PART II

Chapter 7

The private sector and the catalytic role of micro, small and medium-sized enterprises

by

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Micro-, small and medium-sized enterprises (MSMEs) often employ, and provide goods and services to, vulnerable and underserved segments of the population. In this capacity, MSMEs play a pivotal role in promoting inclusive growth and helping to achieve the Sustainable Development Goals in a way that leaves no one behind. This chapter provides an overview of opportunities and challenges in unleashing the potential of MSMEs to benefit the poor, and explains how development co-operation can help including through blended finance. It describes the variety of constraints facing MSMEs, such as barriers in accessing finance and lack of capacity, which hinder their abilities to act as drivers of inclusive growth. The chapter also highlights challenges in current development co-operation practices regarding MSMEs, and concludes with a set of questions for development partners seeking to have effective private sector engagement.
Private sector

KEY MESSAGES

Micro-, small- and medium-sized enterprises (MSMEs) are key players in local economies, often providing jobs for the poorest in society and much-needed services like education and healthcare in underserved areas.

Small companies face many challenges that prevent them from living up to their full potential such as lack of access to affordable loans.

Development co-operation engagement with the private sector can help connect MSMEs to investors, build capacity, and support genuine partnerships and inclusive dialogue forums.

To ensure accountable and transparent support, the development community could agree on guidelines for effective private sector engagement, especially for those activities supporting MSMEs and micro-entrepreneurs.
Micro-, small and medium-sized enterprises create jobs and provide solutions for the poor

Micro-, small and medium-sized enterprises\(^2\) generate up to 90% of formal employment in some low-income countries (Alibhai, Bell and Conner, 2017\[^1\]). Their significant economic contribution is also evident in figures on aggregate production: MSMEs account for more than 35% of GDP in many developing countries (Alibhai, Bell and Conner, 2017\[^1\]). Micro-, small and medium-sized enterprises have created many business and product innovations in recent decades. This is because MSMEs tend to work outside of prevailing paradigms, and are not firmly attached to existing technologies and products (Lundström, 2009\[^2\]). In developing countries, especially in Africa where economic transformation is geared toward creating new labour-intensive industries, the employment capacity and entrepreneurial spirit of MSMEs provides great potential for positive change.

MSMEs are the primary income provider for people at the “base of the pyramid”: the largest, but poorest socio-economic group. In this way, MSMEs are a key contributor in the drive to leave no one behind. According to the United Nations, MSMEs tend to employ a significant proportion of vulnerable people in the global workforce, such as women, youth and marginalised populations.\(^3\)

The International Labour Organization reported that in developing countries, one-third of all micro-enterprises empower women either through self-employment or as workers (ILO, 2015\[^3\]). In Africa, where the informal sector accounts for up to 80% of the labour force in some countries, similar trends exist for smallholder and subsistence farmers living under extreme poverty (AfDB, 2016\[^4\]).

In rural and underserved locations, smaller companies can sometimes be the only source of employment. This is particularly important for young people living in rural areas. The demographic trend is towards high youth unemployment and migration into cities. Small youth enterprises are therefore expected to play an even more significant role in providing job opportunities for young people in their local communities in the future (OECD Development Centre, 2017\[^5\]).

As well as providing jobs, MSMEs contribute significantly towards economic and social well-being through the delivery of services in areas such as health, sanitation, energy or education. This is especially important in regions with limited reach by the public sector. For example, in many remote regions of Africa and Asia, low-cost private schools, or educational MSMEs, remain a key means of providing necessary educational services. These schools aim to improve student performance while minimising costs per student. In some cases, MSMEs also help bridge the gap left by insufficient provision of services such as healthcare and clean energy.\(^4\)

Micro-, small and medium-sized enterprises hit a glass ceiling in a risk-averse lending environment

The operating environment is harsh for many MSMEs, in particular micro-enterprises with fewer than nine employees. Various constraints make it difficult for MSMEs to contribute fully to economic and social well-being. This is reflected in low survival rates of MSMEs, especially micro- and small enterprises (WTO, 2016\[^6\]).

