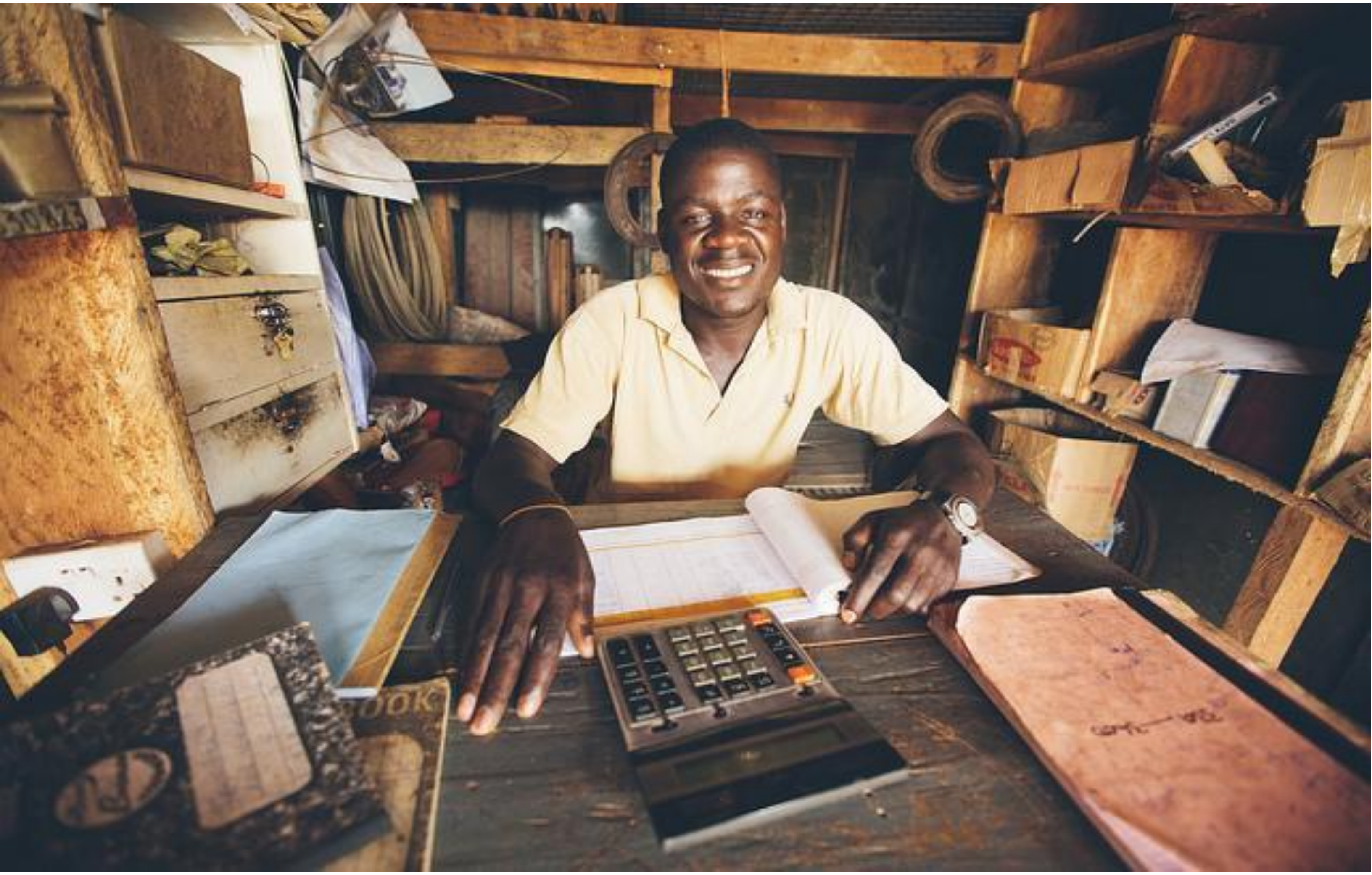


THEORIES OF CHANGE: HIGH-GROWTH SMALL AND MEDIUM ENTERPRISE DEVELOPMENT

May 2019

This study is made possible by the support of the American people through the United States Agency for International Development (USAID). Its contents are the sole responsibility of SSG Advisors, LLC (dba Resonance) and do not necessarily reflect the views of USAID or the US government. It was produced in collaboration with the Bureau for Economic Growth, Education and Environment (E3) Office of Trade and Regulatory Reform (TRR).

TABLE OF CONTENTS

ACRONYMS	ii
EXECUTIVE SUMMARY	1
BACKGROUND	3
METHODOLOGY	4
BUSINESS MANAGEMENT THEORIES OF CHANGE	5
BUSINESS AND TECHNICAL TRAINING	5
CONSULTING SERVICES	9
MATCHING GRANTS FOR BUSINESS MANAGEMENT SERVICES	11
ACCESS TO FINANCE THEORIES OF CHANGE	14
ACCESS TO CREDIT	14
BUSINESS REGISTRATION AND TAXES THEORIES OF CHANGE	22
BUSINESS REGISTRATION	22
TAX POLICIES AND ADMINISTRATION	24
MARKET ACCESS THEORIES OF CHANGE	26
MARKET LINKAGES	26
EXPORT PROMOTION AND SUPPORT	28
INNOVATION THEORIES OF CHANGE	32
PRODUCT INNOVATION SUPPORT	32
CONCLUSIONS AND RECOMMENDATIONS	35
ANNEX 1: BIBLIOGRAPHY	37

ACRONYMS

E3	Bureau for Economic Growth, Education and Environment
GDP	gross domestic product
M&E	monitoring and evaluation
NDB	National Development Board
PFI	participating financial institutions
R&D	research and development
SME	small and medium enterprises
TCA	Trade and Competitiveness Activity
ToC	theory of change
TRR	Office of Trade and Regulatory Reform
USAID	United States Agency for International Development

EXECUTIVE SUMMARY

Small and medium enterprises (SMEs), which form the majority of the business base and are significant drivers of both gross domestic product (GDP) and employment in many developing countries, are popular targets of donor assistance. To help the United States Agency for International Development (USAID) design activities that will best stimulate SME growth in profit and/or employment, the Bureau for Economic Growth, Education and Environment (E3) Office of Trade and Regulatory Reform (TRR) Trade and Competitiveness Activity (TCA) reviewed the latest research and interviewed SME development experts to articulate popular theories of change (ToCs) and to present available evidence around them. The analysis also provides an account of the debates, critiques, and demographic and contextual factors of each ToC, gaps in the evidence, and implications for project design.

INTERVENTIONS, EVIDENCE, AND IMPACT

As summarized in the following table,[1] our research reveals that the level of impact varies greatly among different types of interventions. Our analysis also highlights gaps in the evidence base that make it more difficult to conclusively determine impact of other interventions. Donors should take both of these factors into consideration when designing projects.

INTERVENTION CATEGORY	INTERVENTION TYPE	LEVEL OF EVIDENCE	LEVEL OF IMPACT
BUSINESS MANAGEMENT	Training	STRONG	LOW
	Consulting Services	STRONG	HIGH
	Matching Grants	WEAK	MIXED-HIGH
ACCESS TO FINANCE	Access to Credit	MODERATE	HIGH[2]
BUSINESS REGISTRATION AND TAXES	Business Registration	WEAK	LOW
	Tax Policies and Administration	MODERATE	HIGH
MARKET ACCESS	Market Linkages	MODERATE	HIGH[3]
	Export Promotion and Support	WEAK	MIXED
INNOVATION	Product Innovation Support	WEAK	MIXED

GENERAL RECOMMENDATIONS

Do What We Know Works
Focus on interventions with moderate to strong evidence supporting high impact results (see table summarizing interventions, evidence, and impact)

Carry Out Context-Specific Project Design
Begin with a contextual analysis to identify target SMEs and understand their unique business needs and constraints to growth, and then develop appropriate ToCs

Conduct Additional Research
Fill gaps in the evidence base: lack of segmentation by firm lifecycle stage, age, and size as well as owner age and gender; optimal methods for selecting high-growth SMEs; analyses of cost-effectiveness

Take Cost-Effectiveness into Consideration
Weigh the trade-offs between estimated cost and potential impact, and seek to add to the knowledge base with better cost-efficiency data

---

[1] These findings summarize aggregated evidence collected from a variety of contexts. The level of evidence and/or level of impact of each of the types of intervention may look different if focused on one context.
[2] This ranking is dependent on the access to credit intervention type. Information access and collateral laws have a high impact on SME growth, while findings on credit guarantees and loan subsidies were mixed or low.
[3] Although the impact is high, market linkages must be paired with information transfer from lead firms.

INSIGHTS AND RECOMMENDATIONS BY CATEGORY

In addition to reviewing the evidence that exists surrounding SME development interventions, this report highlights a number of recommendations for donors:

BUSINESS MANAGEMENT

- ***Business and Technical Training***
    - Tailored consulting services and coaching are more effective than classroom-style trainings.
    - The type of training should match your goals, e.g., marketing training typically leads to greater sales and employment while finance training often results in cost-control measures that may actually decrease employment.
    - Training is expensive relative to other interventions, so it should be targeted and ideally paired with access to finance initiatives.
- ***Consulting Services***
    - Identifying existing constraints to the use of consulting services (e.g., information gaps, risk aversion, and credit constraints) and addressing them in program design is critical.
- ***Matching Grants***
    - Programs should seek to identify and address underlying market failure(s), mitigate externalities (e.g., market distortions), and assess the potential for additionality (i.e., whether firms would have paid for the goods or services anyway) when using matching grants.

ACCESS TO CREDIT

- ***Credit Information and Collateral Laws***
    - Reducing information asymmetries (e.g., via the creation or strengthening of credit bureaus) and expanding collateral laws to include moveable assets have positive effects on SME growth.
- ***Subsidized Loans***
    - Subsidized credit lines, in which financial institutions receive funds for on-lending below commercial rates, have not demonstrated a strong return on SME profitability.
- ***Credit Guarantees***
    - Credit guarantees can help SMEs grow faster. However, they are also associated with an increased risk of default.
    - Apply the following best practices from the World Bank, when using guarantee schemes:
        - Leave credit assessments and decision-making to the private sector.
        - Cap coverage ratios and delay the payout of the guarantee until the lender takes recovery actions.
        - Price guarantees to consider the need for financial sustainability and risk minimization.
        - Encourage the use of risk-management tools.

BUSINESS REGISTRATION AND TAXES

- ***Firm Registration***
    - There is limited evidence that formalization has a positive impact on SME growth.
- ***Tax Policies and Administration***
    - Simplifying the costs of tax compliance and reducing the tax burden have been shown to increase SME profitability.
    - Tax policy reforms can also lead to broad SME growth.
    - Limited USAID program cycles pose a challenge to passing and implementing policy reforms.

MARKET ACCESS

- ***Market Linkages***
    - Market linkages programs have been shown to increase SME sales and employment, most effectively through demand-side interventions.
    - Programs must go beyond basic matchmaking to include incentive-based SME capacity building.
- ***Export Promotion and Support***
    - Bundled services combining counseling, planning, and trade missions are most effective when they focus on helping firms break into new markets with new products—and can have an immediate impact on SME profits and employment—but their long-term impact is less clear.

INNOVATION

- ***Product Innovation Support***
    - Support for product innovation has been shown to have an overall positive effect on SME employment.
    - The best ways to support innovation are by improving the enabling environment (e.g., increasing public support for innovation or ensuring a reliable intellectual property rights system), targeting capacity-building to improve SMEs' use of human and capital resources and facilitating access to finance.
    - Donors should consider accelerator models to help build effective, self-sustaining innovation systems.

BACKGROUND

In many developing countries, small and medium enterprises (SMEs)[4] make up the majority of enterprises, account for a substantial share of gross domestic product (GDP), and employ a significant proportion of the workforce.[5,6] Additionally, evidence shows that early-stage SMEs can be drivers for achieving economic growth outcomes, such as increased GDP, particularly in countries with a nascent private sector.[7] For these reasons, policymakers and development practitioners recognize the importance of entrepreneurship and firm development in developing country contexts and have designed and implemented initiatives and programs focused on a range of SME development activities. Building the skills of SME business owners and employees is a priority for government and donor stakeholders for a variety of reasons, namely:

- Local governments rely on firms to increase the competitiveness of products or services in the global marketplace.
- Private sector actors rely on SME suppliers for high-quality products and on-time deliveries.
- Citizens depend on a successful marketplace for employment and, in some cases, poverty alleviation via the goods and services that improve livelihoods and quality of life.
- SME business owners require highly trained workers to contribute to business success and growth.[8,9]

Despite the popularity of SME development programs and policies, theoretical frameworks that outline variables linking entrepreneurship and growth are not always well developed. The study of entrepreneurship draws from multiple academic disciplines, including economics, management, and psychology. Understanding the relationship between entrepreneurship and growth necessarily involves analysis at the level of the individual entrepreneur, at the level of the firm (formal or informal), and at the level of institutions and enabling environments. This makes research in this field a more complex undertaking than in more established fields of economic research.[10]

Moreover, very few newly established enterprises actually succeed, and SMEs often lag behind larger firms in terms of performance. Both of these outcomes are likely due to SME-specific constraints.[11,12,13] Additionally, recent research shows there is substantial heterogeneity among SMEs, with some performing at a subsistence level with limited interest in becoming large firms. These factors make it much more difficult to appropriately target and support SME development. Based on the evidence, there is only a small number of transformational SMEs that grow rapidly, become bigger, and thus have the ability to drive employment and economic growth. Therefore, it is imperative that policymakers, donors, and development practitioners understand how to identify the *high-growth SMEs* that are most likely to benefit from programs and then tailor solutions for these firms.[14] Currently, a large number of interventions designed to support SME growth allow beneficiaries to self-select into programs. A small number of rigorous evaluations are also testing various measurable firm or entrepreneur characteristics, such as ability to write business plans, demographics, intelligence, and psychometric attributes for their effectiveness in predicting high growth, but there is not enough evidence to form conclusions.

---

[4] In this report, *SMEs* are defined as those businesses with between 10 and 250 employees.
[5] Lopez-Acevedo, G., and H.W. Tan. "Impact Evaluation of Small and Medium Enterprise Programs in Latin America and the Caribbean." World Bank, 2011.
[6] Cravo, T., and C. Piza. "The Impact of Business Support Services for Small and Medium Enterprises on Firm Performance in Low- and Middle-Income countries: A Systematic Review." The Campbell Collaboration, 2016.
[7] Cook, P., and E. Olafsen. "Growth Entrepreneurship in Developing Countries: A Preliminary Literature Review." Washington, DC: World Bank, 2016.
[8] Cook and Olafsen, 2016.
[9] Cardon, M. "Contingent Labor as an Enabler of Entrepreneurial Growth." *Human Resource Management*, 42 (2003), 357–373.
[10] Cook and Olafsen, 2016.
[11] Ibid.
[12] Lopez-Acevedo and Tan, 2011.
[13] Cravo and Piza, 2016.
[14] Ayyagari, M., P. Juarros, et al. "Access to Finance and Job Growth: Firm-Level Evidence across Developing Countries." World Bank Policy Research Working Paper 6704, 2016.

This report attempts to provide a comprehensive overview of the interventions that are most effective in spurring SME growth and to offer an account of the debates and critiques, demographic and contextual factors, gaps in the evidence, and implications for project design. In this report, we look at SME growth in terms of increased employment[15] and/or increased profits. The SME intervention areas are organized around the following five theory of change (ToC)[16] categories: 1) Business Management; 2) Access to Finance; 3) Business Registration and Taxes; 4) Market Access; and 5) Innovation.[17] Please note that the ToCs presented in this report are meant to be general across a variety of geographies and contexts and that those applying them for intervention design should contextualize them.

METHODOLOGY

This evidence report provides an organized account of published or publicly available research and studies on SME development. To provide a summary of the research on ToCs, the research team explored the following lines of inquiry:

- What evidence exists that demonstrates the impact of different SME development interventions and growth outcomes? What is the level of rigor of that evidence?
- What gaps exist in the evidence, both in terms of intervention approaches and outcomes, and for specific demographic groups, like women and youth?

