secondary school level.

#### 4.6 Access of MSE owners to education and training

There is a strong policy argument for addressing small entrepreneur's skill and knowledge constraints in order to improve business performance and induce more and better jobs among MSEs (Hampel-Milagrosa et al., 2015; see also Sub-section 3.1.). Against this background, policy discussions have recently evolved over the provision of entrepreneurship training measures aimed at the developing business and managerial skills of micro-entrepreneurs, new start-ups and even more experienced SME owners (Bruhn, Karlan, & Schoar, 2013; Cho & Honorati, 2014; Grimm & Paffhausen, 2014; World Bank, 2013).

The idea behind entrepreneurship trainings is that, since the capacity to acquire skills and to apply them to business constitutes a decisive characteristic of successful entrepreneurs, these capabilities need to be acquired and further developed in specialised trainings (World Bank, 2013). Generally, entrepreneurship training can focus on different aspects of business development, such as business plan development, financial literacy trainings, business and behavioural skills training, and some applied technical education and vocational training measures (see also Grimm & Paffhausen, 2014). Time frames range from short-term measures taking a few days of the entrepreneur's time, to long-term courses and coaching that can last several weeks or months being offered once or several times a week. Further, the specificity and degree of tailoring of training measures varies.

The question that arises is whether entrepreneurship trainings are a sufficient measure to drive entrepreneurial qualities and business management capacities. Overall, evidence suggests that training interventions significantly improve the entrepreneur's business, management and technical skills, financial literacy as well as self-reported behavioural components, for instance motivation, even after a short amount of time (Drexler, Fischer, & Schoar, 2013). However, while business performance was reported to improve in terms of higher investments, increases in R&D activities and sales and revenues, increases in profits and employment were rare or insignificant (see Cho & Honorati, 2014; Grimm & Paffhausen, 2014). There are several possible explanations for this outcome:

A first explanation is that the short-term design of current impact evaluations may miss out employment effects that may only emerge in the long run. Thus, one explanation could be that it is only at later developmental stages that employment effects might be noticeable. Unfortunately, there are not yet any studies that allow the estimation of long-term effects. Considering that training interventions are primarily aimed at improving skills, there is indeed a long way to go from the improvement of skills to visible outcomes such as profits and number of workers. Unfortunately, most evaluations provide insights on the short-term

rather than on the long-term effects of trainings. So far, impact evaluations and assessments of entrepreneurship measures have been performed in Latin America (Bruhn et al., 2013; Calderon, Cunha, & De Giorgi, 2013; Drexler et al., 2013; Valdivia, 2011), Asia (Banerjee et al., 2011; De Mel et al., 2012b, 2013b) and Africa (Cho, Kalomba, Mobarak, & Orozco, 2012; Bandiera et al., 2012; Robb, Valerio, & Parton, 2014). Nevertheless, entrepreneurship trainings can have immediate effects on business performance if entrepreneurs decide either not to pursue a new business any longer or if entrepreneurs decide to close down an existing business due to flaws in the business idea or a lack of profitability. Indeed, Grimm and Paffhausen (2014) find that this is the case for a number of entrepreneurship trainings. As a result, entrepreneurship trainings may function as a selective filter helping entrepreneurs to adjust their investment decisions such as reconsidering the allocation of their labour and capital more carefully.

Second, entrepreneurship trainings are not likely to compensate for the lack of basic education and skills amongst the large majority of less privileged micro- and small entrepreneurs. In a nutshell, entrepreneurship trainings are a drop in the ocean, and, unfortunately, for many MSEs, this kind of isolated intervention comes too late to result in substantial gains in productivity, profitability and jobs. Without core skills and basic quality education, MSE owners are not likely to innovate, become more profitable and expand the employment size of their businesses. In order to introduce and sustain innovative and viable businesses, entrepreneurs rely on essential individual competences such as financial literacy, managerial, analytical and international language skills, creativity, risk-taking, market foresight, need for achievement and other behavioural strengths (Hampel-Milagrosa et al., 2015). While it is debatable whether and to which degree these competences and abilities can be further developed and nurtured in entrepreneurship trainings, the baseline is that nobody will be able to teach someone a new language, business calculations, and how to be creative if that person has not learned to read, write and calculate as well as critically reflect upon questions and problems. This is especially true for behavioural and psychological qualities that are usually developed in early childhood and teenage years.