Many micro-enterprises come into life as start-ups that support self-employment, often driven by a lack of other employment opportunities, including among women and youth (AfDB/OECD/UNDP, 2017\[^7\]). In many cases, the incentives offered to such micro-entrepreneurs to keep operating in the informal sector are outweighed by the prospect of a considerable tax and regulatory burden.

Access to affordable finance is a major challenge for MSMEs. This is especially the case in least developed countries, where about 35% of firms identify difficulties in accessing finance as a major constraint; this compares to 24% in the rest of the developing world.\(^5\) A particular problem in these least developed countries is the lack of working capital or long-term financing available for MSMEs (UNCDF, 2018\[^8\]), with domestic banks and other investors perceiving financing risks as too high for the returns
on offer. In these countries, businesses are also constrained by skill gaps (UN, 2018[9]), which may make lenders reluctant to provide funding.

The global credit gap for both formal and informal MSMEs is high, amounting to around USD 2.1 trillion to USD 2.6 trillion (IFC, 2013[10]). As high-risk borrowers, individual MSMEs face credit costs that are often unaffordable. The prudential regulations imposed on commercial banks in the aftermath of the 2008 global financial crisis have compounded these problems by making lending conditions to MSMEs even more stringent.

Credit through local banks is a vital source of support for the private sector but it is usually collateralised (Blue Orchard, 2017[11]). This is especially a problem for the smallest companies, which lack the financial and physical assets that can be pledged as collateral. For micro-enterprises, smallholders and start-ups, obtaining credit from formal creditor institutions in the long run therefore remains a challenge. Instead, these small entrepreneurs often rely on informal sources of external finance such as payday loans and borrowing from moneylenders and pawnbrokers. These sources generally carry unfavourable loan terms resulting in high levels of debt rollover.6,7

Legal and regulatory frameworks may discriminate against disadvantaged people who are employed by or run MSMEs, such as youth and women. For example, in many countries, women do not have equal rights when it comes to operating a business: they may not be able to own property or obtain employment without their husband’s permission (World Bank, 2013[12]). Several country-level surveys also quote unfavourable legal and regulatory frameworks as a major impediment for young people aspiring to become entrepreneurs (OECD Development Centre, 2017[5]).

Micro-, small and medium-sized enterprises, especially those in rural areas, rarely participate in global value chains and struggle to sustain their businesses (OECD, 2018[13]) (Chapter 3). The most typical route whereby smaller companies can enter global value chains – the sale of goods and services to larger firms and multinational companies – is fraught with risk. It can make these companies susceptible to fluctuations in commodity prices, which in turn influences the cost of goods and services they offer, makes it difficult to set prices, and, as a result, jeopardises their long-term profitability.

In some cases, MSMEs can participate in global value chains in a way that facilitates positive spill-overs or transfer of technical and managerial expertise. Although there are some positive examples of MSMEs working with large and even multinational companies to create sustainable value chains,8 the scale of this kind of integration remains limited.9 In its approach to due diligence, the OECD recommends that companies include MSMEs in global value chains in a way that ensures a comprehensive coverage of risks relating to labour, human rights, environment and anti-corruption (see also the case study on Responsible business conduct by the OECD).10

Other challenges for MSMEs in today’s business climate are more typical constraints. These include a lack of stable market conditions and limited access to skilled labour, business support services and a coherent legal and policy framework, especially one targeted to the needs of small and micro-enterprises.

Co-operatives and social enterprises can help small businesses overcome barriers

Co-operatives and social enterprises, which are MSMEs in themselves, are gaining prominence as players that can help MSMEs overcome the constraints outlined above. Combined with their inclination to address development challenges, this makes co-operatives and social enterprises critical partners in accelerating progress on the Sustainable Development Goals (SDGs). To give a country-level example, in Egypt, 4 million farmers sell their products through agricultural marketing co-operatives (ILO and ICA, 2014[14]).