The report synthesizes findings from a total of 63 reports. Some of the analyzed research papers were referred by the United States Agency for International Development (USAID) Bureau for Economic Growth, Education and Environment (E3) Office of Trade and Regulatory Reform (TRR), and others were identified through an online search and key informant interviews. Each report selected for review fits within the following criteria:

- It contains a hypothesis, ToC, or impact analysis focused on SME growth rather than on micro or large firms.
- It was published in 2000 or later.
- It contains a study sample from developing countries or emerging markets.

The research team also conducted interviews with researchers and USAID and donor experts in the field of SME development. These interviews were used to determine the current state of practice and to gather information on new and emerging research as well as noticeable gaps in the evidence. In addition, TRR and the research team organized a roundtable in Vietnam to discuss and validate the findings and implications identified within the report with other donors. The valuable feedback received, along with additional research highlighted during the roundtable discussion, was incorporated throughout the report.

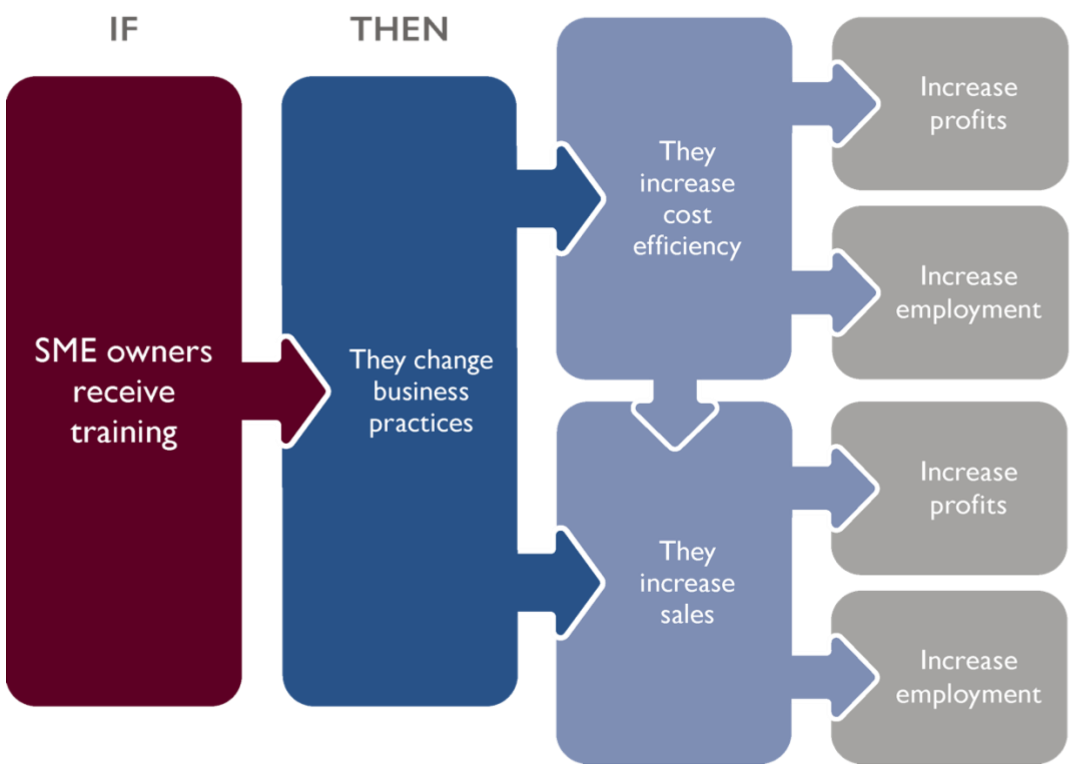
[15] Per the International Labour Organization, persons in employment comprise all those of working age who were engaged in any activity for any amount of time, if only for one hour in the course of the reference week, to produce goods or provide services for pay or profit.
[16] In this report, a *theory of change* is defined as a description of the logical causal relationships between multiple levels of conditions or interim results needed to achieve a long-term objective. It may be visualized as a roadmap of change, and it outlines pathways or steps to get from an initial set of conditions to a desired end result. A theory of change is analogous to a USAID development hypothesis or project hypothesis.
[17] The researchers have parsed interventions into what they feel are the most appropriate categories; however, others may categorize the interventions differently.

BUSINESS MANAGEMENT THEORIES OF CHANGE

Studies show that a lack of managerial skills and capacity among SME employees and leadership constitutes a significant constraint to firm growth and the ability of SMEs to withstand economic shocks and that management skills are a major determinant of productivity.[18,19] Therefore, one common theory among development practitioners is that building the capacity of SME owners and employees will improve the performance of their enterprises, if they acquire new skills, thus leading to an increased demand for labor, along with additional sales revenue and employment generation. Training has become one of the most common forms of support provided by donor interventions to SME owners and employees to improve business practices, core management and administrative functions, and/or technical skills. The World Bank alone invests almost $1 billion per year on skills training programs.[20] However, the literature shows that more tailored consulting services and coaching may have more significant impacts on SME growth.

Increasingly, new training and consulting services interventions are including specified selection processes designed to identify SMEs with potential for high growth, such as business plan competitions, but beneficiary self-selection is still the most common way that SMEs are chosen for business management support. However, since there is a difference in the desire of an SME owner to grow their business and the ability of the business to grow, self-selection may not be the most effective method for identifying high-growth SMEs.

BUSINESS AND TECHNICAL TRAINING
THEORY OF CHANGE



[18] Bruhn, M., D. Karlan, and A. Schoar. "The impact of consulting services on small and medium enterprises." World Bank Policy Research Working Paper 6508. Washington, DC: World Bank, 2013.

[19] Mano, Y., A. Iddrisu, et. al. "How can micro and small enterprises in Sub-Saharan Africa become more productive? The impacts of experimental basic managerial training." *World Development*, 40(3) (2012), 458–468.

[20] Anderson, S.J., R. Chandy, and B. Zia. "Pathways to Profits: Identifying Separate Channels of Small Firm Growth through Business Training." Policy Research Working Paper 7774, 2016.

PROGRAM ASSUMPTIONS

- Owners of SMEs are lacking skills and are aware of this but lack the capital to acquire training commercially.
- Training is the only input participants need to implement new practices (not time, capital, or other inputs) and to realize increases in sales or efficiency.
- SME owners invest in jobs and/or experience greater profit margins from efficiency and/or gains.

Business and technical training interventions can range from large conference sessions, to small workshops, to one-on-one training sessions. However, the studies reviewed for this analysis evaluated classroom-style learning with fixed or preplanned modules or sessions. These **randomized control trials of business training courses found mixed results, in terms of impact on SME performance**.[21] For example, a study compared the impacts of a traditional accounting practices training and the impacts of a rules-of-thumb training on SME performance in the Dominican Republic (the latter approach consisting of the delivery of specific, to-the-point, business recommendations and accounting details or theory—more of a business-coaching approach).[22] The study found that **the rules-of-thumb trainees changed their business practices and their calculated revenues increased by 6 to 12 percentage points, but the traditional accounting practices training had no effect on business practices or firm performance**.

Despite the limited evidence linking general business training and SME performance, the literature has shown that the *type* of training matters and can affect SME development outcomes.[23,24] Based on randomized experiments conducted on management training programs in a number of countries, **basic-level management training was shown to improve business practices and, therefore, increase profits and/or employment, although the extent of improvement on these indicators was small and varied considerably among beneficiaries, depending on their base level of management knowledge and capacity**.[25,26] Those beneficiaries with a lower base level of management knowledge and capacity benefited more from the basic management training and, therefore, improved their management practices to a larger extent.

Additionally, the literature shows that outcomes vary between marketing/sales training and financial literacy training. In South Africa, a study was conducted to analyze the impacts of two 10-week intensive programs, with approximately eight hours per week of face-to-face classroom time—one week on marketing and sales and the other week on finance—delivered to two treatment groups. The marketing and sales training focused on growth, and the finance training focused on cost efficiency.[27,28] A year after the training, the finance group's profits increased by 41 percent and the marketing group's profits increased by 61 percent—although the differences in these effects were not statistically significant.[29] The pathways to these higher profits differed between the two groups. Entrepreneurs who received **marketing training achieved gains by increasing sales and hiring more staff** (i.e., they focused on *growth*). **Finance trainees**, on the other hand, **enhanced profits by trimming costs** (i.e., they focused on *efficiency*).[30] Thus, the former ToC would likely entail increased employment, depending on the sector, and the latter theory might actually decrease employment as a cost.

[21] "Small and Medium Enterprise Program, Five Years in Review: 2011–2016." Innovations for Poverty Action, 2017.
[22] Ibid.
[23] Bruhn et al., 2013.
[24] Mano et al., 2012.
[25] Bruhn et al., 2013.
[26] Mano et al., 2012.
[27] Anderson et al., 2016.
[28] Innovations for Poverty Action, 2017.
[29] Ibid.
[30] Ibid.

DEMOGRAPHIC AND CONTEXTUAL FACTORS

Due to the heterogeneous nature of SMEs, the effect of trainings on business results will vary considerably among different participants, including between male and female business owners and employees.[31] Studies show that training programs for SME owners and employees result in higher impacts in business practices when the complexity of the program is matched with the experience, or sophistication, of the participants. That is, more experienced individuals benefit from detailed, in-depth trainings and, conversely, smaller and less-experienced firms benefit from clear, concise, and simple trainings.[32,33,34] For example, in the study from the Dominican Republic cited in the previous section, the rules-of-thumb finance training produced more pronounced improvements in business practices for clients with the lowest human capital (e.g., level of education or skills), limited ex ante interest in accounting or financial training, and baseline business practices in the lowest quartile.[35]

Firm and entrepreneur characteristics also impact training outcomes. In the study by Y. Mano, A. Iddrisu, Y. Yoshino, and T. Sonobe, less seasoned entrepreneurs tended to do better when they received marketing training, since it encouraged them to look beyond their existing business context and to develop new perspectives on products, customers, distributors, and suppliers. Established enterprises, however, benefited more from finance and accounting skills to reduce costs and increase efficiencies within their businesses.[36,37]

Additionally, the impact of training also depends on the absorptive capacity of entrepreneurs and their employees. In order for training activities to be effective, managers and workers must apply what they learned. The absorptive capacity of SME owners and employees is a function of existing management skills, in-house technical expertise, worker competencies, machine capabilities, and the ability to finance investments. The commitment and motivation, or the mind-set shift, which lead to behavior change of owners and managers is also a key factor in ensuring that new management practices are implemented and retained within an SME's workforce.[38, 39] Finally, often the entrepreneurs who have the most to gain from engaging in training may also have the most difficulty understanding the benefits. This is because they are not aware of how poorly run their businesses are.[40] Training uptake can be incentivized when trainers or training programs can clearly articulate the returns of these training programs to SME employees.[41,42]

GAPS IN THE EVIDENCE

Although there is a significant amount of research on the impacts of training for micro and small enterprises, there is much less evidence and research on the effects of training on more established companies with larger numbers of employees and capital investments and on those firms considered *high-growth ventures*.[43] There are several areas that would benefit from additional evidence. These include:

- Longer-term effects of training interventions beyond a year.[44]

---

[31] Mano et al., 2012.
[32] Bruhn et al., 2013.
[33] Anderson et al., 2016.
[34] Drexler, A., G. Fischer, and A. Schoar. "Keeping It Simple: Financial Literacy and Rules of Thumb." *American Economic Journal: Applied Economics*, 6 (2) (2014): 1–31.
[35] Innovations for Poverty Action, 2017.
[36] Ibid.
[37] Anderson et al., 2016.
[38] Arráiz, I., F. Henríquez, and R. Stucchiet. "Supplier development programs & firm performance: evidence from Chile." *Small Business Economics*, vol. 41 (1) (2013), 277–293.
[39] Woodruff, C. "Addressing constraints to small and growing businesses." Aspen Network of Development Entrepreneurs (ANDE) and International Growth Centre (IGC). London School of Economics Working Paper, 2018.
[40] McKenzie, D., and C. Woodruff. "What Are We Learning from Business Training and Entrepreneurship Evaluations around the Developing World?" World Bank Research Observer, 2014.
[41] Bloom N., B. Eifert, et al. "Does management matter? Evidence from India." *The Quarterly Journal of Economics*, vol. 128(1) (2013), 1–51.
[42] Anderson et al., 2016.
[43] Woodruff, 2018.
[44] Mano et al., 2012.

- Differences based on firm characteristics, including the lifecycle stage of the firm (start-up, early-stage, growth, mature); the age and size of the firm; the competitive nature of the industry and sector the SME is working in; the age and gender of the SME owner; and the SME owner's ambition level, risk-taking ability, or general skill levels.[45]
- Impacts of more advanced SME trainings.[46]
- Impacts of soft and non-cognitive skills training.[47]
- Impacts of different funding models for SME training (e.g., donor-funded trainings versus trainings paid for by SMEs; incentive-based payments).
- Specific effects and impacts of trainings on women and women-owned business or youth and youth-owned business.

A number of training implementers collect data related to the cost of training programs, and they also collect impact at different periods after the training programs. However, **there is a lack of public information on the cost-effectiveness of training programs** as interventions for increasing SME profits and/or employment. Because **training programs can be expensive**, it would be extremely useful to begin analyzing and publishing the cost-effectiveness of training programs, especially when comparing them against other types of interventions.[48]

DEBATES AND CRITIQUES

Although the referenced studies reveal that SME employees and owners can improve their skills and capacities by participating in a training program, the literature, in general, has not validated the link between training and increased sales.[49,50,51] Overall, training programs produced significant improvements in entrepreneurs' skills and behaviors; however, the average effects of the training on the sales and profits of the participants' firms are economically large but statistically insignificant.[52,53,54]

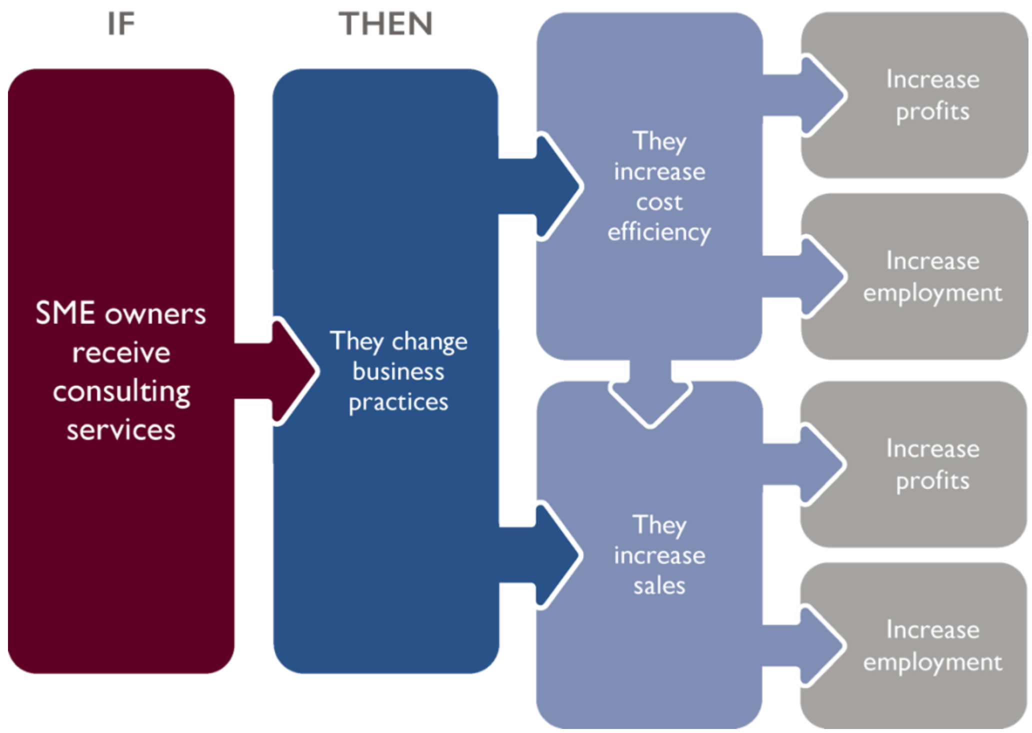
IMPLICATIONS AND RECOMMENDATIONS FOR DONORS

The **cost of delivering training**—defined as classroom-style learning with preplanned modules or sessions—**can be expensive relative to other interventions**, and the results of training interventions are mixed at best. Therefore, donors should consider assessing whether a training intervention is necessary before implementing training activities. After a training intervention is established as required, donors should consider the types of businesses (small, medium, established, new, owners and employees with high education levels, and others) they are targeting and then tailor the training intervention accordingly, since different types of businesses benefit from different training programs.[55] Due to the high costs of training, as a part of the training design process, donors may consider whether an access to finance component should be integrated into the training intervention, since market prices for a training program may significantly hinder SME uptake of that program.[56]

---

[45] Bruhn et al., 2013.
[46] Mano et al., 2012.
[47] In this report, *soft and non-cognitive skills* are defined as a broad set of skills, behaviors, and personal qualities that enable people to effectively navigate their environment, relate well with others, perform well, and achieve their goals.
[48] Woodruff, 2018.
[49] McKenzie and Woodruff, 2014.
[50] de Mel, S., D. McKenzie, and C. Woodruff. "The demand for, and consequences of, formalization among informal firms in Sri Lanka." *American Economic Journal: Applied Economics*, vol. 5(2) (2013), 122–150.
[51] Cook and Olafsen, 2016.
[52] Mano et al., 2012.
[53] Drexler et al., 2014.
[54] Grimm, M., and A.L. Paffhausen. "Do Interventions Targeted at Micro-Entrepreneurs and Small and Medium-Sized Firms Create Jobs?" Discussion Paper No. 8191, 2014.
[55] Anderson et al., 2016.
[56] Ibid.