The policy lesson here is that entrepreneurship trainings address knowledge and skill constraints at a point in time where the majority of MSEs will not be able to make full use of them. Improving knowledge and core skills amongst children and young adults enables them to perform well in business, but also in life more generally, whether employed or self-employed. In order to increase the growth and job-creation potential of all MSEs, governments are therefore advised to improve the overall quality of basic national education systems and to incorporate entrepreneurial competences into schools' and other training institutes' curricula. Modern curricula should therefore go beyond top-down knowledge transfers, but also encourage creativity, reflective and analytical thinking as well as explorative curiosity among young learners. Authorities should further incentivise higher-educational institutes, such as universities and polytechnics, to run business competitions and start-up centres or business incubators as well as to offer complementary industry internships to support entrepreneurial projects of current under- and postgraduate students. These integrated measures have shown to effectively stimulate the first entrepreneurial endeavours of fast-growing IT entrepreneurs in India (Reeg, 2013b).

A third issue is that targeted entrepreneurship trainings are seldom sensitive to their beneficiaries' needs and are thus too general to help already better educated MSE and SME owners who are searching for more substantial counselling, managerial skills and advice on strategic business development in order to expand their business (see Loewe et al., 2013; Reeg, 2013b). It seems fairly intuitive that the effectiveness of entrepreneurship trainings, especially those targeted at 'job creators', depends on the types and developmental stage of beneficiaries. Trainings seem to be more helpful for young enterprises and start-ups, though many do receive additional financial assistance making the establishment of clear cause-effect attributions impossible. Yet, the fact that entrepreneurship programmes typically include a package of interventions, such as training and finance, is found to be effective in producing the intended result of creating profitable start-ups (De Mel et al., 2012b). Entrepreneurship trainings with tailored contents for beneficiaries appear to be the most successful (Bruhn et al., 2013; Drexler et al. 2013). While participants with a higher level of education and skills seemed to benefit from more demanding course contents, less complex trainings showed better results on those with lower educational performance (ibid). This is in line with qualitative studies in Egypt and India where outperforming entrepreneurs reported that most general entrepreneurship trainings available to them were too basic and too short to be helpful for business restructuring and improving performance (Loewe et al., 2013; Reeg, 2013b). The majority of training is rarely tailored to the needs of entrepreneurs, but involves the acquisition of general business knowledge, financial literacy and some vocational skills (Bandiera et al., 2012; Calderon et al., 2013; De Mel, 2012b). Only in a few cases did training measures include an in-depth analysis of business challenges, business plan writing and management consulting (Bruhn et al., 2013; Valdivia, 2011). This insight is particularly relevant as adverse selection and identification problems of broadly advertised entrepreneurship programmes might not be able to reach out to those poorer entrepreneurs whom would be the ones to benefit from more basic trainings and counselling (Bruhn et al., 2013; De Mel et al., 2012b). Rather, it is often the already well-informed, educated, skilled, connected and time abundant entrepreneurs that take part in subsidised trainings. Hence, there is further potential to design entrepreneurship trainings with a stronger industrial focus and connect these to existing business mentoring or even micro-franchising programmes.

In terms of policy implications, governments may additionally adopt educational measures targeted at more experienced entrepreneurs who wish to expand to create more and better jobs. Targeting dynamic 'job-creators', that is, the 'gazelles', requires entrepreneurship trainings to be more substantial and sensitive to the needs of the private sector. Thus, authorities would be advised to hand on the implementation of these trainings to private industry organisations or other dedicated training providers that have relevant know-how at their disposal on recent trends in business management, accounting, legal aspects and other strategic business development matters (Loewe et al., 2013). As entrepreneurship trainings – especially targeted and more substantial ones, tend to be costly – authorities will have to make sure public resources are spent wisely as well as in a fair and transparent manner. This requires targeting schemes to be built on a transparent and accessible application process, objective eligibility criteria (based on a firm's performance rather than on individual entrepreneur characteristics), clear time-frames, and preferably a firm-size oriented partial-payment component.