Credit unions are one form of co-operative that are able to reach out to informal MSMEs. Compared to conventional banks, credit unions can offer flexibility on their lending terms, particularly in relation to collateral. At the same time, co-operatives and social enterprises can help shape an enabling policy
environment, with favourable conditions for MSME operations. In so doing, they can help support financial inclusion, provide access to markets and foster technical innovation.

Co-operatives and social enterprises also have direct impacts for small businesses through the way they operate (and mitigate risks) as powerful partners, suppliers or buyers, and as providers of targeted and affordable services for small-scale entrepreneurs (Box 7.1). As such, co-operatives and social enterprises empower local communities and underserved regions through delivering services such as healthcare, sanitation and education, while often employing local people at the margins of the labour market (Kamal-Chaoui, 2017[15]). They also provide a democratic space for many people who are in danger of being left behind. For example, in India, Mali, Sri Lanka and the United Republic of Tanzania women have formed their own co-operatives, contributing to women’s empowerment and social inclusion (ILO and ICA, 2014[14]).

Development co-operation can help micro-, small and medium-sized enterprises to reach their full potential

Over recent years, both Northern and Southern providers of development co-operation have been investing in public-private collaboration – broadly referred to as private sector engagement. The aim is to encourage the private sector to get involved in development-related activities in which it might not otherwise operate.

**Box 7.1. Micro-, small and medium-sized enterprises reaching the furthest behind: The case of social enterprises**

M-KOPA is a Kenyan company that provides “pay-as-you-go” solar energy to clients who do not otherwise have access to an energy supply (OECD, 2016[16]). In doing so, it fulfils its mission to make solar products affordable to low-income households. Since October 2012, the company has connected more than 600 000 homes in Kenya, the United Republic of Tanzania and Uganda to solar power; it is now adding more than 500 new homes to its supply each day (M-KOPA, 2018[17]).

Clinicas del Azucar operates in the healthcare sector of Mexico to address the specific needs of patients diagnosed with diabetes (Clinicas del Azucar, 2018[18]). Using rigorous processes and technological developments, the company has been able to make diabetes care available at a low cost. More than 12 million people in Mexico are diagnosed with diabetes, and the low-cost clinics have reduced annual costs for diabetes care by 70%.

The LangLang Learning Potential Development Centre in the People’s Republic of China provides professional training and support to children with dyslexia, a learning disability which affects approximately 10% of Chinese children (LangLang, 2018[19]). The centre developed a new education methodology for the treatment of dyslexia – drug-free multi-sensory mental gymnastics. This has yielded positive results for students – reducing reading and writing barriers, as well as boosting self-confidence and self-expression. The centre’s programmes have also helped develop parents’ and teachers’ understanding of dyslexia and have raised public awareness of the condition.


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**Blended finance can fuel development investments**

Since the 2030 Agenda and the Addis Ababa Action Agenda were agreed in 2015, mobilising private finance for development co-operation has received much attention from the international community. Between 2012 and 2015, blended finance unlocked at least USD 81 billion from the private sector. Compared to the estimated annual SDG investment gap of USD 2.5 trillion, this amount is small, but growing.

The OECD-DAC Blended Finance Principles, later also endorsed by the G7, address, among other things, the need to leave no one behind (OECD DAC, 2018[21]). They advocate that blended finance should
be anchored in development and tailored to the local context and that this should be achieved through aligning with national development agendas and strengthening local finance capacity.

Attempts to assess whether blended finance is living up to these principles are limited: it is very difficult to access data concerning the end user population of this additional finance mobilised through private sector engagement. What is clear is that blended finance is mainly used in economic sectors, such as infrastructure and banking (Benn, Sangaré and Hos, 2017[22]) (OECD, 2018c[23]).