CONSULTING SERVICES
THEORY OF CHANGE



PROGRAM ASSUMPTIONS

- Employees or owners of SMEs lack skills and are aware of this need but lack capital to acquire consulting commercially.
- Consulting is the only input SME owners need to implement skills (not time, capital, or other inputs) and to realize increases in sales or efficiency.
- SME owners invest in jobs and/or experience greater profit margins from efficiency and/or gains.

Although the impacts of training programs on SME growth are mixed, studies on consulting services show a stronger link to SME growth.[57] Consulting services differ from standard training in that the technical assistance is typically customized to the firm and its specific needs. Although the process may vary, generally interventions are carried out in a two-phase process: 1) consultants generate a diagnostic report that evaluates the firm's existing management structure and outputs; and 2) consultants implement a consulting plan that advises managers and firm employees.[58]

To test whether consulting services impact SME performance, a field experiment in India analyzed textile firms that had received free services from an international consulting firm. The consulting firm trained and mentored firm employees on modern ways to manage inventory and standard operating procedures, based on the individual needs of the textile plants. Results of the intervention showed that the consultancy **raised productivity by 11 percent** and **increased annual firm profitability by US$230,000** through improvements in quality, efficiency, and inventory controls. In addition, the intervention centralized decision-making and increased the use of computers for data collection by middle management.[59]

---

[57] Innovations for Poverty Action, 2017.
[58] Bloom et al., 2013.
[59] Ibid.

In Mexico, a similar study was conducted on 80 firms that received subsidized support from local consulting firms.[60] The state government paid for most of the consulting fees, with beneficiary firms contributing between 10 percent and 25 percent of the cost, depending on firm size. The process was similar in nature with a diagnostic phase first, followed by implementation. A program evaluation was conducted one year after the intervention concluded. As in the India study, the consultancy resulted in increased SME productivity. In addition, the study found a positive return on assets and entrepreneurial spirit. Consulting services **increased firm employment by 44 percent and wages by 57 percent**.[61] Another Mexico-based study found that the provision of consulting services to SMEs was successful, with an **80 percent increase in sales** and a **120 percent increase in profits**.[62]

GAPS IN THE EVIDENCE

Although the link between consulting services and SME performance is well established, the types of consulting services that are most appropriate for different types of SMEs, and associated with the greatest impact on SME growth, are less known.[63] In addition, the literature reviewed did not identify any evidence specific to the effects of consulting services on firms with different characteristics, including the lifecycle stage of the firm (start-up, early-stage, growth, mature), the age of the firm, and the age and gender of the SME owner. Therefore, we see an opportunity for further research in these areas.[64] As with the training ToC (noted earlier in this report), there are also gaps in evidence on the impact of donor-funded consulting services versus those facilitated by donor programs, while paid for directly by SMEs, along with donor programs supporting existing service providers versus providing consulting directly. Finally, as a donor colleague suggested, further research could shed light on whether sequencing consulting with other interventions, (e.g., after training) might be even more effective.

DEBATES AND CRITIQUES

One critique of consulting services interventions is that most firms will not seek such assistance on their own without additional incentives. Researchers speculate that that there may be a number of market failures that impede or deter SMEs from procuring consulting services, namely[65]:

- **Insufficient information.** SMEs may not have sufficient information on the business management services available and the potential return on investment. Similarly, service providers may lack information about the type or quantity of services demanded by SMEs, leading to inadequate supply and underinvestment from business management service providers.
- **Risk aversion.** SMEs may be risk averse and may avoid investing in services with a high but uncertain potential return. As donor experts pointed out, a related issue could be that SME owners correctly expect that consultants may propose significant changes to their business which SME owners may not be willing to make.
- **Credit constraints.** SMEs may face difficulties accessing credit, and lenders are reluctant to finance consulting activities that cannot be collateralized.[66,67,68,69]

In addition, the effect of *process innovation*—the implementation of a new or significantly improved production or delivery method—on employment is not straightforward. Process innovation can lead to a

[60] Bruhn et al., 2013.
[61] Ibid.
[62] Cook and Olafsen, 2016.
[63] Bruhn et al., 2013.
[64] Woodruff, 2018.
[65] Bruhn et al., 2013.
[66] Bloom et al., 2013.
[67] Bruhn et al., 2013.
[68] Campos F., A. Coville, et al. "Learning from the Experiments that Never Happened." World Bank Policy Research Working Paper 6296, 2012.
[69] Coste, A., and D. Hristova. "How to Make Grants a Better Match for Private Sector Development: Review of World Bank Matching Grants Projects." Washington, DC: World Bank, 2016.

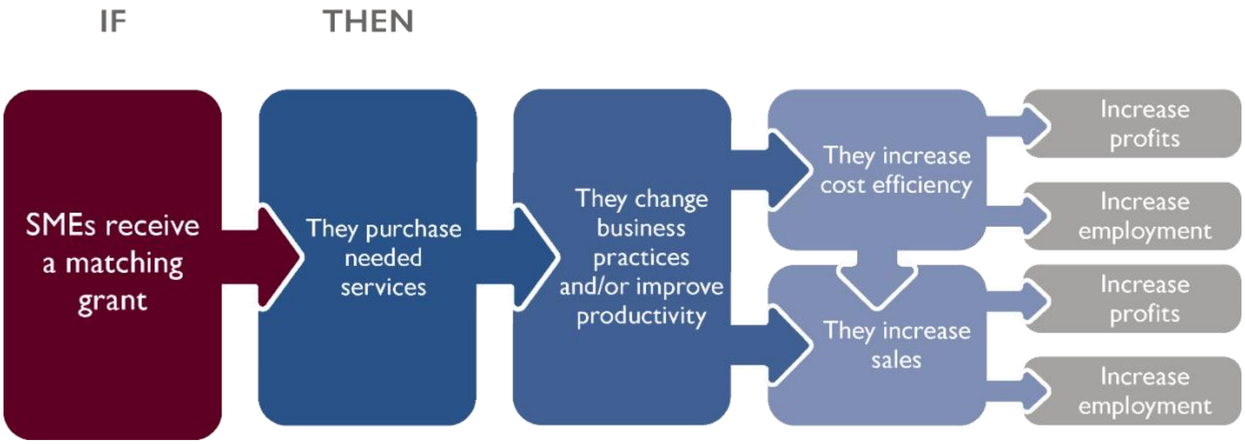
substitution of capital for labor, but it can also increase firm productivity, lower prices, and increase demand for an SME's products or services, leading to higher employment as an input in the firm.[70]

IMPLICATIONS AND RECOMMENDATIONS FOR DONORS

Consulting services can be expensive; however, as exhibited in the research, consulting services are more likely to yield impact over standard training programs. Where possible, incorporating specialized consulting support (whether local or international) into the program design process can yield considerable returns in terms of SME growth. In addition, it is important to identify any market constraints to consulting services that exist (such as information gaps, risk aversion, and credit constraints, among others) and then tailor the intervention design to address these—for example, matchmaking activities that link business management service providers and SMEs, and incentives for business management service providers to tailor services based on SME needs.

MATCHING GRANTS FOR BUSINESS MANAGEMENT SERVICES

THEORY OF CHANGE



PROGRAM ASSUMPTIONS

- SMEs do not have the funds or access to finance to purchase the services they need.
- Through a grant, SMEs are incentivized to purchase services they would not purchase otherwise.
- There is market failure in investment decisions, which justifies taking over financial intermediation.
- SME owners or employees wisely use the cash or in-kind grant for investments.
- SME owners invest in jobs and/or experience greater profit margins from efficiency and/or gains.

In many developing countries, matching grants programs are flourishing as alternative funding options for SMEs and are among the most common tools used to boost firm growth.[71,72] Matching grants are short-term, temporary subsidies provided to SMEs on a cost-sharing basis, with the SME providing anywhere between 10 percent and 50 percent of the cost. Additionally, matching grants programs are often used to encourage SMEs to purchase specialized services—generally aimed at building entrepreneur and employee capacities and knowledge, such as training, capacity-building, marketing, and trade promotion.[73,74] Usually, firms are restricted from using matching grant funds for wages or other recurrent business expenses. Some researchers theorize—though there is no evidence yet to support this—that providing cash subsidies to SMEs directly will be more efficient, since they can choose services or equipment according to business needs. Additionally, matching grants programs are often justified on the grounds that the

[70] Castillo, V., A. Maffioli, et al. "Innovation policy and employment: Evidence from an impact evaluation in Argentina." Technical Notes No. IDB-TN-341. Washington, DC: Inter-American Development Bank, 2011.

[71] Innovations for Poverty Action, 2017.

[72] Campos et al., 2012.

[73] Ibid.

[74] Coste and Hristova, 2016.

increased demand for services may also stimulate a competitive response from existing or new service providers and may create positive externalities, although the evidence for this is also still lacking.[75,76]

In Mexico, a study was conducted of 80 firms that received subsidized consulting from local consulting firms.[77] The state government paid for most of the consulting fees, with beneficiary firms contributing between 10 percent and 25 percent of the cost, depending on firm size. A survey conducted at the end of the program to measure the effect of the consulting services on firm performance indicated that the program led to significant increases in productivity. However, there was no increase in sales or employment after one year of the intervention. In the longer run, three years beyond the intervention, the administrative data revealed important impacts on employment, with a 44 percent higher number of employees and a 57 percent higher total wage bill.[78] **Per this evidence, the link between matching grant programs and SME growth is positive, particularly in the long run, and SMEs can achieve growth through improved firm performance and job creation.**[79,80,81] However, the utility of what the firm purchases with the matching grant is significant.

GAPS IN THE EVIDENCE

Despite the common use of matching grants by policymakers and development practitioners, few impact studies have been successfully carried out. Since matching grants can be used to purchase many types of services and thus provide a variety of outputs, the evidence reviewed from multiple sources is generally insufficient to attribute impact.[82,83,84,85] However, based on the one impact study conducted on this topic (cited earlier), matching grants can have positive impacts on SME growth through improved firm performance and job creation, when they are conditional on effective use of the grant.

More research is also warranted on the impacts of cash and in-kind grants on different SMEs, depending on firm-level characteristics, including the lifecycle stage of the firm (start-up, early-stage, growth, mature) and the age of the firm. Additionally, the literature reviewed did not identify any evidence specific to the effects of grants on women and women-owned business or youth and youth-owned business. Therefore, we see an opportunity for further research in this area.

DEBATES AND CRITIQUES

The main questions surrounding matching grants programs are: 1) whether the grants are necessary; and 2) whether they are the most appropriate intervention, given the context.[86] The assumption underlying the use of a matching grant program is that, by lowering the effective price paid for services, firms will purchase more of these services. It also assumes that firms will purchase enough of a service on their own, with the right grant incentives.[87,88] However, common issues with matching grant programs include the absence of:

- Demand assessments and information about existing services available on the local market.
- A discussion of the specific market failures or the generation of public economic gains that the use of a matching grant would address.

[75] Campos et al., 2012.
[76] Cravo and Piza, 2016.
[77] Bruhn et al., 2013.
[78] Ibid.
[79] Campos et al., 2012.
[80] Cravo and Piza, 2016.
[81] Piza et al., 2013.
[82] Bruhn et al., 2013.
[83] Cravo and Piza, 2016.
[84] Coste and Hristova, 2016.
[85] Piza et al., 2013.
[86] Bruhn et al., 2013.
[87] Campos et al., 2012.
[88] Bruhn et al., 2013.

- An economic analysis of the project's costs and benefits compared with a counterfactual, without the project or the potential use of a different instrument.[89]

Implementation risks increase when donors do not adequately analyze or understand the market. In cases where SMEs are not constrained by lack of capital to purchase a service or by a lack of availability of competitive services, and where such services do not create significant positive externalities, subsidizing these services can create distortions in resource allocation. The most common criticism of matching grants is the risk of limited additionality, meaning that the grants may benefit firms that would pay for the services anyway. Additionally, if matching grants give SMEs only a temporary incentive to procure more services but do nothing to solve the inherent market failure that prevented them from using these services in the first place, the impact of the program may be limited.[90]

Related to this constraint, many matching grants projects lack monitoring and evaluation (M&E) systems to measure a matching grant's impact on the market for certain services (since few matching grant projects identify the precise market failure that is causing a lack of SME growth).[91]

IMPLICATIONS AND RECOMMENDATIONS FOR DONORS

The specific country context and local conditions will determine the need for and design of a matching grants program. To provide an economic rationale for a matching grant intervention and to understand the underlying problem that the matching grants are intended to fix, donors must answer the following questions[92]:

- Given the large effects on productivity, why are business owners or leaders not purchasing these services themselves?[93,94]
- Are matching grants the best way to incentivize private investment to induce public gains, or could other forms of funding or credit be more effective?[95]

This implies that donors must dedicate sufficient resources during project preparation to collect information and to analyze the current obstacles that may limit the use of a service, the potential for additionality and externalities, and whether grants are the best available tool to address market constraints. Inadequate economic rationales may increase the risks of: 1) low uptake by targeted beneficiaries; 2) inappropriate targeting that limits additionality compared to what firms would pay for anyway; and 3) market distortions. Conversely, well-designed projects that are adequately tailored to local circumstances and capacity result in significant additionality, sustainability, and demonstration effects.[96]

[89] Coste and Hristova, 2016.
[90] Ibid.
[91] Ibid.
[92] Campos et al., 2012.
[93] Bruhn et al., 2013.
[94] Campos et al., 2012.
[95] Ibid.
[96] Coste and Hristova, 2016.