## 5 Conclusions

This report has offered guidance for policymakers and development practitioners who wish to leverage the potential of MSEs for job creation and decent work. The study shows that MSEs can only serve the purpose of being (quality) job creators under certain conditions: that is, only if they increase their productivity and follow employment-friendly growth trajectories.

Empirical evidence suggests that only a very small group of affluent micro- and small entrepreneurs have shown themselves to have the potential to drive job creation and improvements in job quality (see Section 2). Consequently, it is argued that various factors play a role in driving MSE growth and employment: (i) human capital (education, training and work experience) and private wealth; (ii) sector/industry focus; (iii) R&D and market research; (iv) workforce training and incentives; and (v) supportive networks. As the majority of MSEs lack the access to these enabling growth factors (human, social and financial capital) few manage to overcome growth constraints and expand in employment and improve working conditions (see Section 3).

As a consequence, in building an inclusive strategy for MSE promotion, policymakers have to address a number of structural and enterprise-specific growth constraints. This report has investigated the effectiveness of policy measures across six policy fields and has made specific recommendations on how to assist MSEs in their growth and job-quality improvements (see Sub-sections 4.1-4.6). This, above all, involves the provision of quality education and training, access to adequate finance, access to market information for all, the design of MSE-sensitive industrial policies, access to quality infrastructure, as well as reforms in the design and enforcement of business and labour regulations.

Based on the insights in these six designated policy areas, the following cross-sectoral policy messages emerge:

- *Creating more and better jobs in MSEs requires that governments create an environment of equal opportunities for all:* Neither will the deregulation of the business environment automatically translate into MSE growth and job creation, nor will an exclusively targeted approach aimed at ‘growth-oriented’ entrepreneurs level out the evident inequality of growth opportunities amongst MSEs. This is not to say that governments should cease their efforts to improve the regulatory business environment and assist MSEs with performance-based targeted interventions; however, on their own, both approaches do not advance the required systematic changes that are needed to address structural inequalities and tensions amongst MSEs in LMICs. Thus, in order to drive productivity growth, job creation and decent work amongst MSEs, policymakers should not forget to undertake more fundamental policy reforms and universalist interventions aimed at creating an environment where equal opportunities exist among all MSEs. This can be seen for example in the case of the effectiveness of educational measures for entrepreneurs, where a combination of active state involvement in the provision of quality public education as well as the offer of specialised targeted entrepreneurship trainings are most appropriate to stimulate learning among current and future entrepreneurs (see Sub-section 4.6).
- *Policy interventions are most successful if combined with others, and integrated into a broader MSE promotion strategy:* Interventions targeted at particular bottlenecks of any kind may help to overcome one growth barrier, yet, fail to address another. MSEs often end up in ‘growth traps’ as several constraints are interrelated and mutually

enhancing, such as financial and knowledge constraints. As a result, combined interventions that tackle several growth constraints simultaneously or provide ‘double-benefits’ might enhance the developmental impact on MSEs. This is particularly true for female entrepreneurs who in contrast to most men tend to suffer from several growth constraints at the same time. This is also why targeted interventions should be seen as an extension to universal measures if MSEs are to be assisted. As more general growth constraints are tackled by universal support measures, less mutually enhancing growth bottlenecks may arise. For example, as shown in the case of targeted MSE business development services (BDS), these will only be effective if integrated into a broader regional or national enterprise promotion and industrial policy that, apart from market access, also addresses other growth and employment constraints (see Sub-section 4.4).