Blended finance can provide much-needed credit to MSMEs, typically by providing debt financing, guarantees or opening credit lines to financial intermediaries active in the local market. With the growth of pooled funds and facilities, the private sector can now invest directly in MSMEs, thereby allowing a more venture capital type of approach. Funds and facilities are increasingly targeting specific regions, sectors and populations, such as women entrepreneurs.

**Blended finance does not tend to benefit least developed countries**

Only USD 5.5 billion (7%) of blended finance has been mobilised for the least developed countries (Figure 7.1). This may be because projects in these countries can be very costly to run, while their financing needs are relatively small to start with. MSMEs in least developed countries typically need credit ranging from USD 50 000 to USD 1 million, what is often referred to as the “missing middle”. Local banks often find such projects too risky and too expensive to support – or have investment options offering better returns. Evidence also shows that development finance institutions do not directly support projects of this magnitude, often because of the transaction costs involved, although they may use instruments such as credit lines and guarantees to encourage onward lending to MSMEs.13 This leaves a wide financing gap for MSMEs and calls for more technical assistance and support for project preparation, as well as for a better understanding of the role blended finance can play in helping to fill these gaps (UNCDF, 2018[8]).

**Private sector engagement through development co-operation must be more effective**

Public resources are increasingly geared towards engaging the private sector in formulating ways to reach the SDGs. At the same time, the private sector is increasingly expected to produce evidence on how its involvement benefits society and sustainable development, thereby offering greater transparency, accountability and a more explicit results focus (OECD, 2018[24]).

The Global Partnership for Effective Development Co-operation is helping to address this challenge. Since 2017, it has collected data on development co-operation projects and partnerships with the private sector. These data are guiding the identification of key areas for future development (Box 7.2) and are helping to inform a global policy debate on how to use public resources to more effectively engage the private sector in the implementation of the SDGs.

Development co-operation benefiting MSMEs has to consider diverse, often untested impacts and should therefore be carefully deployed. Any support bears the risk of distorting local markets, leading to unintended consequences, such as unfair competition. Project leaders should therefore think about identifying shared and measurable results at the very beginning of the project-planning phase. They should also consider appropriate results frameworks and measurement methodologies.

There is a growing body of research looking at the impacts that private sector engagement through development co-operation is having on MSMEs in the developing world. This research considers how the private sector can help to eradicate poverty, reduce inequality and promote sustainable development by investing in MSMEs. Some emerging, context-specific recommendations include:

- **Support should help connect small and micro-enterprises to investors.** MSMEs, by definition, are not a homogenous group of firms. Policy interventions by international financial institutions on improving access to finance for MSMEs often favour larger over smaller businesses. This signals a lack of risk-taking among development partners with regard to smaller firms or an outsourcing of the risk to on-lenders. To fill this gap, specialised not-for-profit organisations and business associations could provide an interface for micro-enterprises to connect with investors.
The private sector can help build the capacity of small and micro-enterprises. Private investors, such as social impact investors, can provide not only much-needed financial support but also technical support. In particular, social impact investors can help MSMEs grow and bring their businesses to scale (OECD, 2015[25]).

Private investors and MSMEs should engage in genuine partnerships. Given their size and needs, MSMEs are primarily recipients rather than providers of private sector support. So engaging MSMEs from the outset of a project is vital. In this way, they can become true partners, bringing a genuine contribution to the table: for example, expertise in identifying local economic and social challenges.

MSMEs should be represented in dialogue forums. While business operations are their main focus, MSMEs should also consider taking steps to influence the policy environment within which they operate. One way of doing this is to engage in public-private dialogue forums. Actively engaging individuals that represent those left furthest behind in decision-making processes can help create currently absent policies that target the most marginalised, the poor and underserved regions.