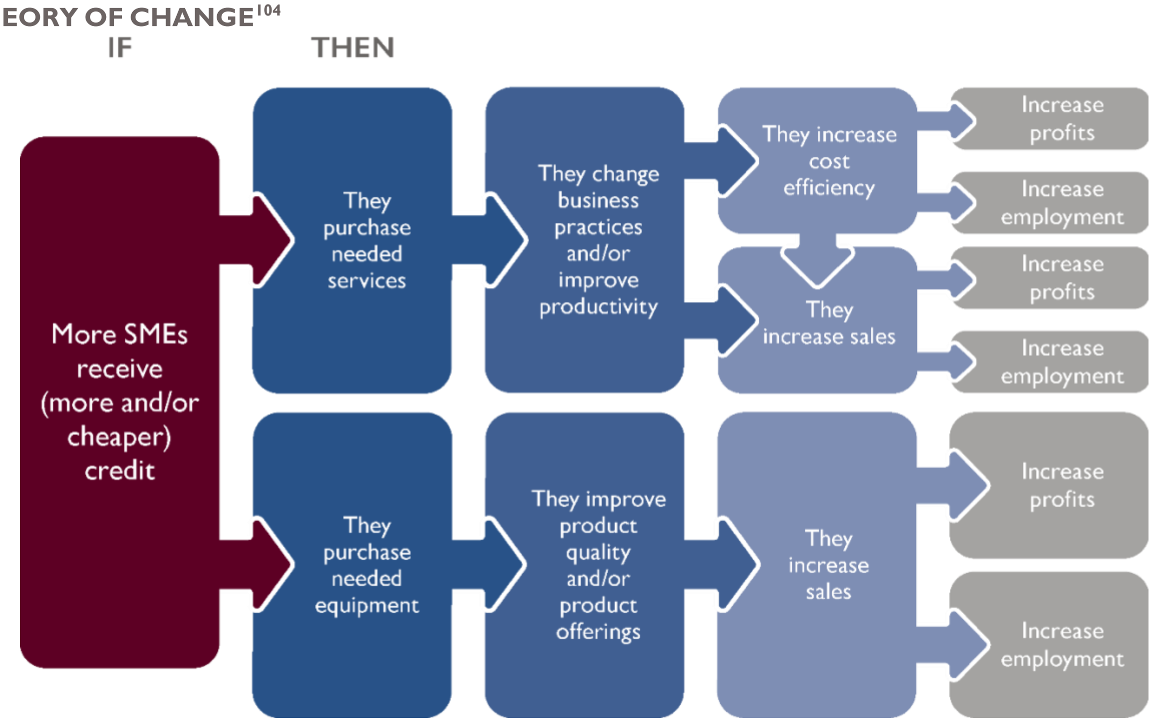
ACCESS TO FINANCE THEORIES OF CHANGE

Limited access to finance for investments is one of the most serious obstacles to SME growth, and access to credit is an important determinant of firm performance.[97] The availability of credit allows firms to invest in productive assets that are likely to lead to productivity growth, increase production, and hire new employees as inputs to production.[98] SMEs need working capital, as well as finance, for investment projects, where the terms match the expected chronology of the returns (e.g., the finance has the right term structure). However, banks in low-income countries generally do not have the appropriate products, and the high transaction costs for lenders to process, monitor, and enforce small SME loans increase interest rates, making borrowing more expensive or unavailable for SMEs, relative to larger firms.[99] Part of the problem is legal (movable collateral, as well as an effective system to actually repossess or foreclose on property). Another part of the problem is informational (credit history and probability of repayment). And another piece is often a shallow financial system that does not do, for example, factoring loans based on contracts or trade credit or equity investing—all of which might benefit high-growth SMEs. As a result, SMEs face high interest rates, do not get longer term loans, or may not even get loans at all.

Due to these constraints, SME financing programs are common among donors and policymakers.[100,101] Over recent decades, financial institutions, governments, and donors invested considerable resources in developing new products and programs to provide SMEs with the financing they need to grow.[102] Interventions include subsidized loans, credit guarantees, and risk-sharing arrangements.[103]

ACCESS TO CREDIT

THEORY OF CHANGE[104]



---

[97] Loening, J., B. Rijkers, and M. Soderbom. "A rural-urban comparison of manufacturing enterprise performance in Ethiopia." *World Development*, vol. 38 (9) (2010), 1278–1296.

[98] Ibid.

[99] Ayyagari M., A. Demirguc-Kunt, and V. Maksimovic. "SME Finance." World Bank Policy Research Working Paper 8241, 2017.

[100] Ibid.

[101] Piza, C., T. Cravo, et al. "Protocol for a Systematic Review: The Impacts of Business Support Services for Small and Medium Enterprises on Firm Performance in Low- and Middle-Income Countries: A Systematic Review." The Campbell Collaboration, 2013.

[102] Innovations for Poverty Action, 2017.

[103] Ibid.

[104] For more detail on the inputs required to get to the "More SMEs receive (more and/or cheaper) credit" phase, please review the following sections and their associated theories of change.

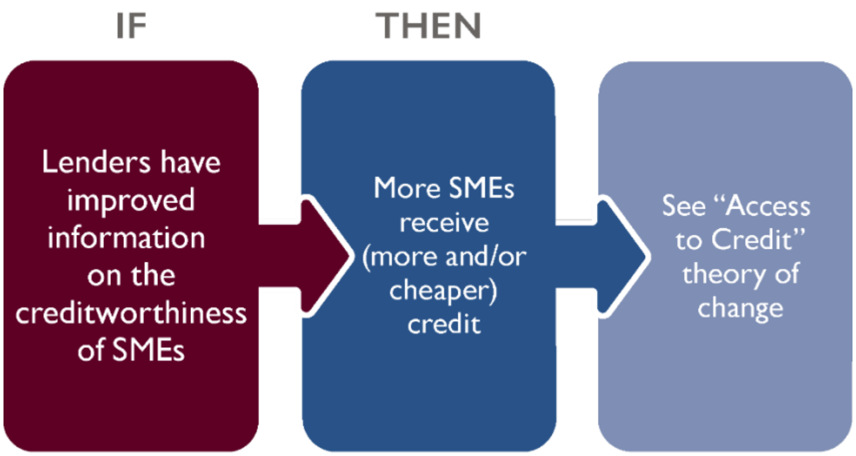
PROGRAM ASSUMPTIONS

- SMEs need a loan or credit to purchase services or equipment.
- SMEs are creditworthy.
- SME owners or employees wisely use the additional financing for investments.
- SME owners invest in jobs and/or experience greater profit margins from efficiency and/or gains.

Several studies investigate the effect of access to finance interventions on SME growth. The research finds that some of these interventions, including improved credit information and collateral law reform, can boost firm performance in areas such as sales and employment.[105]

ACCESS TO CREDIT INFORMATION

THEORY OF CHANGE



PROGRAM ASSUMPTIONS

- SMEs need a loan or credit to purchase services or equipment.
- SMEs are creditworthy.
- SME owners or employees wisely use the additional financing for investments.
- There is information asymmetry on the creditworthiness of SMEs. Lenders need more information—sometimes at a lower cost—on the creditworthiness of SMEs.
- Lenders want to provide loans to SMEs.

The evidence shows that information asymmetries restrict SMEs' access to finance and that credit information can improve financial inclusion for SMEs.[106,107] Such information includes any data that helps a lender decide whether a firm is creditworthy and is often used to generate credit scores predicting repayment on the basis of borrower characteristics.[108] Only about 50 percent of countries have a credit bureau. Recent evidence shows that policy efforts directed at introducing credit registries can reduce information asymmetries between borrowers and lenders and can improve access to finance at the firm level.[109,110,111] **Several studies establish a positive link between reforms in information-sharing systems and increased access to finance. A direct link has also been established between the introduction of credit information-sharing systems and job growth.**[112]

---

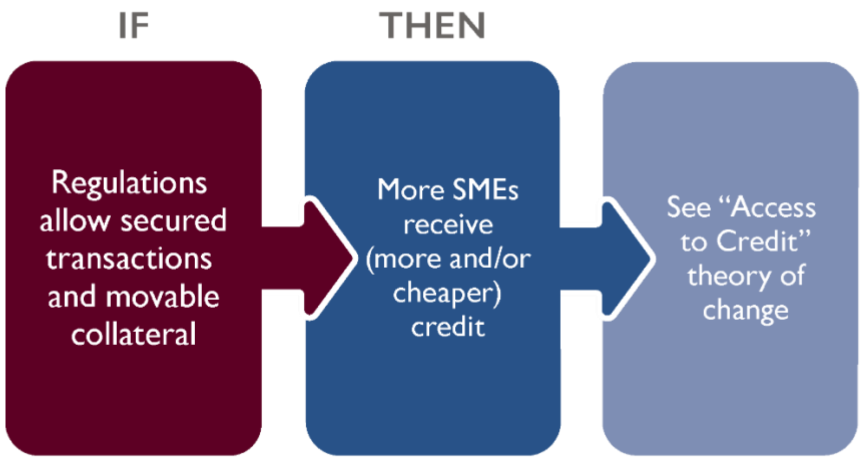
[105] Cook and Olafsen, 2016.
[106] Ibid.
[107] "Global Financial Development Report 2014: Financial Inclusion." DOI:10.1596/978-0-8213-9985-9. Washington, DC: World Bank, 2014.
[108] Ibid.
[109] "Doing Business 2016: Measuring Regulatory Quality and Efficiency." DOI: 10.1596/978-1-4648-0667-4. Washington, DC: World Bank, 2016.
[110] Ayyagari et al,. 2016.
[111] Ayyagari et al., 2017.
[112] Ayyagari et al., 2016.

In addition to credit bureaus, banks are finding new ways to access information about potential SME borrowers. Some banks take advantage of cross-selling opportunities with SMEs by providing checking accounts, transaction banking services, and cash management services. Through these services, the banks develop relationships with the SMEs and gain information about their financial behaviors, which, in turn, leads to SME lending. For example, the World Bank found that "ICICI Bank in India currently derives most of its SME revenues through deposits and other non-lending products. However, its lending revenues are growing quickly as the deposit-only clients begin to take out loans."[113] Banks in emerging markets are also increasingly providing nonfinancial services to SMEs to improve creditworthiness. For example, banks are offering training and consulting services that can improve SME recordkeeping, allowing banks to more easily assess risk by obtaining detailed information about SME business operations, finances, and banking needs.[114]

Overall, additional borrower information (through improved information-sharing systems and credit bureaus) leads to an improvement in the efficiency of credit-allocation decisions and loan performance, which then leads to SME growth.[115]

COLLATERAL LAWS

THEORY OF CHANGE



PROGRAM ASSUMPTIONS

- SMEs need a loan or credit to purchase services or equipment.
- SMEs are creditworthy.
- SME owners or employees wisely use the additional financing for investments.
- The current collateral-based lending systems present barriers to SMEs in accessing credit.
- SMEs want to collateralize their movable assets.
- Movable collateral is commercially viable collateral for lenders.
- Lenders are willing to accept movable assets as collateral.

To compensate for missing information on the creditworthiness of SMEs and because of the general risk in SME lending, lenders tend to ask for collateral to guarantee a loan. Data from World Bank enterprise surveys shows that around 79 percent of loans or lines of credit require some form of collateral. Movable assets, as opposed to fixed assets, such as land or buildings, often account for most of an SME's capital stock. For example, in the developing world, 78 percent of the capital stock of businesses is in movable assets, such as machinery, equipment, or receivables, and only 22 percent is in immovable property.[116] However, lenders are often unable to accept movable assets as collateral because of nonexistent or

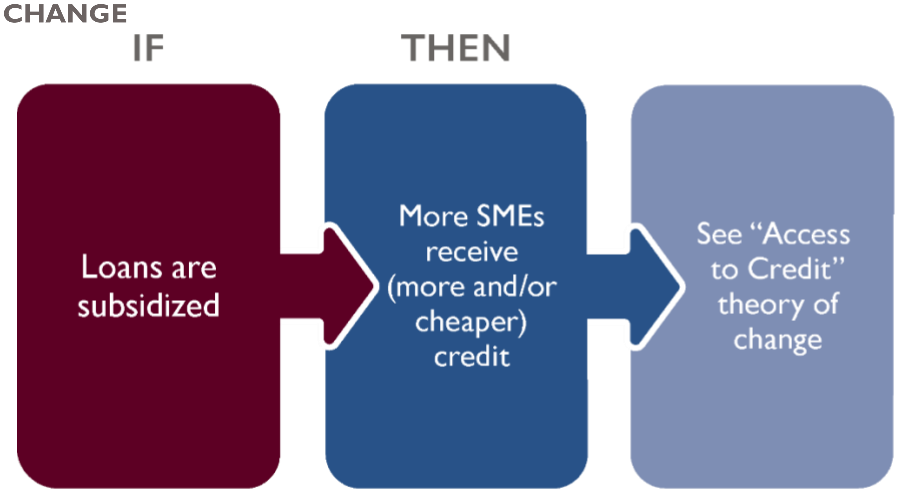
[113] World Bank, 2014.
[114] Ibid.
[115] Ayyagari et al., 2017.
[116] World Bank, 2014.

outdated secured transaction laws and collateral registries. Many legal systems place unnecessary restrictions on collateral, leaving lenders unsure whether a loan agreement will be enforced by the courts.[117] Even with appropriate systems in place, uptake may be slow, since lenders must develop new products, learn to evaluate new types of collateral, and develop new practices for collection and liquidation.

According to the evidence, collateral system reforms can lead to greater lending, especially for smaller and younger firms.[118] Research also found that, after reforms enlarging collateral menus were passed in a number of Eastern European countries to include movable assets (e.g., machinery and equipment), firms in movable-intensive sectors borrowed more, invested more in fixed assets, hired more workers, and became more efficient and profitable.[119,120] **Thus, the expansion of collateral laws to include movable assets can have positive impacts on SME employment growth, efficiency, and profitability.**

SUBSIDIZED LOANS

THEORY OF CHANGE



PROGRAM ASSUMPTIONS

- SMEs need a loan or credit to purchase services or equipment.
- SMEs are creditworthy.
- SME owners or employees wisely use the additional financing for investments.
- SME owners experience greater profit margins from sales efficiency and gains (i.e., all other market conditions are favorable).
- SME owners hire more workers in order to realize sales gains.
- The subsidy is sufficient to change lenders' practices in lending to SMEs.

In subsidized loan programs, a subsidy compensates for the lower returns to lenders from lending to less profitable SMEs that previously could not get financing. Economic theory would suggest that access to subsidized credit should lead to higher SME growth, which is why subsidized credit lines and loans are popular.[121,122]

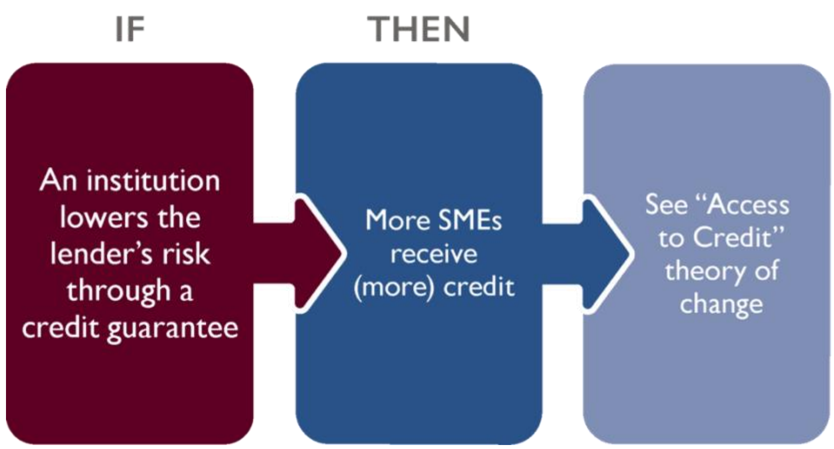
---

[117] World Bank, 2014.
[118] Ayyagari et al., 2017.
[119] Campello, M., and M. Larrain. "Enlarging the Contracting Space: Collateral Menus, Access to Credit, and Economic Activity." *Review of Financial Studies* , vol. 29 (2016), 349–383.
[120] Ayyagari et al., 2017.
[121] Aivazian, V., and E. Santor. "Financial constraints and investment: assessing the impact of a World Bank credit program on small and medium enterprises in Sri Lanka." *Canadian Journal of Economics/Revue canadienne d'économique*, vol. 41 (2) (2003), 475–500.
[122] Cravo and Piza, 2016.

Between 1979 and 1991, the World Bank provided Sri Lanka with $110 million in financing for SMEs through a series of four credit programs, known as the Small and Medium Industries (SMI) program. The World Bank did not lend the funds directly; rather, the program operated through an autonomous body known as the National Development Board (NDB). The NDB provided capital to participating financial institutions (PFIs), which then retailed the loanable funds to firms. Under the program, firms would approach the participating credit institutions and apply for a loan. Upon approval, the firm's application would be forwarded to the NDB, which, in turn, would approve the loan and consequently refinance the PFI. A 10-year study of the program showed that, although receiving the subsidized loan did lead to higher levels of investment for financially constrained firms, **the firms did not increase their profits any more nor become more economically efficient than those firms that received a loan without the subsidy**.[123]

CREDIT GUARANTEES

THEORY OF CHANGE



PROGRAM ASSUMPTIONS

- SMEs need a loan or credit to purchase services or equipment.
- SMEs are creditworthy.
- SME owners or employees wisely use the additional financing for investments.
- Lenders would not have issued the loans without the credit guarantees.
- The guarantee is sufficient to lower lenders' risk profiles in lending to SMEs.

Donors and policymakers can encourage banks to lend to SMEs by taking on some of the credit risk through guarantees, either for a portfolio of loans or for individual loans. Risk-sharing arrangements, in which a donor or institutions reimburse a bank for a portion of the principal losses incurred on defaulted loans, can increase lending to SMEs. They do this by lowering the amount of collateral that an SME needs to pledge to receive a loan because the guarantor provides part of the collateral. According to the research, **credit guarantees can help SMEs grow more rapidly in terms of capital growth; however, the loan guarantee also increases the probability of default**.[124]

[123] Aivazian and Santor, 2003.
[124] World Bank, 2014.