- *The implementation of targeted interventions aimed at particular MSEs such as high-growth firms needs to be precise, performance-based, transparent and issue-focused to prevent potentially adverse secondary effects:* As many growing MSEs base their business success on structural privileges, targeting these involves a substantial risk of spending public money on the growth promotion of an already advantaged and small group of entrepreneurs who may have experienced growth sooner or later anyways (‘windfall effects’). It is therefore essential to develop a precise definition of growth-orientation that allows bureaucracies to identify beneficiaries based on objective enterprise performance criteria, and not only on individual characteristics. Further, the application process for public support schemes, subsidies or other benefits involved, needs to be made transparent and open to all MSEs. This is of particular importance in the provision of publicly subsidised finance schemes (see Sub-section 4.3). Also, even if authorities manage to objectively identify growth-oriented but constrained MSEs, the question remains as of what happens to those that are not categorised as ‘growth-oriented’. While targeted interventions may induce positive developments in beneficiaries, it is difficult to say what kind of indirect and unintended effects might occur elsewhere. At the present time there is only little knowledge about the indirect effects of targeted interventions on other MSEs, for example crowding-out effects. In other words, in terms of net employment creation, it is hard to tell if new jobs were created or destroyed by using targeted interventions, or whether workers were attracted by other, maybe more productive, activities. This is for example the danger when adopting hiring incentives or wage subsidies (see Sub-section 4.5). In a ‘worst case’ scenario, targeted MSE policies could protect uncompetitive jobs for too long and inhibit the efficient allocation of capital and labour. Thus, in order to reduce the possibility of large, adverse effects, targeting programmes should be focused on particular issues and regularly revisited in their scope.
- *Few targeted MSE policy interventions are primarily aimed at employment creation or the job quality of workers:* The majority of policy instruments are not designed to induce employment creation in MSEs, but to increase their incomes, that is, the job quality of MSE owners. As most MSEs are solely run by own-account workers, interventions primarily address constraints to profitability and productive investments (see Section 4). However, MSE interventions aimed at business performance do not necessarily lead to higher employment growth or better job quality for workers (see Sub-section 2.2). Inducing enterprise growth and employment creation in MSEs requires a substantial push of investments and, as a consequence, more concentrated and long-term-oriented policy measures. For example, in the majority of cases, hiring

will only be induced if MSEs substantially increase production capacities (see also Sub-section 4.3). Also, quality improvements in working conditions for employees take place rather slowly and gradually (see Sub-section 4.2). In consequence, policymakers need to be very clear about their short-term and long-term policy goals when designing interventions. Policy support, however, should not be contingent on the creation of employment within MSEs but primarily facilitate productivity gains. Additionally, assistance and incentives for the enhancement of decent working conditions can be introduced as accompanying measures, for instance through the gradual phasing-in of labour laws, wage-incentives and awareness-raising on HRD. In the long run, however, the evidence suggests that the best long-term employment promotion policy amongst MSEs is the promotion of productivity growth amongst MSEs.

As the overall policy agenda arising from these observations is going to be highly context dependent and nuanced, this report suggests that policymakers follow a two-pronged approach:

- I. *Universalist policy measures:* In order to increase the overall number of productive start-ups and existing MSEs, governments should adopt policy measures to overcome structural growth constraints and create an environment where equal opportunities among all MSEs prevail. This, above all, involves the provision of quality education and training, access to adequate finance, access to market information for all, the design of industrial policies that are sensitive not only to the needs of medium-sized and large, but also to those of smaller enterprises, access to quality infrastructure as well as reforms in the design and enforcement of business and labour regulations.
- II. *Targeted policy measures:* As universalist MSEs policies might not be sufficient and effective in addressing very specific growth constraints such as access to particular markets, knowledge on the implementation of new quality standards for exports, and so on; and as even fast growing MSEs (gazelles) tend to have difficulties in stabilising their growth achievements, sustaining employment growth and overcoming ever more complex constraints to growth and employment expansion, policy interventions that target a number of bottlenecks and/or target a specific group of MSE may be cost-effective in driving MSE employment growth and job quality in such cases. Targeting should, however, be precise, performance-based, transparent and issue-focused in order not to lose sight of potentially adverse indirect effects.

Finally, it should be mentioned that employment creation within MSEs is a very complex undertaking and that there is still a lot that we do not know, particularly when it comes to net employment effects and other unintended consequences of policy interventions. On the research side, this will require more empirical work aimed at MSEs, in particular on informal MSEs, and labour markets in LMICs general. On the policy front, policymakers and development practitioners alike are greatly encouraged to experiment while at the same time ensuring effective monitoring, documentation and evaluation of MSE policy interventions. Yet, in favour of sustainable economic, development policy support should not be contingent on the creation of employment within MSEs but should primarily facilitate productivity gains. Additionally, assistance and incentives for the enhancement of decent working conditions should be accompanying measures, but should be based on principles of applicability and proportionality.



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