Figure 7.1. Amounts mobilised from the private sector by country grouping, 2012-15

<table>
<thead>
<tr>
<th>Country Grouping</th>
<th>Amount (Billion USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Upper middle-income</td>
<td>11.3</td>
</tr>
<tr>
<td>Lower middle-income</td>
<td>5.5</td>
</tr>
<tr>
<td>Least developed country</td>
<td>2.2</td>
</tr>
<tr>
<td>Other low-income</td>
<td>27.4</td>
</tr>
<tr>
<td>Unallocated</td>
<td>34.6</td>
</tr>
</tbody>
</table>

Source: (Benn, Sangaré and Hos, 2017[22]) “Amounts mobilised from the private sector by official development finance interventions”, https://dx.doi.org/10.1787/81356a8de-en.

Box 7.2. Making development co-operation work for micro-, small and medium-sized enterprises: Country case studies

Stakeholder feedback and country studies indicate that effective private sector engagement through development co-operation relies on at least three conditions: 1) harnessing the comparative advantages of the development co-operation community to engage the private sector; 2) making private sector engagement work in programmes at the country level; and 3) achieving sustainable results, impact and accountability with projects that involve private sector engagement.

This initial assessment stems from a mapping of 919 projects involving private sector engagement and a series of interviews in 4 case study countries (Bangladesh, Egypt, El Salvador and Uganda). While the findings are illustrative, the exercise also offers new insights into how development partners can support micro-, small and medium-sized enterprises (MSMEs): from the 42% (or 385 projects) of the sample that involved MSMEs, only a handful of projects involving private sector engagement explicitly benefited underserved regions, marginalised populations and social sectors. Other projects may have provided such benefits, but in a more indirect way. This suggests that development partners need to consider how to target their private sector engagement to MSMEs so that benefits reach those left furthest behind. In addition, few of the mapped projects had the frameworks necessary to monitor results and to assess whether activities helped to ensure that no one is left behind.
Are we asking the right questions?

As engagement with the private sector grows, development co-operation will continue to play a myriad of vital support functions – from promoting an enabling environment and responsible business conduct to developing and financing the private sector and building capacity and partnerships. In the long run, the litmus test for development co-operation in private sector engagement will be whether it can help companies with a real “SDG-business case” to address social and environmental challenges while still making a profit.

Many small social businesses are embracing this shift, and are leading the way towards inclusive growth that genuinely shares value between business profit and development impact. It is imperative to identify such champions and better understand their ambitions, needs and concerns – learning from them and putting them in the centre of development discourse. The discourse needs to move beyond dealing with the private sector simply as financiers (investors) or beneficiaries (especially the MSMEs on the receiving end), and instead should see enterprises as leaders and partners. This will be the first step towards creating a convincing, collective narrative on effective partnering for sustainable development.

Reaching those left behind through private sector engagement requires clear principles and guidelines

In this context, the development community would benefit from agreed guidelines that underpin the effective delivery of private sector engagement, especially those activities geared towards supporting MSMEs and, within this bracket, micro-entrepreneurs. Through such guidelines, development partners could address more systematically questions such as: How can we build an approach for targeting disadvantaged groups in the allocation decisions of our programmes for private sector engagement? What data are needed to inform such decisions? How can we better respond to the needs of MSMEs and focus on practical solutions that lead to a better policy environment, greater empowerment of MSMEs and, ultimately, more decent jobs and better services for the poor? How can we raise awareness of opportunities for private sector engagement that benefit those left furthest behind, and identify and match-make with MSMEs at the country level? How can this be co-ordinated with the partner country governments?

Box 7.2. Making development co-operation work for micro-, small and medium-sized enterprises: Country case studies (cont.)

The findings also signal that local knowledge held by MSMEs is critical for creating decent work opportunities and good quality services for the poor. But MSMEs’ engagement in systematic policy exchanges is limited. This seems to be because MSMEs are more concerned with accessing affordable finance and know-how. MSMEs are also wary about dealing with cumbersome donor procedures and receive insufficient information on the opportunities of private sector engagement. Overall, this means that the knowledge and experiences of MSMEs are, in many cases, overlooked.