DEMOGRAPHIC AND CONTEXT FACTORS

Evidence suggests that women-owned firms tend to be fewer and smaller than firms owned by men and that they tend to grow at a slower rate.[125] Several factors, including type of business, managerial skills, regulatory environment, and others, may spur these differences, but access to financial services also matters. There is a demonstrable gender gap in access to finance, which can be explained in two dimensions[126]:

- Bias or discrimination against women.
- Differences in women's education level, income level, formal employment involvement, and other aspects of creditworthiness.[127]

In contexts where gender bias or discrimination is relevant, interventions should consider anti-discriminatory programs or competition-enhancing strategies.[128] If differences in the dimensions of education, income, or employment for women are the main cause of the gap in access to finance, interventions should aim to improve these binding constraints. For instance, interventions aimed at increasing access to finance for women-owned SMEs may also need to include management consulting services or financial training. In nine countries in Sub-Saharan Africa, Aterido, Beck, and Iacovone found that, although there are fewer women-owned firms in these countries, there was no evidence of gender discrimination or of lower inherent demand for financial services from these firms.[129,130]

Access to credit issues for SMEs may, in some contexts, be due to a lack of competition in the banking system. With lack of competition, there is no incentive for banks to engage new customers, such as SMEs, and they will choose to remain liquid or invest in government securities. If the root cause of a lack of access to credit for SMEs is a lack of competition in the banking system, the earlier referenced ToCs may not have any impact.

GAPS IN THE EVIDENCE

Access to credit interventions are becoming more popular within development policies and programming; however, they can be **very expensive and there is limited research on the cost-effectiveness of these interventions compared to other types of interventions**. Additionally, the literature largely focuses on debt for SMEs, but some SMEs may require other sources of financing, such as private equity. Private equity financing can allow firms to take on more risk in investment because it allows the firm to share the risk with a private equity investor. Other advantages of private equity include:

- It can provide financing that is longer-term relative to debt instruments, particularly for riskier and more opaque borrowers, because banks often offer such borrowers shorter-term loans, which then need to be renewed or renegotiated.[131]
- It can allow firms to grow more quickly, since equity does not need to be paid back right away, so any increased revenues as a result of equity investments can be reinvested into the company.
- Investors are more willing to take on higher risks and to work with entrepreneurs who may not meet all of the requirements that banks demand.
- Investors, as partial owners of the firm, may utilize their own networks and expertise to support growth.

---

[125] Bruhn, M., and D. McKenzie. "In Pursuit of Balance: Randomization in Practice in Development Field Experiments." *American Economic Journal: Applied Economics*, vol. 1 (4) (2009), 200–232.

[126] World Bank, 2014.

[127] Ibid.

[128] Beck, T., P. Behr, and A. Madestam. "Sex and Credit: Is There a Gender Bias in Lending?" European Banking Center Discussion Paper No. 2011-027, 2011.

[129] Aterido, R., T. Beck, and L. Iacovone. "Gender and Finance in Sub-Saharan Africa: Are Women Disadvantaged?" Policy Research Working Paper WPS 5571. Washington, DC: World Bank, 2011.

[130] World Bank, 2014.

[131] Ibid.

However, the effect of debt versus equity financing on SME growth in developing countries has not been widely or rigorously analyzed. In addition, there are a number of new access to credit models emerging, including fintech applications, blended finance, convertible debt, provision of technical assistance to banks for new loan products, and angel investor networks, to name a few, and their impacts have not yet been thoroughly studied.

Finally, although women's access to finance has been researched, the literature reviewed did not identify any evidence specific to the effects of access to credit on youth and youth-owned business or on other firm characteristics, including the lifecycle stage of the firm (start-up, early-stage, growth, mature), the age and size of the firm, and the industry and sector the SME is working in.[132] Therefore, we see an opportunity for further research in this area.

DEBATES AND CRITIQUES

The literature shows that SMEs have more difficulty accessing finance than larger firms and suggests that providing access to finance through some of the means outlined earlier may be necessary for SME growth but may not be sufficient in isolation. Financial interventions were more effective if they were combined with business training or capacity-building activities.[133,134]

- **Subsidized loans.** The evidence that subsidized loan interventions lead to SME growth is weak, since studies find that SMEs receiving subsidized loans do not experience faster growth over the sample period than those that received a loan without the subsidy.[135] These findings may be a result of SMEs' access to cheaper capital, which can lead to overinvestment and, according to one source, "Firms may have viewed the program as a one-off government program and thus deliberately overinvested in equipment for fear that they would miss the opportunity in the future."[136]
- **Credit guarantees**. One of the common challenges outlined in the research regarding credit guarantees and risk-sharing arrangements is that, depending on the context and individual lender, this intervention may not lead to an increase in lending to SMEs. Instead, banks may use these credit guarantees to lower the risk on loans that they would have issued in the absence of the credit guarantees. Additionally, although guarantees may increase the probability of default, it is unclear whether SMEs receiving those loans are *aware* that their loan is guaranteed, which may increase this probability. However, the higher probability of default may reflect the riskier, but potentially more profitable, investments made by the firms because of the loans. The investments may be beneficial from an economic policy perspective and could justify the loss of some guarantee costs. On the other hand, guarantee schemes also lower the repayment incentives of firms if they are aware of the guarantee, and the schemes need to be designed carefully and managed effectively to prevent large-scale losses.[137] Moreover, guarantees can inhibit uptake of collateral-lending reforms. Recent work in Colombia found that banks preferred guaranteed lending to the hard work of developing the collateral-lending market.[138]

IMPLICATIONS AND RECOMMENDATIONS FOR DONORS

Donors may consider directing resources toward supporting the provision of an environment conducive to lending, since that seems to be one of the most critical success factors for driving access to finance and, in turn, SME growth. In the design of programming, donors should propose interventions to ensure that the legal and regulatory environment for lending is strong, an effective credit bureau is operational, and

[132] Ayyagari et al., 2017.
[133] Cook and Olafsen, 2016.
[134] World Bank, 2014.
[135] Aivazian and Santor, 2003.
[136] Ibid.
[137] World Bank, 2014.
[138] "From Laws to Loans: Opportunities and Challenges in Achieving the Promise of Secured Lending Reforms." USAID, 2018.

the securitization and the realization of (movable) collateral are efficient.[139,140] Additionally, focusing on innovations within financial institutions to help SMEs access credit, including better screening mechanisms, closer relationships between lenders and borrowers, and more flexible credit products, can all result in increased credit for SMEs.[141] Finally, donors should consider pairing access to finance activities with other types of interventions, such as consulting services or technical assistance, particularly for women and women-owned businesses.

There may also be a role for government and donors to directly encourage lending to SMEs through guarantee funds, though emphasis should be placed on working with banks to incentivize long-term lending (to continue after the guarantee program has been completed). Credit guarantees and risk-sharing arrangements are difficult to design and, on their own, do not necessarily ensure an increase in bank lending to SMEs. If these activities are to be implemented, the World Bank has provided a series of best practices for credit guarantees, based on the experience of a number of researchers and practitioners:

- Leave credit assessments and decision-making to the private sector.
- Cap coverage ratios and delay the payout of the guarantee until recovery actions are taken by the lender so as to minimize moral hazard problems.
- Price guarantees to consider the need for financial sustainability and risk minimization.
- Encourage the use of risk-management tools.[142]

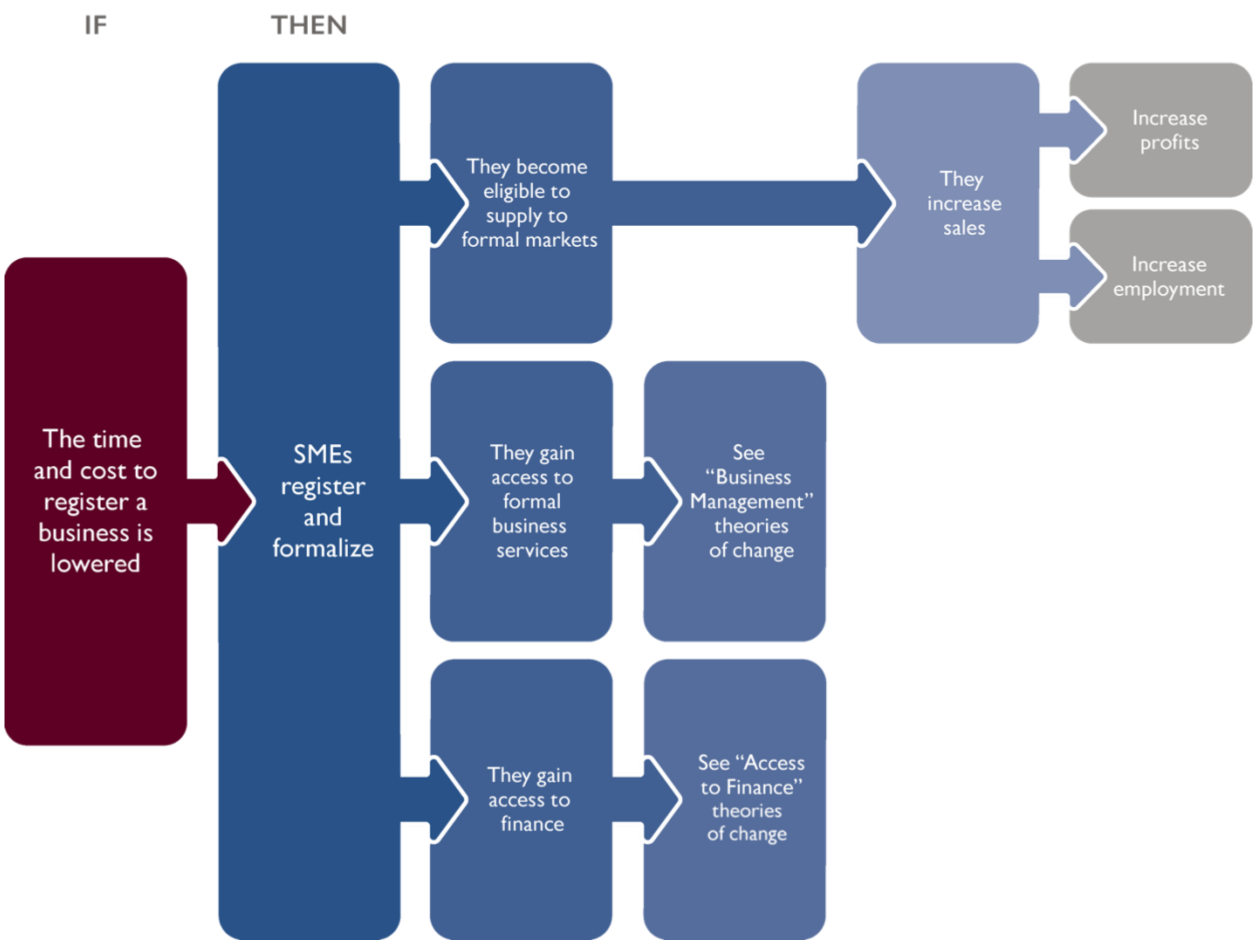
[139] World Bank, 2014.
[140] Ibid.
[141] Innovations for Poverty Action, 2017.
[142] World Bank 2014.

BUSINESS REGISTRATION AND TAXES THEORIES OF CHANGE

"A thriving and vibrant SME sector (characterized by a high rate of entry of new and innovative entrepreneurial firms and exit of less successful ones) […] with environments that promote ease of entry and exit due to a low administrative burden, have sound contract enforcement mechanisms, effective property rights registration procedures, strong creditors' rights protections, low tax burden on new and small firms, and more flexible labor markets."[143] Numerous policy and legal factors can erode the capacity of SMEs to create employment opportunities, foster innovation, sustain themselves, and increase profits. Even when the policy and legal instruments themselves are supportive of SMEs, their enforcement and implementation may be inadequate or inefficient.

Excessive business regulations can deter and/or prevent SMEs from growing into larger and more productive firms.[144,145] Therefore, successful enabling environment interventions, such as those related to firm registration, tax administration, and tax policy reform, which relieve constraints faced by SMEs, may lead to significant SME growth, particularly for high-growth SMEs.

BUSINESS REGISTRATION
THEORY OF CHANGE



---

[143] Cook and Olafsen, 2016.

[144] Beck, T., A. Demirguc-Kunt, and V. Maksimovic. "Financial and Legal Constraints to Growth: Does Firm Size Matter?" *The Journal of Finance*, vol 60 (1) (2005), 137–177.

[145] Ayyagari et al., 2017.

PROGRAM ASSUMPTIONS

- Employees or owners of SMEs lack awareness of the requirements for registration.
- Fees or time burdens of registration are the only factors discouraging SME owners from registering, i.e., SME owners want to grow, and the benefits of formality[146] outweigh the costs for SME owners.
- By formalizing, SMEs become eligible for government-sponsored business management and other services.
- SME owners invest in jobs and/or experience greater profit margins from gains.

A majority of firms in developing countries operate informally and are not registered with their national or local government, nor do they pay taxes. Local governments often see the formalization of SMEs as an opportunity to increase tax revenue and to improve the productivity of firms. Formalization can also make SMEs eligible to access government-sponsored business development services and can allow for bank accounts and loans to be opened in the firm's name rather than in the owner's name. As a result, governments and development practitioners have implemented a number of interventions with the goal of transitioning informal firms to the formal sector.[147] To encourage this SME formalization, governments and other actors have put in place policy reforms, including the removal of financial and logistical constraints of business registration and the simplification of registration processes. However, many SMEs choose to remain informal, since they see the costs of formalization as exceeding the benefits.[148]

In general, **formalization may help the government generate domestic taxes, but it is unclear whether interventions to encourage formalization lead to increased SME formalization and growth**. There is only one example found in the literature that links formalization with an increase in profits and, in this example, only a small subset of the sample demonstrated any growth.[149]

DEMOGRAPHIC AND CONTEXT FACTORS

Firm registration and the results of formalization are very context-specific. It is likely that impacts of firm registration on the growth of the SME are heavily influenced by the types of regulations in a country affecting SMEs and by the enforcement of those regulations.

Some literature also investigates the characteristics of firms that benefit the most from formalization. For example, high-growth SMEs tend to benefit more from formalization than firms that are not growing and do not expect to grow in the future.[150] In other words, formalization is a consequence of firm growth—not vice versa. This may account for why many women-owned SMEs remain in the informal sector, since women entrepreneurs often pursue business ventures with low-growth potential. Additionally, the informal sector may offer an environment that is conducive to improving the autonomy of women SME owners.[151]

GAPS IN THE EVIDENCE

Research has yet to prove that formalization leads to SME growth and whether the resources and potential growth experienced through the formal sector outweigh the costs of remaining in the informal sector for most SMEs. Additionally, more research is required to understand which types of informal businesses (women- versus men-owned, high-growth versus low-growth, or SMEs at various stages of their lifecycle, among others) would be most interested in growth and formalization. Finally, the literature reviewed did not identify any evidence specific to the effects of firm registration on youth and youth-owned business. Therefore, we see an opportunity for further research in this area.

---

[146] In this report, *formal businesses* are defined as those that are registered with the government.
[147] World Bank, 2016.
[148] Benhassine N., D. McKenzie, et al. "Finding a Path to Formalization in Benin: Early Results after the Introduction of the Entreprenant Legal Status." World Bank Policy Research Working Paper 7510. Washington, DC: World Bank, 2015.
[149] de Mel et al., 2013.
[150] Cook and Olafsen, 2016.
[151] Minniti, M., and W. Naudé. "What do we know about the patterns and determinants of female entrepreneurship across countries?" *The European Journal of Development Research*, vol. 22 (2) (2010), 1–12.

DEBATES AND CRITIQUES

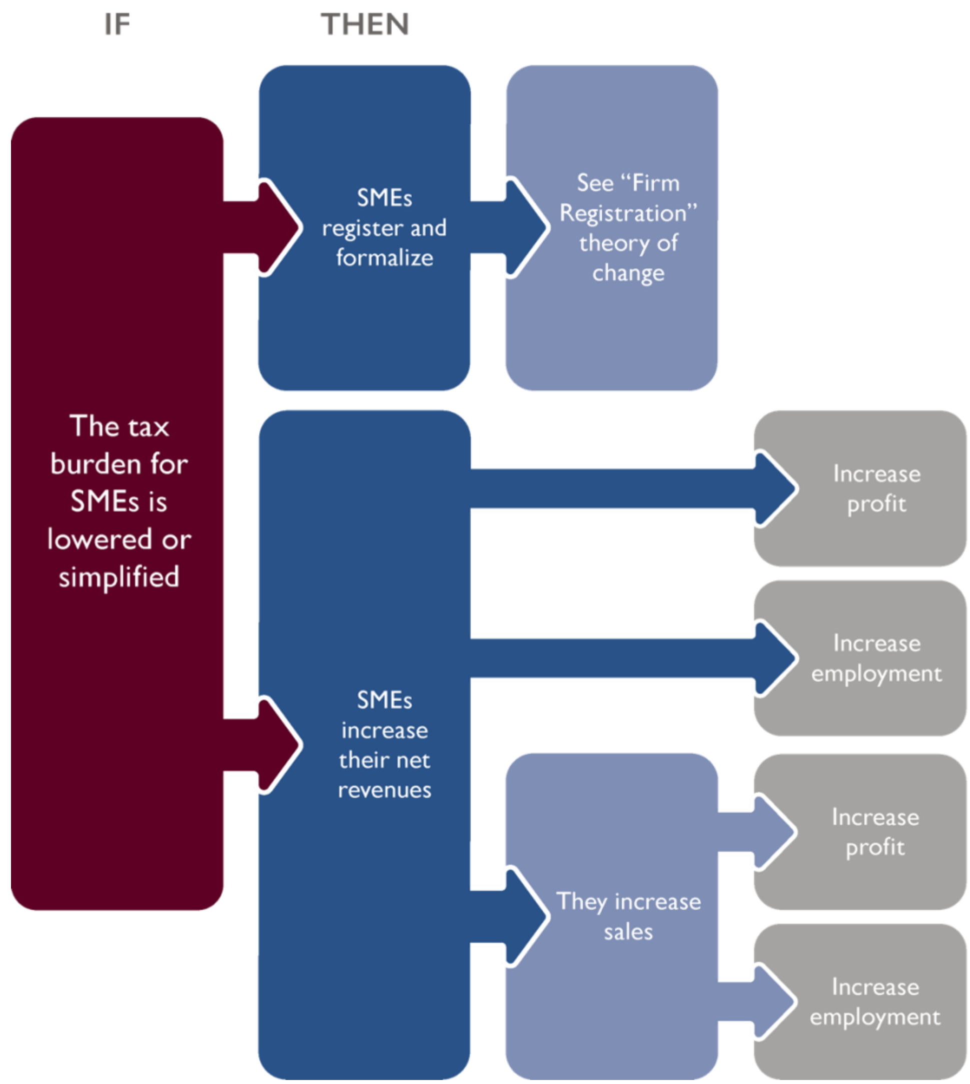
Because many of the studies review the process of getting informal firms to register—but not the outcomes or impacts of registration—it is difficult to determine whether formalization leads to profitability, increased sales, or increased employment.

IMPLICATIONS AND RECOMMENDATIONS FOR DONORS

Since the benefits of SME participation in the formal versus informal sector are not fully understood, and researchers cannot yet validate whether formalization leads to SME growth, donors working on SME development programs should carefully analyze all possible outcomes of formalization on SMEs before investing in policy reforms that reduce business registration constraints for SMEs or in SME development programs that encourage formalization.[152]

TAX POLICIES AND ADMINISTRATION

THEORY OF CHANGE



[152] Benhassine et al., 2015.

PROGRAM ASSUMPTIONS

- The tax burden or compliance costs for SMEs are the main factor inhibiting their growth.
- The tax burden and compliance costs for SMEs can be lowered or simplified.
- SME owners invest in jobs and/or experience greater profit margins from gains.

Tax rates and the administrative costs of tax compliance are key concerns of business. Studies suggest that high compliance costs can contribute to a business's decision to operate informally. This is particularly relevant for SMEs, which tend to face disproportionately high compliance costs. Based on the literature, **simplifying the costs of tax compliance and reducing the tax burden, including its ex ante uncertainty, is a proven method to increase SME profitability.**[153] For example, in a Ugandan study, a 10 percent decrease in taxes on firms is associated with a 15 percent increase in annual firm sales.[154] Additionally, the SIMPLES program in Brazil benefits small companies by consolidating municipal, state, and federal taxes (tax on industrial products, tax on services, employer's social security contributions, and more) into one simple tax. Through the tax consolidation process, the government offers exemptions and helps small businesses to reduce and predict their tax burden. This program has resulted in revenue increases of 37 percent among SMEs.[155,156]

The evidence also suggests that **reforms to firm tax policies result in the growth of the SME sector as a whole**. A study of 118 economies found that a 10 percent reduction in administrative costs associated with taxation increased annual business entry by 3 percent.[157]

GAPS IN EVIDENCE

Some country case studies suggest that reducing tax compliance costs can lead to more formal firms and higher sales. However, there is currently a need for more rigorous evidence to support this.[158]

In addition, the literature reviewed did not identify any evidence specific to the effects of tax policy or administration interventions on firms with different characteristics, including the lifecycle stage of the firm (start-up, early-stage, growth, mature), the age of the firm, and the age and gender of the SME owner. Therefore, we see an opportunity for further research in these areas.

DEBATES AND CRITIQUES

Although tax reform can spur SME growth, the research shows that special tax regimes for SMEs that include simplified procedures and lower tax rates may provide some incentives for firms to stay small.[159]

IMPLICATIONS AND RECOMMENDATIONS FOR DONORS

Even though tax reforms are proven to positively impact SME profitability and growth of the SME sector in general, reforms can be challenging to pass and implement within a donor program cycle. Additionally, governments need to balance lower tax rates with tax revenue goals, which may make the case for reform more complicated. However, donors may consider advising host countries on tangible, field-tested interventions, such as the SIMPLES regime used in Brazil, to promote reform while improving SME profitability in the formal sector.

---

[153] Bruhn, M. "Reforming business taxes: what is the effect on private sector development?" Viewpoint: Public Policy for the Private Sector. Note No. 330. Washington, DC: World Bank, 2011.

[154] Fisman, R. and J. Svensson. "Are Corruption and Taxation Really Harmful to Growth? Firm-Level Evidence." *Journal of Development Economics*, vol. 83 (1) (2007), 63–75.

[155] Bruhn, 2011.

[156] The research did not stipulate whether this was net revenue or revenue after taxes.

[157] World Bank, 2016.

[158] Bruhn, 2011.

[159] Bruhn, M., and J. Loeprick. "Small Business Tax policy, Informality, and Tax evasion - Evidence from Georgia." Policy Research Working Paper WPS 7010, Impact Evaluation Series. Washington, DC: World Bank Group, 2014.

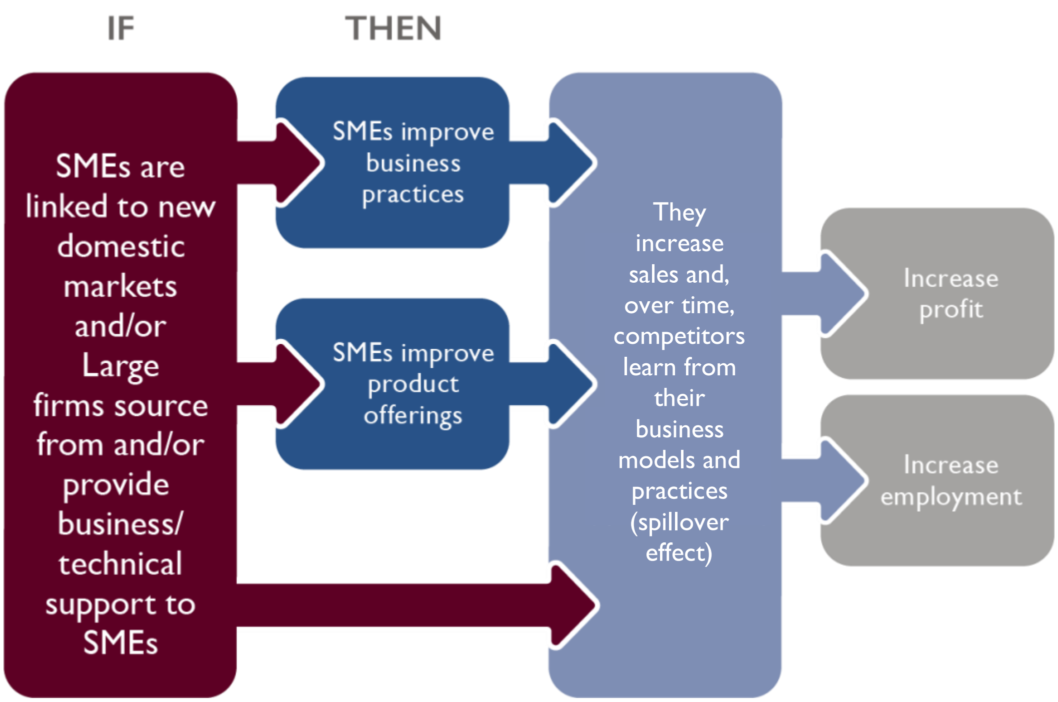
MARKET ACCESS THEORIES OF CHANGE

Reaching new markets (either domestic or international) can provide SMEs with opportunities to scale. However, entering these markets can be a formidable challenge. SMEs struggle to access information about market opportunities, and potential clients do not know how to easily find SMEs that can meet their needs. Moreover, many market opportunities are out of reach for SMEs, due to legal and financial constraints, along with high quality standards.[160,161]

In comparing market access with other ToC categories, a review by Innovations for Poverty Action (2017) suggests that profit, quality, and productivity increases are generally much larger than corresponding results from microcredit access or business training programs. This suggests that increasing market access may be relatively more important to SME growth in developing countries.[162]

As with the business management ToCs, beneficiary self-selection is still the most common way that SMEs are chosen for support accessing markets. However, self-selection may not be the most effective method for identifying high-growth SMEs for support. There may be alternative ways to select beneficiary firms by testing for various measurable firm or entrepreneur characteristics.

MARKET LINKAGES
THEORY OF CHANGE



PROGRAM ASSUMPTIONS

- SMEs want to be linked to new domestic markets.
- SMEs can meet the needs of new markets beyond an initial transaction.
- The SMEs are operating in supportive, enabling environments, with policies such as trade liberalization and stable macroeconomics.
- Large firms want to source from and/or support SMEs.
- Market linkages incentivize SMEs to improve their products and/or their business practices.
- SME owners invest in jobs and/or experience greater profit margins from efficiency and/or gains.

[160] Innovations for Poverty Action, 2017.
[161] Ibid.
[162] Ibid.

According to the literature, a market linkages approach (supporting the development of long-term business relationships between SME suppliers and larger buyer firms) positively benefits both the SME and the large buyer firm. Through this approach, SMEs can achieve a stable market for their products and services, while the large buyer firms expand their base of suppliers of quality products and services. The evidence suggests that **market linkages programs increase SME sales and employment and that these programs positively affect SME sustainability. In the case of buyer firms, a market linkages approach contributes to increased sales and positively affects their ability to export**.[163]

Additionally, **demand-side supplier development interventions** (designed to engage buyer firms to support and build the capacity of SME suppliers) appear to be **the most effective market linkages approach in achieving positive and persistent effects on SME employment and profit**.[164] The goal of these supplier development programs is to promote mutually beneficial, long-term commercial relations between large buying firms, potential exporters, and local SME suppliers, with the aim of increasing competitiveness.[165] Through these programs, large firms contribute to strengthening the management and technical skills of SME suppliers, according to areas that the large firms wish to develop.[166]

DEMOGRAPHIC AND CONTEXTUAL FACTORS

Market size may be an important indicator for the success of a market linkages program and resulting SME growth. Low levels of economic density and interaction mean small, scattered levels of demand, which result naturally in small, localized production.[167] This then inhibits the ability of SMEs to operate and grow, since missing or incomplete market information limits partnerships between large firms and SMEs.

Additionally, although market linkages have positive impacts on SME growth in all contexts, supplier development programs tend to work better in more advanced markets with supportive enabling environments and appropriate policies, such as trade liberalization, macroeconomic and political stability, and encouragement of foreign direct investment.[168]

GAPS IN THE EVIDENCE

One popular theory is that market linkages incentivize SMEs to learn and improve their products and their business practices. However, there is limited research on the impact of domestic market linkages on an upgrading response among targeted SMEs. There is also **limited research on the cost-effectiveness of market linkages interventions compared to other types of interventions**. As a result, more research should be considered to determine the costs of market linkages interventions and to explore outputs related to new SME products and business practices.

Interventions to create market linkages have focused on international markets, public procurement, and building SME capacity to supply to larger firms, rather than fostering SME access and capacity for domestic, commercial end-markets. Therefore, more research is needed on interventions that support SMEs seeking to directly sell products and services domestically.

Finally, the literature did not identify any evidence specific to the effects of market linkages or supplier development programs on firms with different characteristics, including the lifecycle stage of the firm (start-up, early-stage, growth, mature), the age of the firm, and the age and gender of the SME owner. Therefore, we see an opportunity for further research in these areas.

[163] Arráiz et al., 2013.
[164] Innovations for Poverty Action, 2017.
[165] Arráiz et al., 2013.
[166] Ibid.
[167] Loening et al., 2010.
[168] Arráiz et al., 2013.

DEBATES AND CRITIQUES

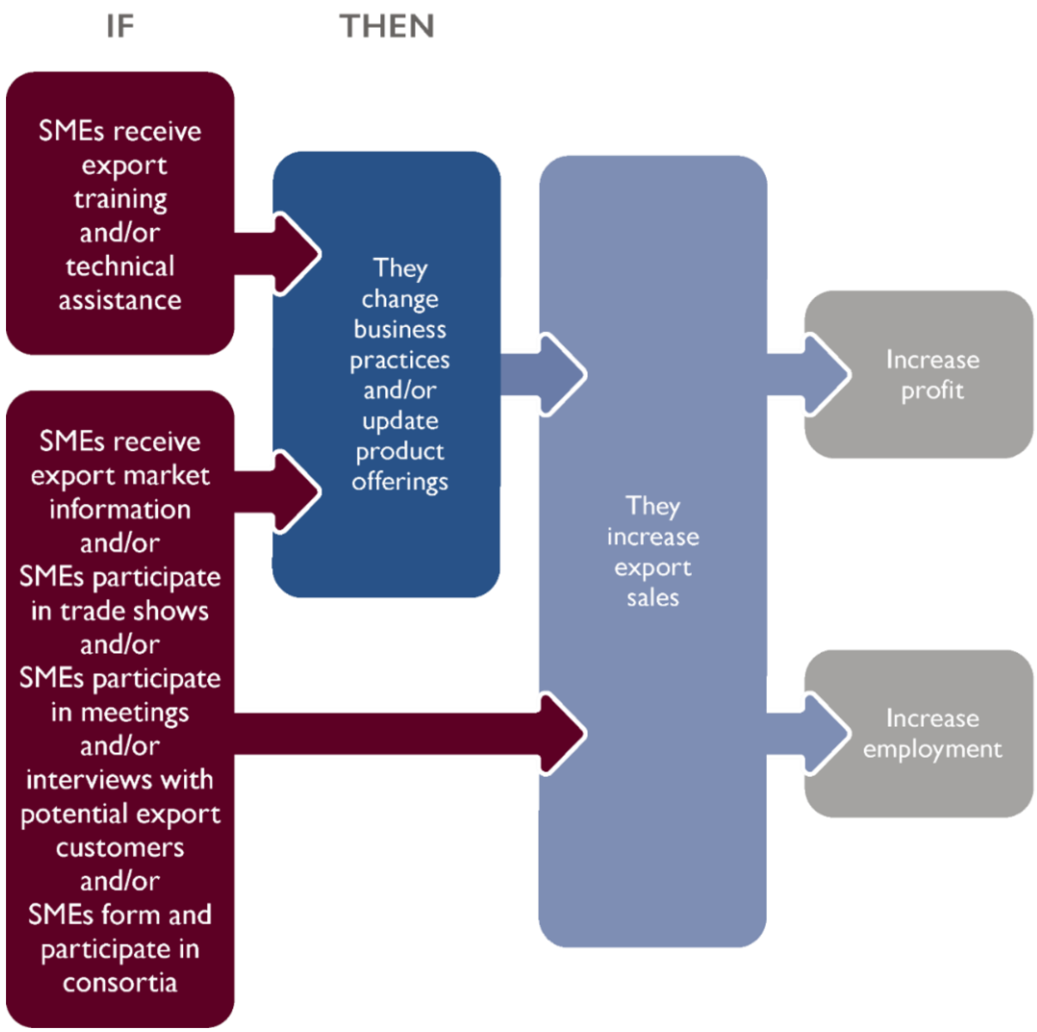
Although the link between market linkages programs and SME growth is strong, the research shows that, when a large firm is simply connected to or "matched" with a local SME, the underlying problems are not likely to be resolved.[169] Larger buyer firms often complain that local SMEs lack information, experience, and the human and financial resources to implement the management and technology changes required to do business with them, and they find that SME products or services do not meet their procurement standards. Therefore, even when a large buyer connects with an SME, the SME may still lack absorptive capacity and the ability to complete orders on time and at cost or to meet quality requirements.[170]

IMPLICATIONS AND RECOMMENDATIONS FOR DONORS

Simple information-sharing or matchmaking programs between SME suppliers and large buyers are not sufficient, since they do not address some of the underlying capacity issues that large firms identify in local SMEs. When designing market linkages programs, donors should consider exploring incentive-based SME capacity-development programs, including components, such as payments to consultants when SMEs acquire national and international certifications, that are supported and/or sponsored by large firms.[171]

EXPORT PROMOTION AND SUPPORT

THEORY OF CHANGE



[169] Innovations for Poverty Action, 2017.
[170] Arráiz et al., 2013.
[171] Ibid.