The four country studies point to good examples of social impact investment, social entrepreneurs and funding mechanisms. These examples include a provision for higher risk taking by development partners in order to create incentives for private sector investment and partnerships to support MSMEs. These examples therefore target underserved communities and the people left furthest behind.

Further analysis and policy debate on how to improve private sector engagement for MSMEs can help to ensure they effectively contribute to the drive to leave no one behind. It can also enable MSMEs to respond to sometimes polarising views on private sector engagement through development co-operation among partner country governments, civil society and some development partners.

The OECD spearheads analysis and policy dialogue to help address these questions and provide answers on how the diverse private sector can best contribute to the 2030 Agenda and the Paris Agreement in policy areas such as responsible business conduct. The OECD’s work on the role of development co-operation is particularly important in this regard. The OECD Development Co-operation Directorate is working on measuring the impact of blended finance pulling together the experience of social impact investing. And, under the aegis of the Global Partnership for Effective Development Co-operation, it works with governments, the private sector and civil society in order to agree on principles and guidelines for effective private sector engagement through development co-operation.\textsuperscript{14}

In creating clear principles and guidelines for private sector engagement in development co-operation, it is critical to bring together business and development leaders to discuss effective private finance for sustainable development. Diverse forums to discuss the private sector’s contribution to the SDGs already exist, but often stop short of discussing the practical details involved in effectively partnering to reach those left furthest behind. To make private finance work for sustainable development, engaging MSMEs in this context is particularly important, as is creating opportunities for Northern and Southern bilateral and multilateral partners to discuss issues amongst themselves, and with partner country governments, the private sector and civil society. Fruitful dialogue in this regard requires a shared agenda, a common objective and simple language, understandable to all.

**Notes**

1. The authors wish to thank Paul Horrocks, Karen Wilson, Wiebke Bartz and Irene Basile of the OECD Development Co-operation Directorate for their contributions to this chapter.

2. MSMEs are non-subsidiary, independent firms that employ less than a given number of employees – the number varies across countries. The most frequent upper limit designating a MSME is 250 employees. Small firms are generally those with fewer than 50 employees and micro-enterprises have at most 10, or in some cases 5, workers. For a more detailed definition of MSMEs, see: https://stats.oecd.org/glossary/detail.asp?ID=3123.


4. A mapping of development partners’ investments in health sector companies in Bangladesh, many of them MSMEs, shows that they focus on: supporting services for poor and underserved areas, such as slums; social marketing to raise awareness and improve access to services; technology transfer to improve services; and developing health networks or franchises (GPEDC, 2018\textsuperscript{26}).

5. Enterprise Surveys of the World Bank (www.enterprisesurveys.org), as noted in (UN, 2018\textsuperscript{28}).

6. Beck, Lin and Ma (2014\textsuperscript{29}) show that access to formal financing proxied by financial outreach is a main driver of transition from informal to formal activities worldwide.

7. For a specific example from Malawi on informal loan contracts, see (Bolnick, 1992\textsuperscript{30}).

8. For an example from Egypt, see: http://schools.aucegypt.edu/Business/ABR/Pages/Odd-Couple-Or-Perfect-Match.aspx.

9. No global figures are available, but there are regional efforts to understand challenges and policy actions. See, for example, (ADB, 2015\textsuperscript{27}).


11. Private sector engagement is defined as: “An activity that aims to engage the private sector for development results, which involve the active participation of the private sector.” See: http://www.oecd.org/dac/peer-reviews/Inventory-1-Private-Sector-Engagement-Terminology-and-Typology.pdf.

12. The OECD defines blended finance as the strategic use of development finance for the mobilisation of additional finance towards sustainable development in developing countries, where additional finance should primarily be commercial finance (OECD, 2018c). Blended finance has the potential to significantly scale up resources for development by crowding in additional commercial finance that is not currently deployed to support development outcomes.

13. See guest piece by Malena Rosman: “The power of guarantees in mobilising private finance” (UNCDF, 2018\textsuperscript{8}).

References


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