PROGRAM ASSUMPTIONS

- SMEs want to begin exporting, increase their exports, or expand into new export markets.
- SMEs are able to absorb and implement export promotion and support activities and can meet the demand specifications of export markets without any additional intervention.
- Increasing their exports contributes to SMEs' higher overall revenues.
- SME owners invest in jobs and/or experience greater profit margins from efficiency and/or gains.

The theory that access to high-income export markets can drive developing country SME growth is one of the motivations behind the significant development resources flowing to export promotion initiatives around the world.[172,173] For example, the World Trade Organization–led Aid for Trade initiative secured $48 billion in annual commitments to help developing countries overcome trade-related constraints. And, over recent decades, several developing countries established national trade and export promotion organizations with the purpose of helping firms overcome export barriers.[174,175]

SMEs face a variety of obstacles and barriers when entering export markets, with information asymmetries being the most frequent and severe.[176,177] Interventions supporting export promotion and access to external markets are addressing some of these obstacles through:[178]

- Training on the export process.
- Co-financing technical assistance for market prospection, export plan development, promotion, product development, firm development, and foreign subsidiary creation.
- Providing information on market opportunities, market intelligence, and counseling services.
- Arranging meetings and interviews with potential customers.
- Coordinating and organizing trade missions, shows, and fairs.
- Co-financing SME participation in trade missions, shows, and fairs.
- Sponsoring the creation of export consortia to enhance the competitive position of SMEs in international markets.[179,180,181]

Undertaking any one of these interventions in isolation assumes that the other obstacles are not binding.

The research suggests that SMEs' identification of and adaptation to external markets generates exports as part of increased production, which, in turn, may improve firm profits and employment creation.[182] This is because exporting can entail quality upgrading, better technical skills, efficiencies, and increased productivity.[183,184] A review of a program in Egypt that provided rug producers with access to export opportunities found that the profits and productivity of the supported SMEs increased. The study also suggested that increases in product quality were due to "learning by exporting."[185]

---

[172] Innovations for Poverty Action, 2017.
[173] Atkin, D., A.K. Khandelwal, and A. Osman. "Exporting and Firm Performance: Evidence from a Randomized Experiment." *The Quarterly Journal of Economics*, vol. 132 (2) (2016), 551–615.
[174] Ibid.
[175] Carballo, J., and C. Volpe Martincus. "Export Promotion: Bundled Services Work Better." *The World Economy*. Washington, DC: Inter-American Development Bank, 2010.
[176] Ibid.
[177] Ibid.
[178] Cravo and Piza, 2016.
[179] Carballo and Volpe Martincus, 2010.
[180] Cadot, O., A.M. Fernandes, et al. "Are the Benefits of Export Support Durable? Evidence from Tunisia." *Journal of International Economics*, vol. 97(2) (2015), 310–324.
[181] Ibid.
[182] Cravo and Piza, 2016.
[183] Innovations for Poverty Action, 2017.
[184] Atkin et al., 2016.
[185] Innovations for Poverty Action, 2017.

However, **evidence on the impact of export promotion initiatives on SME growth over the long run is limited**.[186] A study of an export promotion project in Tunisia shows that, while the beneficiary firms' total exports exceed temporarily the control group's total exports, one year after treatment the differential in growth rates of total exports is no longer significant. Three years after treatment, export levels are no longer significantly different.[187]

DEMOGRAPHIC AND CONTEXT FACTORS

The literature suggests that export promotion activities are effective in helping SMEs to increase their exports by facilitating an expansion of the *extensive margin* (the number of types of products exported and the number of countries served) but that these activities do not have a consistently significant impact on SMEs' *intensive margin* of exports (the volume of products exported).[188,189] These results suggest that export promotion is most effective in helping firms break into new markets with new products. It is also consistent with the fact that, absent assistance, SMEs are likely to face more significant information gaps when they attempt to enter new export markets abroad versus exporting to countries that are already among their destination markets.[190]

GAPS IN THE EVIDENCE

Export promotion interventions are increasing in popularity, but **the scarcity of rigorous evaluations makes it difficult to assess** their benefits to SME growth and **cost-effectiveness**. In addition, the lack of evidence establishing the impact of specific or disaggregated export promotion activities on SME growth inhibits the ability to improve the design of future export promotion interventions.[191,192,193]

The literature reviewed did not identify any evidence specific to the effects of export promotion and support interventions on firms with different characteristics, including the lifecycle stage of the firm (start-up, early-stage, growth, mature), the age of the firm, and the age and gender of the SME owner. Therefore, we see an opportunity for further research in these areas.

DEBATES AND CRITIQUES

There have been attempts to assess the overall impact of different export promotion activities. However, the evidence on the relative and comparative effectiveness of different types of support initiatives is scarce.[194] The findings that do exist suggest that market prospection and promotional activities correlate more significantly with export outcomes.[195,196]

Additionally, bundled services combining counseling, export planning, and trade missions and fairs that build buyer-seller relationships with foreign partners are more effective for export outcomes than isolated assistance actions (for example, trade missions and fairs alone).[197]

IMPLICATIONS AND RECOMMENDATIONS FOR DONORS

Findings suggest that SMEs supported by export promotion activities increase exports by facilitating an expansion of the extensive margin, but these activities do not have a consistent, significant impact on SMEs' intensive margin of exports.[198,199] Thus, donor assistance may be more successful in helping firms

[186] Cadot et al., 2015.
[187] Ibid.
[188] Carballo and Volpe Martincus, 2010.
[189] Ibid.
[190] Ibid.
[191] Cadot et al., 2015.
[192] Ibid.
[193] Atkin et al., 2016.
[194] Carballo and Volpe Martincus, 2010.
[195] Cadot et al., 2015.
[196] Ibid.
[197] Carballo and Volpe Martincus, 2010.
[198] Ibid.
[199] Ibid.

overcome hurdles to break into new product or geographic markets than in ramping up export volumes to their existing markets.[200]

Donors should also consider bundled services combining counseling, export planning, and trade missions and fairs that build buyer-seller relationships with foreign partners. This is particularly true since (per the research on market linkages in the earlier chapter) the promotion of buyer-seller market linkages between suppliers and international buyers is likely to have an impact on SME growth. It should be acknowledged, however, that **a strategy based on a combination of support services might be costly**.[201] Donors supporting research on the impacts of specific interventions could contribute to global knowledge by also tracking the cost of these interventions.

[200] Cadot et al., 2015.
[201] Carballo and Volpe Martincus, 2010.

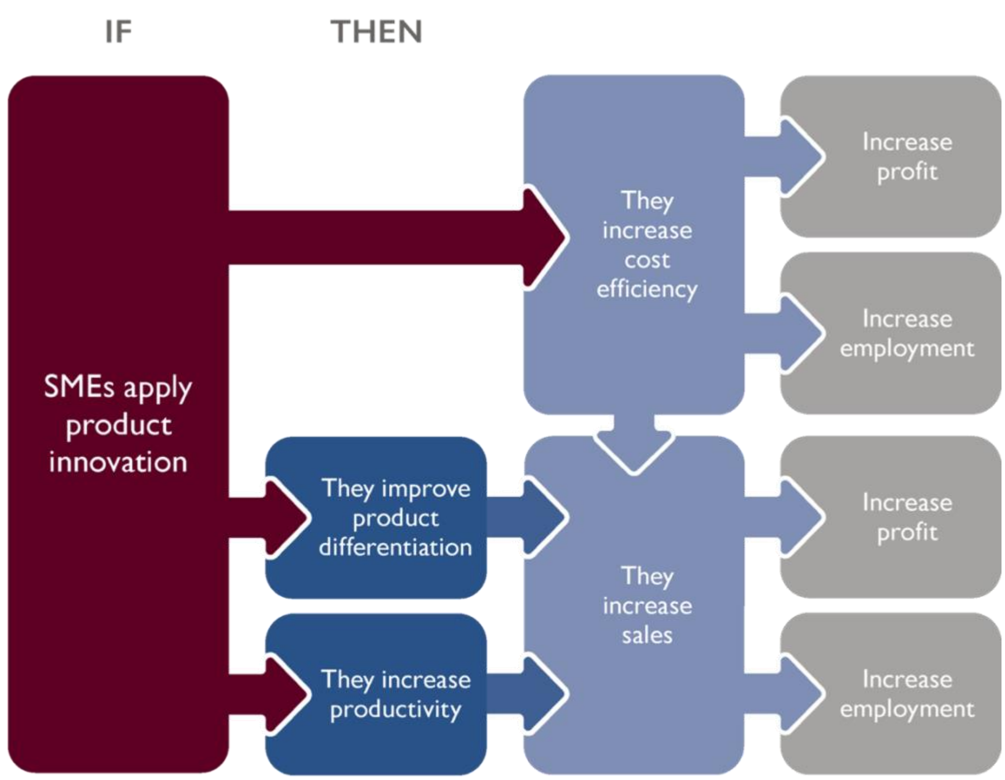
INNOVATION THEORIES OF CHANGE

Innovation is a key element of competition and driving efficiency within markets.[202] However, on average, SMEs are less innovative than large enterprises and they innovate in a different way. SMEs command fewer resources, have less research and development (R&D), and generally face more uncertainties and barriers to innovation.

Since innovation is vital for increasing productivity and contributing to overall economic growth,[203] governments and donors are supporting interventions that foster a sound business environment, help SMEs to develop and use their internal strategic resources effectively, and build an innovation system that is effective in the commercialization of research and inclusive of a large range of SMEs. The aim is to strengthen the innovation capacity of SMEs, including supporting R&D programs. In addition, the rationale for supporting SMEs by encouraging R&D is that high-growth SMEs are often characterized as more R&D-intensive than less rapidly growing firms or average firms and they demonstrate a certain level of innovativeness.[204,205,206,207]

For the purposes of this report, we define *innovation* as involving the creation or re-engineering of products or services to meet new market demand. Although innovation can be considered an outcome of other SME development inputs or interventions (such as business management or finance), we focus this section on interventions that explicitly target product innovation.

PRODUCT INNOVATION SUPPORT
THEORY OF CHANGE



[202] Castillo et al., 2011.
[203] Piza et al., 2013.
[204] Ibid.
[205] Castillo et al., 2011.
[206] Crespi, G., and P. Zuniga. "Innovation and Productivity: Evidence from Six Latin American Countries." IDB Working Paper No. 74, 2010.
[207] Cravo and Piza, 2016.

PROGRAM ASSUMPTIONS

- SME owners want to apply product innovations.
- SME owners are able to absorb interventions and apply product innovations.
- Product innovations are valued by the market.
- SME owners invest in jobs and/or experience greater profit margins from efficiency and/or gains.

The evidence shows that applying technological advances leads to more effective use of productive resources. The transformation of new ideas into new economic solutions (new products and services) is the basis of sustainable competitive advantages for firms. Furthermore, several cross-country studies demonstrate a virtuous circle on a national level, in which **R&D spending, innovation, productivity, and per capita income mutually reinforce each other** and lead to long-term, sustained growth.[208]

Although the aim of innovation programs is not often to create jobs, they are implemented assuming that they do—or at least that they do not destroy jobs. The empirical evidence seems to support the hypothesis that **innovation has an overall positive effect on employment but that different effects should be expected from different types of innovation**, as we explain in the following sections.[209]

DEMOGRAPHIC AND CONTEXT FACTORS

For SMEs, *innovation* often implies uncertain or delayed rewards, and innovation risks tend to be exacerbated in the context of developing countries, where the path to scale is already difficult.[210] Interventions designed to support innovation should be customized based on the country context, the specificities of a country's policies or agencies established to promote innovation, and SME innovative behavior. At least three dimensions are important to keep in mind:

- Public support, which has increased innovation efforts in SMEs in some countries.
- The role of intellectual property rights in firms' decisions to invest in innovation.[211]
- Access to finance for innovation, which is often a product of the overall business environment.[212]

Aside from business environment issues, such as investor protection, firms may face severe financing constraints on innovative investments because of information asymmetries. Firms seeking to make new inventions through R&D frequently have better information about the likelihood of success and the nature of the completed project than potential lenders. In addition, because inventions can be easy to imitate, firms may be reluctant to disclose much information about their projects, making it difficult to find financing. Therefore, the availability of non-bank financing, especially venture capital or angel investment, may be critical in fostering innovation. Venture capital firms and angel investors address information asymmetry problems by intensively scrutinizing firms before providing capital and by then monitoring them afterward.[213]

GAPS IN THE EVIDENCE

Overall, the results of innovation appear to be positive. However, the comparative effects of different types of innovation interventions on SME growth are not well researched. Identifying which innovation interventions have the most impact on SME growth will be important.

Although innovation seems to positively impact SME profit and employment rates, productivity, and income, innovation and R&D investment can be prohibitively expensive (both in terms of financial costs and of necessary human capital) and may require longer time horizons to demonstrate results.[214]

---

[208] Crespi and Zuniga, 2010.
[209] Castillo et al., 2011.
[210] Cook and Olafsen, 2016.
[211] Crespi and Zuniga, 2010.
[212] Cook and Olafsen, 2016.
[213] World Bank, 2014.
[214] Crespi and Zuniga, 2010.

Studies show that the probability of innovation increases with the size of the firm and with the human capital of its workers.[215] However, the literature reviewed did not identify any evidence specific to the effects of innovation interventions on firms with different characteristics, including the lifecycle stage of the firm (start-up, early-stage, growth, mature), the age of the firm, and the age and gender of the SME owner. Therefore, we see an opportunity for further research in these areas.

DEBATES AND CRITIQUES

The effect of innovation on employment is not straightforward. Innovation is often seen as a potential threat to employment, in particular when technological change may lead to the substitution of labor with capital. Over time, the discussion of this relationship has shifted, considering how different types of innovations under different market conditions may produce varied effects on employment and employment composition. For instance, *product innovation* (the introduction of a good or service that is new or has significantly improved characteristics or intended uses) can open up new markets for a firm and can increase market share for innovators, without generating new employment.[216]

IMPLICATIONS AND RECOMMENDATIONS FOR DONORS

Donors can support innovation in SMEs by helping to foster a sound business environment (which includes public support for innovation and a reliable intellectual property rights system), helping SMEs to develop and use their human and capital resources effectively, and building an innovation system that can commercialize R&D and include a large range of SMEs. Since the availability of financing may be critical for fostering innovation, we also recommend that innovation interventions are provided in conjunction with appropriate access to finance. Donors should also consider accelerator models, which can reduce the risk, enhance the impact, and speed up the process of technology innovation by building the capacity of entrepreneurs and connecting them to markets, finance, and other key innovation actors.

---

[215] Benavente, J.M., and R. Lauterbach. "Technological innovation and employment: complements or substitutes?" *The European Journal of Development Research*, vol 20 (2) (2008), 318–329.

[216] Castillo et al., 2011.

CONCLUSIONS AND RECOMMENDATIONS

This report summarizes how SME development interventions may affect SME growth outcomes, including firm productivity, profits, and employment, while analyzing how these outcomes vary depending on a range of factors, including firm characteristics (e.g., age and size of the firm and education levels of the owners), policy environments, market dynamics, and time horizons, to name a few. Several intervention types have the most significant impact on SME growth and should be considered for future development programming. Following is a summary of these findings[217]:

INTERVENTION CATEGORY	INTERVENTION TYPE	LEVEL OF EVIDENCE	LEVEL OF IMPACT
BUSINESS MANAGEMENT	Training	STRONG	LOW
	Consulting Services	STRONG	HIGH
	Matching Grants	WEAK	MIXED-HIGH
ACCESS TO FINANCE	Access to Credit	MODERATE	HIGH[218]
BUSINESS REGISTRATION AND TAXES	Business Registration	WEAK	LOW
	Tax Policies and Administration	MODERATE	HIGH
MARKET ACCESS	Market Linkages	MODERATE	HIGH[219]
	Export Promotion and Support	WEAK	MIXED
INNOVATION	Product Innovation Support	WEAK	MIXED

In addition to reviewing the evidence that exists surrounding SME development interventions, this report highlights a number of recommendations for donors:

- **Do what we know works.** Based on the summary table, there is strong evidence that consulting services have a high impact on SME growth in profit and/or employment. There is also moderate evidence that certain interventions to boost credit, simplify tax policies, and improve market linkages have high impact. Donors should consider supporting these interventions over classroom-based business training.
- **Carry out context-specific project design.** Project design should start with an assessment to understand the actual constraints to SME growth, the demands of new or growing SMEs, and the characteristics of the targeted SMEs and SME owners, and then articulate an appropriate ToC. In addition, the SME project design should:
  - Lay out the assumptions for the intervention and its design.
  - Clearly identify the target group.
  - Evaluate the aspects of the ToC that have not previously been well-researched.
- **Conduct additional research.** There are ample opportunities for more research and evidence in each ToC explored in this report, with additional research warranted in a number of areas that are either more nascent in practice or are not covered extensively in the literature. This includes:
  - The impact of advanced training, matching grants, private equity, financial technology applications, domestic end-market linkages, export promotion, business formalization, the reduction of tax compliance, and product and process innovation on SME growth.

[217] These findings summarize aggregated evidence collected from a variety of contexts. The level of evidence and/or level of impact of each of the types of intervention may look different if focused on one context.
[218] This ranking is dependent on the access to credit intervention type. Information access and collateral laws have a high impact on SME growth, while findings on credit guarantees and loan subsidies were mixed or low.
[219] Although the impact is high, market linkages must be paired with information transfer from lead firms.

- The impact of interventions on firms with different characteristics, including the lifecycle stage of the firm (start-up, early-stage, growth, mature), the age of the firm, and the gender and age of the owner.

High-growth firms have been shown to be a key factor for economic growth and structural change, and because of this, these firms have drawn growing attention from policymakers and academics. However, knowledge about these firms is still scattered, and little knowledge is available regarding differences over countries. Therefore, additional research and evidence is also needed in this area to determine the best methods for identifying and selecting high-growth SMEs for support through donor programs.

- **Take cost-effectiveness into consideration.** Project design should also consider the trade-offs between cost and impact of specific interventions on the target group and should only adopt the most cost-effective interventions. However, there is a lack of publicly available analysis and comparison on the cost-effectiveness of different interventions. Implementers often collect data on the cost of interventions and sometimes collect data on their impact, but they do not analyze data for the cost per job created or cost per percentage point increase in revenue. Therefore, research publishing this data would add much to global understanding of SME development interventions. In addition, with improved methods for identifying and selecting high-growth SMEs, donor programs could target funding toward those SMEs most likely to experience growth.

ANNEX 1: BIBLIOGRAPHY

Citation	Strength of Research[220]
Aga, G., D. Francis, and J. Meza. "SMEs, Age, and Jobs." World Bank Policy Research Working Paper 7493. Washington, DC: World Bank, 2015.	High
Aivazian, V., and E. Santor. "Financial constraints and investment: assessing the impact of a World Bank credit program on small and medium enterprises in Sri Lanka." *Canadian Journal of Economics/Revue canadienne d'économique*, vol. 41 (2) (2003), 475–500.	High
Anderson, S.J., R. Chandy, and B. Zia. "Pathways to Profits: Identifying Separate Channels of Small Firm Growth through Business Training." Policy Research Working Paper 7774, 2016.	Moderate
Arráiz, I., F. Henríquez, and R. Stucchiet. Supplier development programs & firm performance: evidence from Chile." *Small Business Economics*, vol. 41 (1) (2013), 277–293.	Moderate
"Assessing Firm-Support Programs in Brazil. Office of Evaluation and Oversight (OVE)." Inter-American Development Bank & Inter-American Investment Corporation, 2017.	Moderate
Aterido, R., T. Beck., and L. Iacovone. "Gender and Finance in Sub-Saharan Africa: Are Women Disadvantaged?" Policy Research Working Paper WPS 5571. Washington, DC: World Bank, 2011.	High
Atkin, D., A.K. Khandelwal, and A. Osman. "Exporting and Firm Performance: Evidence from a Randomized Experiment." *The Quarterly Journal of Economics*, vol. 132 (2) (2016), 551–615.	Moderate
Ayyagari, M., A. Demirguc-Kunt, and V. Maksimovic. "SME Finance." World Bank Policy Research Working Paper 8241, 2017.	High
Ayyagari, M., A. Demirguc-Kunt, and V. Maksimovic. "Who creates jobs in developing countries?" *Small Business Economics*, vol. 43(1) (2014), 75–99.	High
Ayyagari, M., P. Juarros, M. Peria, and S. Singh. "Access to Finance and Job Growth: Firm-Level Evidence across Developing Countries." World Bank Policy Research Working Paper 6704, 2016.	High
Ayyagari, M., T. Beck, and A. Demirguc-Kunt. "Small and medium enterprises across the globe." *Small Business Economics*, vol. 29 (2007), 415–434.	Low
Beck, T., A. Demirguc-Kunt, and V. Maksimovic. "Financial and Legal Constraints to Growth: Does Firm Size Matter?" *The Journal of Finance*, vol 60 (1) (2005), 137–177.	Moderate
Beck, T., P. Behr, and A. Madestam. "Sex and Credit: Is There a Gender Bias in Lending?" European Banking Center Discussion Paper No. 2011-027, 2011.	Moderate
Benavente, J.M., and R. Lauterbach. "Technological innovation and employment: complements or substitutes?" *The European Journal of Development Research*, vol 20 (2) (2008), 318–329.	High
Benhassine, N., D. McKenzie, V. Pouliquen, and M. Santini. "Does inducing informal firms to formalize make sense? Experimental evidence from Benin." *Journal of Public Economics*, vol. 157 (2018), 1–14.	Moderate

[220] "How to Note: Assessing the Strength of Evidence." Department for International Development. March 2014.

Benhassine, N., D. McKenzie, V. Pouliquen, and M. Santini. "Finding a Path to Formalization in Benin: Early Results after the Introduction of the Entreprenant Legal Status." World Bank Policy Research Working Paper 7510. Washington, DC: World Bank, 2015.	Moderate
Bennett, J. "Informal firms in developing countries: Entrepreneurial stepping stone or consolation prize?" *Small Business Economics*, vol. 34 (1) (2010), 53–63.	Moderate
Bloom, N., B. Eifert, A. Mahajan, D. McKenzie, and J. Roberts. "Does management matter? Evidence from India." *The Quarterly Journal of Economics*, vol. 128(1) (2013), 1–51.	Moderate
Bruhn, M. "License to sell: the effect of business registration reform on entrepreneurial activity in Mexico." World Bank Policy Research Working Paper 4538. Washington, DC: World Bank, 2008.	High
Bruhn, M. "Reforming business taxes: what is the effect on private sector development?" Viewpoint: Public Policy for the Private Sector. Note No. 330. Washington, DC: World Bank, 2011.	Moderate
Bruhn, M., D. Karlan, and A. Schoar. "The impact of consulting services on small and medium enterprises." World Bank Policy Research Working Paper 6508. Washington, DC: World Bank, 2013.	High
Bruhn, M., D. Karlan, and A. Schoar. "What Capital is Missing in Developing Countries?" Field Experiments in Firms. Session Chair: John Van Reenen. Massachusetts Institute of Technology, 2010.	Moderate
Bruhn, M., and D. McKenzie. "In Pursuit of Balance: Randomization in Practice in Development Field Experiments." *American Economic Journal: Applied Economics*, vol. 1 (4) (2009), 200–232.	Moderate
Bruhn, M., and J. Loeprick. "Small Business Tax policy, Informality, and Tax evasion - Evidence from Georgia." Policy Research Working Paper WPS 7010, Impact Evaluation Series. Washington, DC: World Bank Group, 2014.	High
Cadot, O., A.M. Fernandes, J. Gourdon, and A. Mattoo. "Are the Benefits of Export Support Durable? Evidence from Tunisia." *Journal of International Economics*, vol. 97(2) (2015), 310–324.	High
Campello, M., and M. Larrain. "Enlarging the Contracting Space: Collateral Menus, Access to Credit, and Economic Activity." *Review of Financial Studies*, vol. 29 (2016), 349–383.	Moderate

Campos, F., A. Coville, A. Fernandes, M. Goldstein, and D. McKenzie. "Learning from the Experiments that Never Happened." World Bank Policy Research Working Paper 6296, 2012.	Moderate
Campos, F., M. Goldstein, and D. McKenzie. "Short-Term Impacts of Formalization Assistance and a Bank Information Session on Business Registration and Access to Finance in Malawi." Policy Research Working Paper 7183, 2015.	Moderate
Carballo, J., and C. Volpe Martincus. "Export Promotion: Bundled Services Work Better." *The World Economy*. Washington, DC: Inter-American Development Bank, 2010.	Moderate
Carballo, J., and C. Volpe Martincus. "Is Export Promotion Effective in Developing Countries? Firm-Level Evidence on the Intensive and the Extensive Margins of Exports." *Journal of International Economics*, vol. 76 (1) (2010), 89–106.	Moderate
Cardon, M. "Contingent Labor as an Enabler of Entrepreneurial Growth." *Human Resource Management*, 42 (2003), 357–373.	Moderate
Castillo, V., A. Maffioli, S. Rojo, and R. Stucchi. "Innovation policy and employment: Evidence from an impact evaluation in Argentina." Technical Notes No. IDB-TN-341. Washington, DC: Inter-American Development Bank, 2011.	Moderate
Cook, P., and E. Olafsen. "Growth Entrepreneurship in Developing Countries: A Preliminary Literature Review." Washington, DC: World Bank, 2016.	Moderate
Coste, A., and D. Hristova. "How to Make Grants a Better Match for Private Sector Development: Review of World Bank Matching Grants Projects." Washington, DC: World Bank, 2016.	Low
Cravo, T., A. Gourlay, and B. Becker. "SMEs and Regional Economic Growth in Brazil." Loughborough University, 2010.	Moderate
Cravo, T., and C. Piza. "The Impact of Business Support Services for Small and Medium Enterprises on Firm Performance in Low- and Middle-Income countries: A Meta-Analysis." The Campbell Collaboration, 2016.	Moderate
Crespi, G., and P. Zuniga. "Innovation and Productivity: Evidence from Six Latin American Countries." IDB Working Paper No. 74, 2010.	Moderate
de Giorgi, G., and A. Rahman. "SME Registration Evidence from a Randomized Controlled Trial in Bangladesh." World Bank Policy Research Working Paper 6382, 2013.	Moderate
de Mel, S., D. McKenzie, and C. Woodruff. "The demand for, and consequences of, formalization among informal firms in Sri Lanka." *American Economic Journal: Applied Economics*, vol. 5(2) (2013), 122–150.	Moderate
"Doing Business 2016: Measuring Regulatory Quality and Efficiency." World Bank. DOI: 10.1596/978-1-4648-0667-4. Washington, DC: World Bank, 2016.	High
Dollar, D., M. Hallward-Driemeier, and T. Mengistae. "Investment climate and firm performance in developing economies." *Economic Development and Cultural Change*, vol. 54 (1) (2005), 1–31.	Moderate
Farrell, D. "The Hidden Dangers of the Informal Economy." *McKinsey Quarterly*, vol. 3 (2004), 26–37.	Moderate

Fisman, R., and J. Svensson. "Are Corruption and Taxation Really Harmful to Growth? Firm-Level Evidence." *Journal of Development Economics*, vol. 83 (1) (2007), 63–75.	Moderate
"From Laws to Loans: Opportunities and Challenges in Achieving the Promise of Secured Lending Reforms," USAID, 2018.	Moderate
"Global Financial Development Report 2014: Financial Inclusion." World Bank. DOI:10.1596/978-0-8213-9985-9. Washington, DC: World Bank, 2014.	High
Grimm, M., and A.L. Paffhausen. "Do Interventions Targeted at Micro-Entrepreneurs and Small and Medium-Sized Firms Create Jobs?" Discussion Paper No. 8191, 2014.	Moderate
Grimm, M., and A.L. Paffhausen. "Interventions for employment creation in micro, small and medium-sized enterprises in low-and middle-income countries: A Systematic Review." The Campbell Collaboration, 2013.	Moderate
Lelarge, C., D. Sraer, and D. Thesmar. "Entrepreneurship and Credit Constraints: Evidence from a French Loan Guarantee Program." *International Differences in Entrepreneurship*. University of Chicago Press, 2010, 243–273.	Moderate
Levy, D.L. "Political Contestation in Global Production Networks." *Academy of Management Review*, vol 33 (2008), 943–963.	Moderate
Loening, J., B. Rijkers, and M. Soderbom. "A rural-urban comparison of manufacturing enterprise performance in Ethiopia." *World Development*, vol. 38 (9) (2010), 1278–1296.	Moderate
Lopez-Acevedo, G., and H.W. Tan. "Impact Evaluation of Small and Medium Enterprise Programs in Latin America and the Caribbean." World Bank, 2011.	High
Maloney, W.F. "Informality Revisited." *World Development*, vol 32 (7) (2004), 1159–1178.	Low
Mano, Y., A. Iddrisu, Y. Yoshino, and T. Sonobe. "How can micro and small enterprises in Sub-Saharan Africa become more productive? The impacts of experimental basic managerial training." *World Development*, vol. 40(3) (2012), 458–468.	Moderate
McKenzie, D., and C. Woodruff. "What Are We Learning from Business Training and Entrepreneurship Evaluations around the Developing World?" World Bank Research Observer, 2014.	Moderate
McKenzie, D., and C. Woodruff. "Business Practices in Small Firms in Developing Countries." *Management Science*, vol. 63 (9) (2015), 2967–2981	Moderate
McKenzie, D., and Y.S. Sakho. "Does it pay firms to register for taxes? The impact of formality on firm profitability." *Journal of Development Economics*, vol. 91 (2010), 15–24.	High
Minniti, M., and W. Naudé. "What do we know about the patterns and determinants of female entrepreneurship across countries?" *The European Journal of Development Research*, vol. 22 (2) (2010), 1–12.	Moderate

Piza, C., T. Cravo, L. Taylor, L. Gonzalez, I. Musse, I. Furatdo, A.C. Seirra, and S. Abdelnour. "Protocol for a Systematic Review: The Impacts of Business Support Services for Small and Medium Enterprises on Firm Performance in Low- and Middle-Income Countries: A Systematic Review." The Campbell Collaboration, 2013.	High
Rand, N., and N. Torm. "The Benefits of Formalization: Evidence from Vietnamese Manufacturing SMEs." *World Development*, vol. 40 (5) (2012), 983–998.	Moderate
"Small and Medium Enterprise Program, Five Years in Review: 2011–2016." Innovations for Poverty Action, 2017.	Moderate
Tamvada, P. "Entrepreneurship and Welfare." *Small Business Economics*, vol. 34 (1) (2010), 65–79.	Moderate
Tan, H. "Evaluating SME support programs in Chile using panel firm data." World Bank Policy Research Working Paper 5082. Washington, DC: World Bank, 2009.	High
Woodruff, C. "Addressing constraints to small and growing businesses." Aspen Network of Development Entrepreneurs (ANDE) and International Growth Centre (IGC). London School of Economics Working Paper, 2018.	Moderate